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Bank Valuation: A Focus on Earnings Quality

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Investors have often viewed banks as less volatile than non-financial companies due to several factors including: a high level of regulatory oversight, less variance in earnings from period to period, and favorable dividends. However, investors' traditional perception of the volatility of financial institutions may no longer be true in the current environment. The banking industry has been a casualty of the turmoil in the broader debt markets brought on by the unwinding of the housing bubble, which accelerated in mid-May 2007. Bank stocks, as reflected in the total return for the SNL Bank Index, were down 31.3% from January 1, 2007 to February 29, 2008 compared to a decrease of 6.07% for the S&P 500.

The most significant factor weighing on bank stocks' performance in recent months has been credit quality. According to a review by the *American Banker* of third-quarter 2007 financial statements for 16 of the nation's largest banks, "rising loan delinquencies and their attendant costs constitute the most immediate threat to earnings." Smaller, privately-held banks have not been immune to this difficult operating environment either, as concerns regarding other lending areas that many smaller banks are dependent upon such as construction and development lending have also developed. Due to increasing levels of impaired loans and concerns regarding other loans that may become but are not yet impaired, many banks have experienced earnings pressure in recent quarters and anticipate the difficult operating environment to continue in the near-term.

The Federal Deposit Insurance Corporation's Quarterly Banking Profile for the Fourth Quarter of 2007, which provides a review of public and private banks, noted increased loan loss provisions (particularly at larger institutions), increased charge-offs, and a faster pace of reserve growth, although the increases in the reserves failed to outpace growth in non-current assets for the same period.

Given the earnings challenges facing numerous banks and the declining valuations of publicly traded banks during 2007, it is important to know how to analyze a bank's earnings quality as a precursor to understanding its earning power. In this article, we will examine the philosophy of earnings quality analysis and overarching earnings quality issues and focus on an analysis of the adequacy of the loan loss reserve, which is one critical earnings quality issue facing banks in the current environment. We will also provide some general recommendations of how to construct a reasonable estimate of earning power after assessing earnings quality.

Philosophy of Earnings Quality Analysis for Banks

Valuation is, by its nature, forward looking. Value is a function of future cash flows, not historical cash flows. However, historical cash flows can help predict (or confirm other estimates of) future cash flows as any prediction of the future depends on the quality of the inputs. Analyzing the quality of historical earnings and making appropriate adjustments thereto can aid in making better predictions of future earnings.

Adjusting earnings is a relative concept, and the analyst should view potential adjustments in relation to the subject bank's history, the market for publicly traded banks, and the banking industry in general. Adjustments appropriate for one bank may not be applicable to another. However, it is always important to keep in mind that items deemed unusual, non-recurring, and/or discretionary do create and destroy shareholder value.

Non-recurring items flow through the equity account just like recurring revenue and expense. The gain or loss to shareholders from the non-recurring items can be measured as the amount that the bank can use (if there is a gain) or could have used (if there is a loss) to pay dividends, repurchase stock, make an acquisition, or grow the balance sheet.

Additionally, it is important to remember the interaction between earnings quality analysis and risk assessment when valuing banks. Short term earnings can be enhanced by taking more risk (of the credit or interest rate variety), and the impact of accepting an inappropriate level of risk is usually not immediately evident in a bank. However, earning power can be viewed as a long-term concept and not necessarily a prediction of next quarter's earnings.

Bank financial analysis is different from other industries in that the balance sheet drives its income statement. Thus, the key to a solid analysis of the earnings quality of a bank begins with a thorough review of the subject bank's balance sheet. While a detailed discussion of all the elements to focus on when reviewing the balance sheet is beyond the scope of this article, we have focused on one issue of current importance, the loan loss reserve.

Focus on Adequacy of the Loan Loss Reserve

With credit concerns currently looming as one of the most pressing earnings issue for numerous banks, a determination of the adequacy of the loan loss reserve, which can serve to either mitigate or heighten these credit concerns, is vitally important. When analyzing asset quality, it is important to focus on two components of the financial statements: the loan loss provision (an income statement component) and the loan loss reserve (a balance sheet component). Analysts should ask the following questions regarding these accounts:

- Does the current period loan loss provision reflect a normalized provision?
- Is the loan loss reserve adequately funded?

Loan Loss Provision. When examining the loan loss provision, the analyst should attempt to determine whether the current period's loan loss provision reflects a normalized provision. The analyst should look at, for instance, trends in the ratio of the loan loss provision to loan charge-offs. Other than for short periods, loan charge-offs cannot exceed the loan loss provision, and charge-offs in excess of the provision are generally a sign of lower quality earnings. The loan loss provision can also be analyzed by examining trends in the composition of the bank's loan portfolio and the risk of the portfolio. For example, an increase in consumer loans, which tend to generate higher losses, may require a higher loan loss provision going forward.

Loan Loss Reserve. The loan loss reserve represents an amount necessary to cover the losses inherent in the loan portfolio. Under the current accounting methodology, the loan loss reserve contains the following components:

- Specific reserves against identified impaired loans (per Statement of Financial Accounting Standards No. 114); and,
- Reserves for non-impaired loans (per SFAS 5) based on the bank's prior charge-off history, adjusted for "environmental" factors that could cause future losses to diverge from recent history (e.g., changes in portfolio delinquencies, local economic conditions, loan concentrations, etc.).

Several factors can be used to analyze the bank's loan loss reserve:

- *Loan Loss Reserve / Loan Ratio.* A declining ratio suggests that the bank's loan loss provision is either not keeping up with loan growth or that current period loan charge-offs are more than the loan loss provision. Future income could be affected as provisions are recorded to increase the loan loss reserve / loan ratio.
- *Loan Loss Reserve / Non-Performing Loans Ratio.* Non-performing loans are usually defined as the sum of loans for which interest accrual has ceased and loans that are 90 days or more past due that are still accruing interest. An increasing level of non-performing assets suggests that credit risk in the portfolio may be increasing, while a lower ratio of reserves to non-performing loans may indicate that future increases in loan loss reserves (and provision) could occur.
- *Composition of the Loan Portfolio.* It is important to analyze the diversity of the bank's loan portfolio, both in terms of type of borrower and type of loan product. Potentially, a more concentrated loan portfolio in terms of both borrower and/or loan type is indicative of perhaps higher risk. It is important to remember though that each bank is unique and this diversification should be considered in light of other factors as well. For example, community banks often have less diversification in terms of types of loans and borrowers and are generally tied to the economic health of the local market served by the bank. This factor may be mitigated to some extent by a strong management team's understanding of the their local market and the unique risk present better than their larger, more diversified counterparts who may have extended into unfamiliar product lines and/or markets.
- *Other Factors.* These factors include, for example, the analyst's impression of management, the bank's primary market area, types and quality of collateral, and the type of loans emphasized by the bank.

How does the earnings quality analysis affect your valuation analysis?

After the analyst's assessment of the overall quality of the bank's earnings, the analyst must then consider how this assessment affects the valuation analysis. We will briefly describe four ways to handle this assessment in the valuation analysis either individually or in some combination with each other.

1. **Adjust the historical financial data.** Once the analyst has assessed the bank's earnings quality, the analyst may identify adjustments to apply to the Bank's historical earnings. By adjusting historical earnings, the analyst seeks to derive a better depiction of the bank's underlying earning capacity from which future growth may occur.
2. **Estimate earning power via a normalized return on assets ("ROA") or return on equity ("ROE"), which are common measures of profitability in the banking industry.** In some cases, a bank's earnings may have so much "noise" that determining specific adjustments is difficult. In this instance, it may be beneficial to use historical returns to estimate earning power. For example, the analyst might take an average of the bank's ROA and ROE measures for a five year period prior to the current year and apply this normalized ROA and ROE measure to the bank's assets or equity in the current period. An important assumption in this approach is that the bank's historical returns are reasonably indicative of its future returns.
3. **Carve out part of the business and value separately.** This type of analysis may be helpful when a significant component of the bank has a different risk/return profile than other parts of the bank. For example, consider a bank with a substantial mortgage subsidiary. Mortgage companies tend to have more volatile earnings than commercial banks, and publicly traded mortgage banks are often valued differently in the market than commercial banks. Rather than attempting to "smooth out" the volatility of a bank's mortgage company, the mortgage company could be valued separately and added to the value of the other parts of the bank.

Once earning power has been specified using one of the preceding approaches, the analyst can proceed with valuation analyses commonly used in appraisals of financial institutions, such as a guideline public company analysis, guideline change of control transaction analysis, or discounted cash flow analysis.

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