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The Bank Vault

FEBRUARY 2023

Asset Quality Primer: Are Banks Better Positioned for the Next Credit Cycle? What Is Already Priced in?

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Contents

1

Executive Summary

Executive Summary

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With much discussion in the market on whether the economy will experience a soft or hard landing in 2023 and beyond, we thought a credit primer might be timely as investors prepare for whatever the economy may throw at it in 2023. Although balance sheet growth, net interest margins, and expenses are always popular topics of conversation and can have varying degrees of impact on any given quarter, credit is the real killer for the banking industry and typically a key differentiator in how bank stocks are valued over time and through a cycle. We are not making a call on the economy in this piece, nor singling out banks that may or may not experience more credit issues than others, but rather offering a bit of a reference piece as we brace for another potential credit cycle.

Key Takeaways

- Over the last 5-10 years, bank stocks have traded at a median multiple of 12x-13x,.but currently banks find themselves trading at a 3x-4x multiple discount to the average despite producing near record profitability metrics. Our sense is that the discount is a function of hesitancy among investors wanting to pay a historic market multiple for what might be considered peak earnings as net interest margins have likely peaked and loan growth is showing signs of slowing.
- Moreover, banks have operated for more than a decade in a near zero credit cost environment following the Great Financial Crisis. At some point, credit costs will likely normalize, but predicting the timing and magnitude is always a challenge. Many investors like to point to the last cycle's biggest credit losers as the likely losers again. However, the last cycle is more than 10 years in the past, thus we think simply targeting past cycle credit losers is difficult given the significant changes many of these companies have undergone and the significant stress testing that has occurred since the GFC. Moreover, the list of top 100 banks in the U.S. have more than 55 new names on the list relative to year end 2006 meaning that these names were at most minimal participants if not beneficiaries from the fallout of the last cycle.
- As a result, we would rather focus on a bank's ability to weather whatever storm the economy may throw its way in 2023 and beyond as this cycle's credit losers are likely to be totally different, while at this point there is not a single asset class that stands out yet that should be targeted. Consumer, including credit card, buy now, pay later, and auto, continue to be areas of focus, while office is also receiving a fair amount of attention. Lending standards have tightened across the board, which resulted in a meaningful rise in NPAs and charge-offs last cycle.
- Only time will tell how severe the next cycle will be, but we hope that the banks are better prepared this cycle considering what is seemingly fair warning for the upcoming recession, the impact of stress testing, CECL, and lessons learned from the Great Financial crisis.

Call to Action: Portfolio Manager's Summary

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The perfect or ideal bank stock does not currently exist in our view given the aforementioned headwinds to net interest margins, loan growth, and expenses, while it is unlikely that credit costs remain at essentially zero. In our view catalysts for earnings are minimal, while the best path for bank outperformance in 2023 is likely tied to multiple expansion due to the clearing of credit clouds. Bank stocks are cheap by historic standards and we would advise those more bullish on a soft landing to be buyers, while a harder landing for the economy would not be good for the stocks in the sector. That said, we do think the industry is better positioned this time around, and there will be banks that fare better than others this cycle. We cover nearly 240 bank stocks at Piper Sandler, thus distilling our coverage into a handful of best ideas is always a challenge. For purposes of this report, we are highlighting three of our favorite Overweight-rated large cap names that our analysts believe should fare better in whatever the economy may bring in 2023 and beyond.

Focus Stocks

- **JPMorgan Chase & Co. (JPM – Scott Siefers):** Among the universal banks, we view JPM as having the most defensible outlook with which to contend with a toughening revenue picture. Just as importantly, strong capital & reserves (incl. 13.2% CET1 ratio and a 2% reserve), not to mention its excellent track record through volatile times, position it well for whatever macro weakness may come. JPM is pricey, but we feel it is worth the valuation for the quality/defensibility, and we consider it an excellent port in the storm.

- **U.S. Bancorp (USB – Scott Siefers):** With the market still grappling with the group's likely direction, we view USB as one of the best positioned large regionals to contend with a challenging backdrop. The company's track record, conservative credit culture, and 1.9% reserve lead us to consider it a strong risk play in potentially tougher times. Moreover, we view the revenue stream (specifically, NII) as well-insulated from rate-based volatility, and we like the cost savings opportunity from the recently-closed UB transaction. We therefore see multiple touchpoints of opportunity. Finally, we consider the valuation compelling, with the shares trading at just ~ 9x our 2024E EPS.

- **Truist Financial Corporation (TFC – Stephen Scouten):** While legacy BB&T had a reputation as one of the most stable/conservative/consistent names in the sector due to its mostly community bank model, the jury is still out to a degree on the new Truist due to legacy STI's more wholesale model. However, we remain positive on the relative strength of the combined institution's core deposit base, diversified loan book, revenue mix (~38% fees/rev), and desirable geographic footprint. In addition, TFC continues to show favorably in the CCAR stress tests, helped by exemplary stressed PPNR levels given the stability from its insurance platform, as well as the lowest average loan loss rate in the severely adverse scenario (2013-2021 at 5.2%).

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