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GLOBAL IDEAS

13 December 2012

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US Regional banks: PNC Financial Services—Best exposure to US banks?

US banks, both the investment banks and the regional banks, are trading on cheap P/E and P/book multiples. Further, the US economy seems farthermost down the road of digesting the after-effects of the Great Recession and its banks are the most robust they have been in many decades (in terms of balance sheet strength and capital ratios). These factors highlight the US banks as potentially offering great value. There is, however, an important split between the investment banks and the regional/commercial banks – amongst other things the former seem to be much riskier, the latter are lending much more actively into the recovering US housing market, and investment banking income is slumping – which could see their relative performance diverge materially.

The purpose of this note is to investigate one of the main US regional banks, PNC Financial Services (PNC), to gain a preliminary understanding of this market so that we could make a well-informed choice between the investment and regional banks should we decide to be long US banks. I also hoped to gain a better understanding of the attractiveness of the sector given that P/E's and P/book multiples can be misleading.

PNC's metrics are as follows:

Spot ($)	56.24
Mkt Cap ($mn)	29 743.00
12M fwd P/E	8.6
10 Average P/E	12.4
10 Average DY	2.71
FYE	31-Dec
P/Book Ratio	0.85
12M trailing DY	2.73
12M fwd DY	2.74

Source: Bloomberg, Anchor Capital

Why PNC? It's the biggest regional bank and I still favour larger banks in this environment of higher regulation and lower yields because of economies of scale. It's also the cheapest on a two-year forward P/E.

The following table shows some valuation metrics for the members of the S&P 500 Regional Banks Index (P/E multiples below 10x are highlighted in yellow):

Name	Price ($)	P/E	DY	Mkt cap ($mn)	P/Book	12M fwd P/E	24M fwd P/E	12M fwd DY
BB&T CORP	28.46	10.90	2.81	19 912	1.06	9.94	9.76	2.76
FIRST HORIZON NATIONAL CORP	9.45	13.17	0.42	2 335	1.04	11.67	11.25	0.43
FIFTH THIRD BANCORP	14.53	9.20	2.75	13 040	0.98	9.06	9.15	2.48
HUNTINGTON BANCSHARES INC	6.26	9.48	2.55	5 355	0.99	9.69	9.72	2.56
KEYCORP	8.23	9.35	2.43	7 684	0.77	9.56	9.36	2.21
M & T BANK CORP	97.80	15.00	2.86	12 519	1.37	11.82	11.67	2.86
PNC FINANCIAL SERVICES GROUP	56.24	10.04	2.84	29 743	0.85	8.60	8.49	2.77
REGIONS FINANCIAL CORP	6.76	14.08	0.59	9 552	0.64	8.71	8.68	0.56
SUNTRUST BANKS INC	27.59	8.93	0.73	14 866	0.74	10.45	10.01	0.73
ZIONS BANCORPORATION	20.48	19.32	0.20	3 772	0.79	12.56	11.91	0.20

Source: Bloomberg, Anchor Capital

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For comparative purposes the following table shows the same metrics for the large US investment banks:

Name	Price ($)	P/E	DY	Mkt cap ($mn)	P/Book	12M fwd P/E	24M fwd P/E	12M fwd DY
JPMORGAN CHASE & CO	42.64	8.15	2.81	162 092	0.85	8.23	8.09	2.79
CITIGROUP INC	37.00	9.61	0.11	108 503	0.58	8.16	8.07	0.11
WELLS FARGO & CO	33.29	10.31	2.64	175 248	1.24	9.30	9.16	2.60
BANK OF AMERICA CORP	10.51	17.23	0.38	113 278	0.52	11.30	10.71	0.36

Source: Bloomberg, Anchor Capital

The investment banks are significantly cheaper on these consensus earnings forecasts. Whether this is a reflection of economic reality really depends on what is being forecast for future investment banking earnings (my opinion is that these forecasts are not particularly bullish).

One of the 'big questions' at the moment is whether investment banking businesses are in a structural decline. There are good arguments in both directions. My view is that the 'fluff' has already been eliminated and that the more robust investment banking businesses have a legitimate reason to exist and will continue existing. The big banks are licking some wounds at the moment and I do not think this is the time to turn bearish on them.

There are all sorts of legacy woes being rather painfully digested through bank income statements: interest rates and credit spreads are low, asset markets have been awful, legal frameworks are undergoing massive change, etc. All of this is weighing heavily on earnings. An important question is the durability of this malaise. In my view interest rates will stay low for many years to come which will not assist an earnings rebound.

On the other hand the world's population is growing, some major asset markets are bottoming (US housing) and people are working hard to resolve global imbalances. The macro picture for banks is mixed and I think it is important that we take into account both the very real positives and the very real negatives. Therefore, for example, although it is likely that net interest income will be under pressure in future, many of the banks are restructuring their income statements towards fee income which will mitigate this negative.

The macro case for regional banks

In my view there are four main reasons to consider US regional banks:

- **Their only direct exposure is to the US economy.** This has both positive and negative implications - no direct exposure to Europe (positive, for now) but also no direct exposure to emerging market (EM) growth. Indirectly, they are exposed to both of these themes, but the US is a relatively closed economy, so the indirect exposure is not very large.
- **They are lending into the home mortgage market much more than the big banks.** This is a market to which we should have exposure.
- **Limited high-risk investment banking exposures** (but this is well known and well reflected in prices already. Should we not perhaps take the contrarian view now and buy risky investment banking earnings?)
- **Portfolio construction** – Even if we have a relative preference for a JP Morgan we may still consider buying a regional bank, instead of the investment bank, in a portfolio that is highly exposed to Europe (e.g. if a portfolio contains Aviva we may want to buy a PNC instead of a JPM so the client is not overly exposed to Europe)

Despite the very attractive P/E and P/Book ratios of these US banks, and the favourable position of the US economy vs other developed markets (the US has made the most progress with digesting the 2008 recession), there are some key risks for the US banks:

- They are being pushed to repurchase bad mortgages they made during the housing boom, this is resulting in increased provision charges hitting their finances. PNC's CEO made a good point in this regard – there are only so many of these old mortgages and as they are being dealt with, so the associated risk is declining.
- Legal expenses are high and come with risk (i.e. customer settlements)
- Heightened regulation which may erode their international competitiveness (this is more a risk for the big global banks like JPM, Citi, BofA); it is potentially a macro differentiator between the international and the regional banks.
- US regulatory price controls on banking services (I don't know how extensive this is but Wells Fargo, in their annual report, commented on some services which have a price cap below the cost of providing the service)

PNC Financial Services Group

This section focuses on PNC Financial services, the largest of the US regional banks. In short I would be happy to buy the stock. It's not as cheap as the investment banks but it is also not exposed to complicated derivative structures that could blow up, or surprise trading losses, etc. I also like the relatively purer exposure to the recovery in US housing.

Basic overview

Although PNC is categorised as a regional bank, and it does indeed have regions in which it is dominant, it operates throughout the US. They do have some foreign exposures but in their own words these are "not material".

PNC's business involves three broad categories: lending money in its various forms (retail, corporate and business banking, residential mortgages, asset-backed lending), transaction advisory and facilitation activity, and wealth management services (the usual asset management and wealth management businesses).

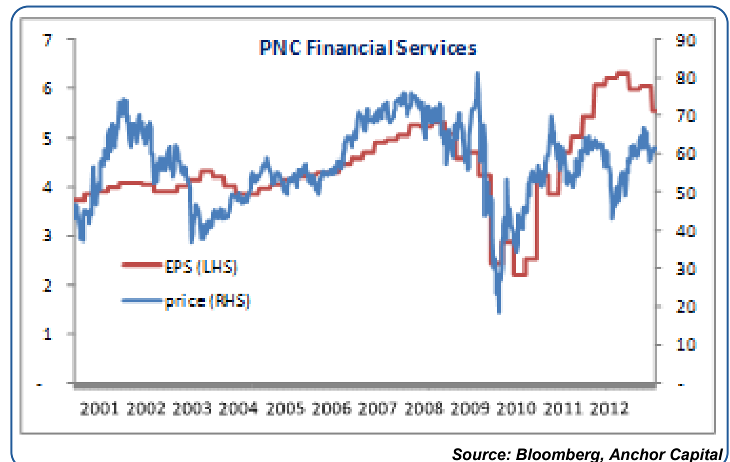
The bank has little investment banking exposure (it does have corporate finance/advisory business in its institutional banking segment, as well as treasury, but it seems the riskier proprietary/trading activity is largely absent). It has a 21% equity stake in BlackRock which has a market value of $6bn (this is about 20% of PNC's market cap) but this is a high P/E wealth management business.

Earnings

During the past two quarters the company had some items, apparently abnormal, that hit earnings but the underlying operational result was "very strong" (in their words). Basic EPS for the quarter was $0.98 (vs c. $1.50 for the previous few quarters) so on the face of it very bad. But the number includes some abnormal/once-off items (in my view legitimately once-off) which shaved $0.76 off EPS (so without these, EPS would have been $1.74; annualised P/E of 8.3x). The main abnormal item was a whopping residential mortgage repurchase-provision of $438mn (vs earnings of $546mn for the quarter). They 'called', i.e. bought back, some high-yielding sources of funding and this resulted in a charge to the income statement. PNC also incurred costs associated with integration of its acquisitions (more on this below).

Their baseline/core/normalised earnings capacity in this low-rate environment is $1.50 - $1.70/quarter (P/E of 9.5x – 8.3x). Most likely the abnormal items referred to above will be over quite soon. In responding to a question in this regard, management said they expect no further integration costs in 2013 (no more acquisitions), there are no more trust securities to call and they "hope" they have provided sufficiently for the mortgage repurchase liability. This "hope", on the face of it, is not confidence inspiring, but given that the pre-2008 vintages are limited and given the enormity of their latest provision (as well as the fact that management seem like 'straight shooters' to me), I am prepared to place some trust in their opinion here.

The following graph compares the share price with the EPS (note the EPS number includes most of what I have termed 'abnormal', i.e. it has not been stripped out; it seems that the treatment of abnormal items is not always consistent with the data companies as some get away with polishing and sanitising their EPS, while others don't do this).



Source: Bloomberg, Anchor Capital

PNC is growing (organically) its customer base quite rapidly and taking market share from its competitors. It is also growing through acquisitions. PNC actually mentioned that if its business continues growing at the current rate there will be no need to make further acquisitions. Management made two major comments on this customer growth:

- Much of it is only expected to show up in earnings in 12 – 18 months time;
- Because it does not expect to make significant acquisitions (since organic growth has been so strong) it will return a "great deal" of capital to shareholders.

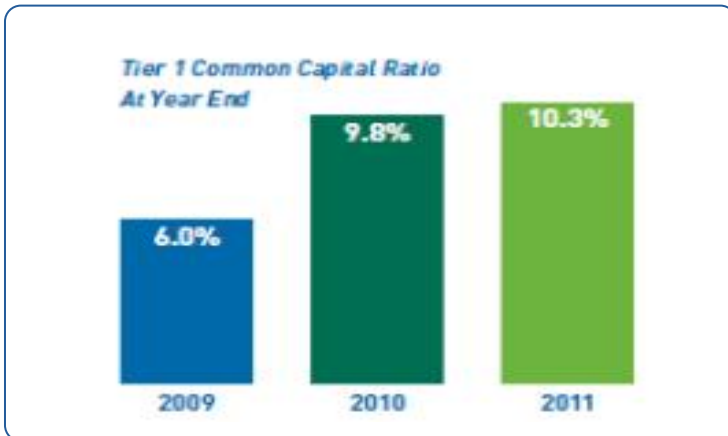
Recently the company has been bedding down some strategic acquisitions made during 2011, the largest of which was RBC Bank (US) which added 400 branches to its franchise (a 16% increase in total branches).

Presently there are both headwinds and tailwinds to EPS growth. Note however that the company is in good shape, management is extremely positive, and the underlying growth in clients is very strong.

The headwinds will probably result in a medium-term squeeze on profits as assets reprice to lower rates (which will reduce net interest income). Interest spreads have also declined on corporate loans (corporates are in good shape and the market for lending into corporates is very competitive) but the rate of decline has slowed, so the compression appears to be bottoming.

PNC expects earnings composition to shift towards a greater share of fee income and proportionately less net interest income. It also expects the present low rate environment to help credit quality (if so, this would result in a release of reserves).

Like most US banks, its capital position is very strong at present. "US bank capital ratios are at their highest level in six decades". Also, PNC is among the best capitalised banks in the peer group (AR 2011 pg 4).



Source: Bloomberg, Anchor Capital

Although US 'local banks' are quite unknown to South Africans, they are certainly not unloved and unknown in the US – there are 35 research houses listed on PNC's website which formally cover the stock. So if one of these banks looks like a 'no brainer' it probably isn't.

There are many smaller particulars that I have not delved into in any detail (trust securities repurchase, shift towards ATM and internet banking vs branches [a relative shift, of course it still has many braches]), but which would fall under the heading of cost reductions. In general the company is managing its cost base downwards.

Also, I got the impression that PNC is a pretty innovative company. This is difficult to assess without actually going to visit them, but the type of innovations they are making, their way of speaking about their challenges, all these 'soft issues', gives me quite a positive impression of the bank. The macro environment is certainly tough, but as far as I can tell PNC seem like 'winners' and I would be comfortable backing them.

The following table is an extract from their 2011 (Y/end is December) financials. I have made some comments on pertinent aspects below.

Business segment summary, 2011 and 2010

		Income (Loss)		Revenue		Average Assets (a)	
Year ended 31 December - in millions		2011	2010	2011	2010	2011	2010
Retail Banking	$	31	144	5 042	5 386	66 448	67 428
Corporate & Institutional Banking		1 875	1 794	4 669	4 950	81 043	77 540
Asset Management Group		141	137	887	884	6 719	6 954
Residential Mortgage Banking		87	269	948	992	11 270	9 247
BlackRock		361	351	464	462	5 516	5 428
Non-Strategic Assets Portfolio		200	-57	960	1 136	13 119	17 517
Total business segments		2 695	2 638	12 970	13 810	184 115	184 114
Other (b) (c)		376	386	1 356	1 366	81 220	80 788
Income from contuing operations before non-controlling interest (d) (c)	$	3,071	3 024	14 326	15 176	265 335	264 902

Source: Company reports

The glaring issue with this summary is the low return and profit margin on its retail banking book (ROA was 0.05% in 2011, 0.2% in 2010). Its revenue is higher than the corporate book yet its income is a small fraction. The low profitability is caused by a number of things: impairment provisions are still large (18% in 2011; 20% in 2010) and in conjunction with non-interest expenses at c. 81% of revenue, these leave very little earnings (0.6% profit margin).

Part of the explanation for this low profitability is that PNC sees the retail banking segment as a source of cheap funding (it offers free cheque accounts). It is also a result of the low interest rate environment. I am inclined to regard the retail banking division as containing quite a lot of upside if the economy picks up. It presently makes very little contribution to group earnings (1%) despite accounting for 25% of group assets, so there is a recovery optionality here.

The CEO noted that the retail bank, under 'normal' circumstances, is a $1.5-$2bn business – this would increase EPS by 50%. I had a look at the 2006 financials to gauge the reasonableness of this statement. To earn $1.75bn (mid-point of range) on the 2011 asset base would require a ROA of c. 2.5%. ROA in 2006 was 2.6%. So, if you take 2006 as 'normal', then this earnings capacity is possible.

Business segment summary, 2006 and 2005

		Earnings		Revenue (a)		Average Assets (b)	
Year ended 31 December - in millions		2006	2005	2006	2005	2006	2005
Retail Banking	$	765	682	3 125	2 868	29 248	27 618
Corporate & Institutional Banking		463	480	1 472	1 335	26 548	25 309
BlackRock (c) (d)		187	152	1 170	1 229	3 937	1 848
PFPC (e)		124	104	879	846	2 204	2 128
Total business segments		1 539	1 418	6 646	6 278	61 937	56 903
Other		1 056	-93	1 951	82	33 075	31 645
Total consolidated	$	2 595	1 325	8 597	6 360	95 012	88 548

Source: Company reports

My concern however is that this kind of analysis can be applied to almost any cyclical business (think what this method would tell us about resource company earnings). As an extreme case reference point, if you take the group ROA from 2006 (2.7%) and apply it to 2011's total assets (2.7% x $ 265,335mn) then earnings would theoretically be $7,250mn or $1,811mn per quarter (latest quarterly earnings were $546mn). In other words, current earnings are by no means inflated.

The company thinks it is “positioned to deliver strong results in 2012”. More specifically, their outlook guidance is as follows:

- Loan growth in the mid to high-teens (vs 2011)
- Revenue growth in the high single-digits
- Non-interest expenses to increase in the high single-digits

PNC’s guidance gives the impression that there may be some further abnormal costs in 2012 but thereafter earnings seem pretty clean. But this is always the case, right? Almost everyone forecasts another year or two of mess and plain sailing thereafter (e.g. IMF forecasts for Greek GDP). But, again, despite the possibility of cynicism here, I am inclined to take the more optimistic view. Their abnormal costs were largely related to pre-2008 legacies which must be getting close to a resolution now. Furthermore, the company has excess capital and a generally robust business, so it could absorb a disappointment without catastrophic results.

Defined Benefit Pension concerns

I had a concern about their defined benefit pension plan which has an assumed ROA on plan assets of 7.75% p.a. and that this was too high. In a sense this concern is quite generic, or at least relevant to all companies that have these pension funds (my approach to dealing with this potential landmine is to first determine whether we like the core business, and only if that is the case, then attempt to quantify the potential loss associated with pension shortfalls. Since I do like the core business of PNC I have dug a little further into this issue).

PNC noted that for every 1% decrease in expected return on plan assets, the pension expense will increase by $8mn (annual increase because the difference is amortised over an extended period). I think it’s reasonable to shave 2% off its 7.75% assumed ROA which would then increase group expenses by $16m/p.a. (0.4% of 2011’s pre-tax earnings). So this is not going to be a problem after all, at least in PNC’s case.

Blake Allen

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