

# Price-to-Earnings Multiples

Can bank valuations hold in a tough stock marketing environment?



By Bill Sammon

**While community banks could continue trading at very strong multiples, history tells us that this is no guarantee.**

In the public market for community bank stocks, most companies trade versus their price to earnings multiple. Some community banks are still trade versus their book value, but this is typically in the case where there are not enough earnings to trade off of. The goal for all publicly traded banks is to trade at price-to-earnings (P/E) multiples above their peer group. Community banks that trade at premiums have a greater ability to use their stock for acquisitions and a strong P/E multiple can also act as a deterrent from unwanted offers for the bank.

From a price-to-earnings standpoint, community banks continue to trade close to 10-year highs on multiples despite many macro trends that are adversely affecting the sector. For any bank that will need to tap the capital markets in the near future, these influences should be watched closely. Looking to the recent past will also reveal how negative influences can affect valuations.

A look at Chart 1 shows how community banks below \$2.5 billion in assets have traded over the last 10 years. During that period banks have been valued as high as 17.8 times, earnings and as low as 11.4 times in the past decade. As you can see, the community bank sector saw a dramatic shift in multiples in the late 1990s and a number of factors played into that decline. Merger and acquisition activity was very strong and multiples in the community bank sector reflected this.

The jump in multiples from 1996

to 1997 reflects a market where there was much speculation on who would be the next community bank to go. As the M&A market cooled, bank stock multiples due to “take out” speculation pulled back. In addition to M&A activity, interest rates have had and will continue to have a dramatic effect on the entire sector.

The Fed’s interest rate tightening in the late 1990s also had an effect on bank stock multiples. Historically, bank stock investors get nervous in a rising interest rate environment in anticipation of net interest margin pressure and potential hits to the securities portfolio.

Sector rotation can also play a role in where community bank stocks are valued. Anyone who was an investor in 1998 and 1999 can remember looking at the tech stock market in amazement as huge paper gains were created on a daily basis. When this type of activity is taking place, it is difficult for a broker to get an investor excited about a bank with a 15 percent return on equity when millionaires are being created by listening to the next idea that hits the air waves of CNBC. The tech stock boom pulled significant dollars away from bank stocks and added to the downward trend in our sector.

Today, investors are struggling with these strong valuation levels in the face of a difficult operating environment, especially when no apparent catalyst is emerging that could propel bank stock valuation levels higher over the near-term. Anticipation that the Fed may end

Chart 1

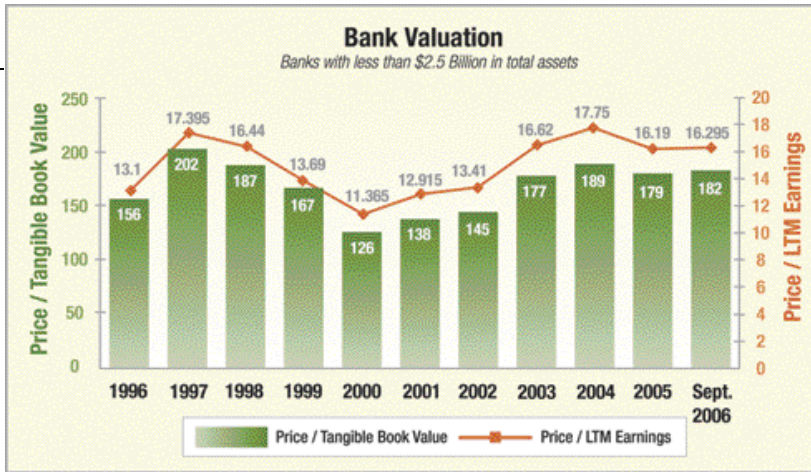
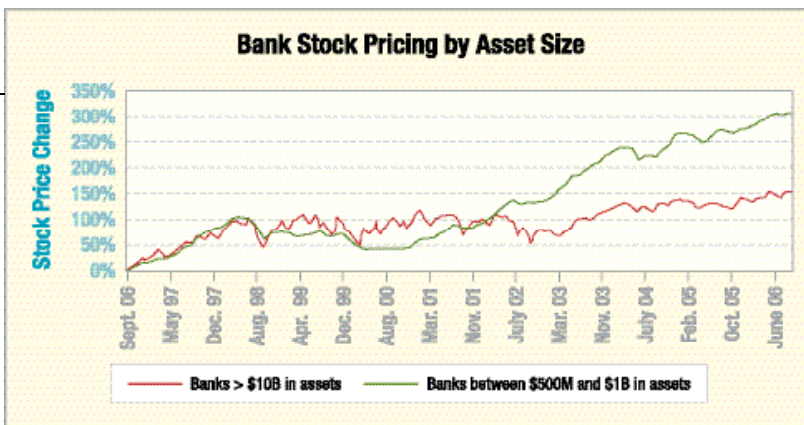


Chart 2



or pause its tightening cycle could provide a bounce for the community bank valuations over the near-term. However, this bounce in valuation may be tempered due to additional net interest margin pressures as some depositors move from low-cost checking account to higher yielding money markets and CDs.

Along with higher interest rates is the fear that borrowers will come under greater pressure and already depressed reserve ratios will need to be rebuilt over the near-term. Although credit quality was relatively tame during the first half of 2006, community banks appear to be at the point where credit quality trends have stopped enhancing earnings growth and could potentially restrain it. While no one is antic-

ipating material deterioration in credit quality or aggressive rebuilding of reserves, earnings growth could be impacted in a negative fashion as provisioning returns to more historic levels.

To the banking sector's good fortune, no other sector has proven compelling enough over the last couple of years to warrant a dramatic rotation away from community banks. What is interesting, and should be watched, is a trend that is taking place within the banking sector and demonstrated in Chart 2. Starting in 2001, the community bank sector began to dramatically outperform the larger banks in the country. If this trend continues, more community banks could see rotation within their sector as investors move away

from higher valued community banks and look for value in the regional and national players.

As community banks look at their strategic plans and their need for new capital it is important to understand where we are in the current cycle. While community banks could continue to trade at very strong multiples for the foreseeable future, history tells us that this is no guarantee. If P/E multiples were to decline, management teams will be faced with a difficult decision; restrain growth that could add value to shareholders, or raise capital at lower earnings multiples and deal with greater dilution.

While tapping the market when multiples are favorable is always preferable, use of proceeds is a critical factor in investor's decisions

to buy or not. Even raising capital at high multiples can drag on earnings per share and return on equity if not properly employed.

For banks that will have a need for capital over the next 12 to 24 months and have a compelling reason for tapping the capital markets, studying these trends and understanding that these windows do close, allow for better decision making. The goal of any capital raise, especially an equity offering, should be to get the capital that is needed while creating as little dilution as possible to the current shareholders. **ib**

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