# Studying a Bank's Revenues and Expenses

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*Editor's note: Our thanks to Scott D. Horsburgh, CFA, for contributing this article on analyzing bank stocks using NAIC stock study tools and techniques. Scott is a research analyst and portfolio manager with Seger-Elvekrog Inc., Bloomfield Hills, Mich., and a contributing editor of* Better Investing. *As always with BITS editorial features, no investment recommendation is intended. Emphasis is totally on learning.*

As with last month's presentation on the difficulty of analyzing insurance companies, there are also unique challenges when analyzing banks.

When using Investor's Toolkit to prepare a Stock Selection Guide on a bank, one of the first pieces of data you are required to enter is the company's sales. But, what are the "sales" of a bank? The part of a Value Line sheet usually reserved for "quarterly sales" actually shows a bank's loans outstanding.

The NAIC datafiles have a closer definition of sales. The data presented in these files generally adds a bank's interest income and "noninterest"

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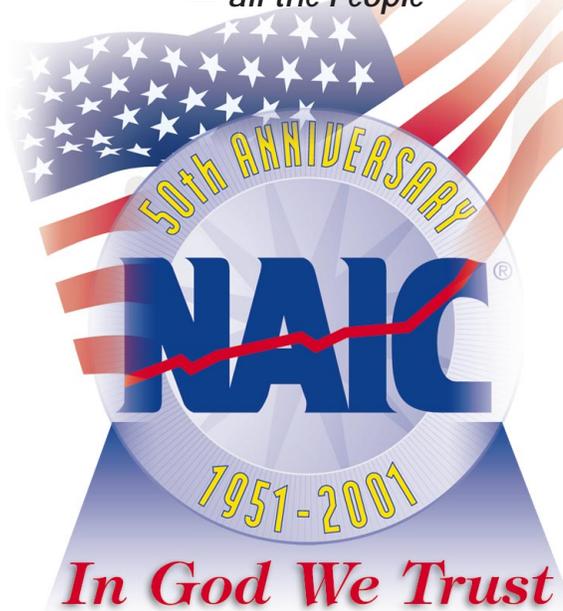


**This month's NAIC Congress in Detroit will celebrate 50 years of helping all Americans enjoy the benefits economic freedom brings through investment education.**

*Computer Group members heading to Detroit for NAIC 50th National Congress and Expo, Oct. 24 - 27, will find nine new educational tracks (see box, page 8) with plenty of computer related seminars. Featured general session speakers include Ralph Acampora, managing director and head of technical analysis for Prudential Securities; Kelvin Boston, financial commentator, author and entrepreneur; Susie Gharib, co-anchor of* Nightly Business Report; *and Bill Griffeth, one of the nation's most respected financial journalists.*

*In addition, speakers at sessions open to the public include David L. Littman, senior vice president and chief economist for Comerica; and Edwin A. Finn, Jr., editor and president of* Barron's, *the Dow Jones Business and Financial Weekly. For the most up-to-date information on the NAIC Congress, visit the NAIC Web Site.*

## Studying a Bank's Revenues and Expenses – continued from page 1

income. Noninterest income includes such items as bank fees, trust department fees, mortgage servicing income and gains from sales from assets like loans and securities.

It has been the convention of the banking industry to define revenues as "net interest income" (as opposed to interest income) plus noninterest income.

A bank's net interest income is defined as its interest income (from loans and investments) minus its interest expense (to depositors). The lending business is considered to be a "spread" business. That is to say, most banks attempt to coordinate their loans and deposits in such a way that they produce a steady stream of net interest income regardless of whether interest rates are rising or falling.

Banks will attempt to match up their fixed rate loans with fixed rate deposits, like perhaps a long-dated Certificate of Deposit. Similarly, they will attempt to match up their portfolio of floating rate loans (like adjustable rate mortgages) with deposits with interest rates that reset frequently (like short-term CDs).

By doing this, net interest income almost becomes a sort of fee on top of whatever the interest expense turns out to be. In my 10-year career as an analyst following financial firms, I have always used net interest income plus noninterest income to define a bank's revenue. That is what NAIC recommends as well, adjusting for loan losses as appropriate (I'll comment on that later.) *(Editor's note: We will check to see that "net interest income" is used in reporting bank revenues in the NAIC/ S&P Datafiles.)*

There are a whole host of games that banks can play even when defining revenue. Noninterest income can include many things that are not part of the ordinary course of business. For example, gains on sales of securities, and sometimes sales of mortgages, can impact the company's reported revenues and profits. Check for consistency versus prior periods. If a bank reports a quarter of exceptionally good earnings, is it solely because they sold

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*"A bank's SEC Form 10-Q will provide a much more detailed breakdown of expenses. It is important to look at this list for signs of anything unusual."*

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off a bunch of loans or investments? The timing of those sales is generally up to management, so such gains could be considered a "nonrecurring" item and excluded from your calculation of profits.

Some of the cleanest reporting comes from banks like Synovus Financial that generally report relatively little in the way of gains on the sale of securities.

### A Focus on Fee Income

Banking is an extremely competitive business, so many banks have been focusing on fee income to reduce their reliance on loans. Very few banks have as high a proportion of noninterest income as Synovus Financial.

Here, noninterest income, significantly from its Total System Services data processing subsidiary, actually exceeds net interest income from banking operations. In general, a more desirable bank may be one that has more noninterest income since this has been the source of greatest growth for banks

given the very competitive lending environment.

The largest expense faced by banks is usually interest expense. However, we've netted that out from interest income when defining revenues. Banks will list other expenses including compensation, occupancy, outsourced services, telecommunications and amortization of goodwill. There are very frequently a whole host of other expenses that are simply lumped together as "other."

It is very important for bank investors to seek out exactly what these other expenses are since there is the potential to play games with these numbers, too. A bank's SEC Form 10-Q will provide a much more detailed breakdown of expenses. It is important to look at this list for signs of anything unusual.

Many years ago, savings and loans were forced to pay a one-time fee to shore up the finances of the federal deposit insurance program for S&Ls. This was a one-time expense and you might want to exclude that when analyzing a company.

Another "expense," even though it is not found in the expense section of a bank's income statement, is the provision for loan losses. One of the problems when investing in bank stocks is that banks only provide an estimate of which loans are going to go bad, partly due of course to the fact that they don't know for sure if a loan will go bad.

An extremely well-run bank

like Synovus Financial may have set aside 1.25 to 1.5 percent of its loans as uncollectible and may add 0.25 to 0.50 percent of loans to this balance on a quarterly basis. It wouldn't be uncommon for an average quality bank to have double this loss exposure.

As with most forms of financial analysis, the thing to be concerned about when looking at the provision for loan losses is the trend. Is the bank having to set aside ever-higher amounts for bad or questionable loans, and is this amount growing faster than its competitors? If that is the case, the bank may not be doing a good job policing its loan officers.

It is also desirable to have a bank that has made ample provisions for loans that may go bad. In their 10-Qs, banks will divulge further information about asset quality. They will compare their provision for loan losses to their charge-offs — a charge off is the actual writing off of a bad loan.

It is comforting to see a provision that is at least two times the level of non-performing (late) loans. In its 10-Q for June 30, 2001, Synovus Financial reported that non-performing assets were 0.49 percent of loans and that makes the ratio of the allowance to the non-performing assets a rather comforting 397 percent. That is to say it has four times the level of non-performing assets set aside for a rainy day. That gives shareholders and the company plenty of cushion to absorb any increase in problem loans.

On the other hand, some banks have a ratio of only 1.3 to 1.5 times the level of non-performing assets. Any increase in bad loans could

eat into this cushion and cause the bank to have to set aside more of its earnings for bad loans. This would depress earnings and probably hurt the price of the bank's stock.

Banks tend to have a high pretax profit margin due to the way that I calculate revenues. Return on equity tends to be moderate. However, many of the better-run banks feature a return on equity of around 18 percent and this includes Synovus Financial. A bank growing at a more moderate rate may have an ROE in the mid-teens.

Most banks also pay out a fairly high percentage of their earnings in the form of dividends. This is important because a moderate return on equity and high payout ratio suggest that future growth may be only moderate.

A rough estimate of long-term growth potential can be obtained by multiplying return on equity by (1 minus the percent payout). This would show the growth rate that a company (including a bank) might be expected to achieve if it can reinvest its retained earnings (earnings not paid out to shareholders) at the same return that it received on previous equity capital.

You can see how a moderate ROE and high dividend payout would suppress future earnings possibilities. This is another way of suggesting that investors keep earnings expectations moderate when analyzing bank stocks. This moderate earnings growth outlook also tends to keep P/E ratios fairly low in the banking industry.

### Making the SSG Judgments

Two factors led me to my forecast of 13 percent annualized growth in Synovus' earnings per share *(see SSG, pages 23-24)*. First, actual growth over the past four years (1996-2000) has been 13.1 percent, although the

# Meet Your Three New Computer Group Board Associate Directors

Three new associate directors were recently appointed by the NAIC Computer Group Advisory Board of Directors to serve one-year terms. Here are brief biographical sketches of the new associate directors.

**Esther C. Curnutt** lives in San Antonio, Tex. She is a Computer Group member and has been active in two clubs as secretary of one and president of the other, which she formed.

Esther is active in the South Texas Chapter and has been vice president of education and computer chair for the chapter. She created the chapter's newsletter, helped with class registration and has worked as a volunteer at every investors fair South Texas has had over the past five years.

Esther has taught Value Line and Investor's Toolkit classes. She started her own advertising, marketing and public relations agency and has used her organizational abilities and computer skills in many community service organizations.

**Marvin H. Eargle** lives in Birmingham, Ala. He is a club member having served as first vice president and vice president of education. He is active in the Alabama Chapter and has been first vice president of the chapter, co-director of the Alabama NAIC investors fair committee, investors fair registration chairman and Central Alabama NAIC education committee chairman.

Marvin maintains the Alabama database of members, club contacts, youth members, subscribers, etc. and is organizing a Central Alabama Computer Users Group. Marvin was a division engineering manager with BellSouth for 30 years, has taught at the University of

Alabama for seven years and is co-owner of a family business involved with legal depositions and medical case planning.

**Judy M. Proud** lives in Pacific Grove, Calif. She is a Computer Group member and has held just about every office in the two investment clubs she has been a member of for the past five years. Judy has been active in the Loma Prieta Chapter for the past three years and has taught the SSG, Investor's Toolkit and several how-to classes. She has been the chapter's secretary, contact, publicity person and has had other administrative roles.

Judy has been involved in fund-raising activities for several community organizations and following her husband's retirement started a family business from home in art, antiques and mural painting.

10-year figure is higher because of upper-teen growth in the earlier years. Second, return on equity (ROE) has been relatively stable in the 18 to 18.5 percent range since 1996.

Using the previous formula for long-term growth, multiply the ROE by (1-dividend payout rate). Expressed numerically, this would be an ROE of 18.4 percent multiplied by (1 minus .402, or .598) which results in an implied growth rate of 11 percent. A forecast of growth higher than 11 percent implies either a higher future ROE or a lower dividend payout rate. Since the dividend payout rate has been steadily rising, it is unlikely that Synovus would be able to return to the high-teens growth of previous years. Growth of 13 percent will take

some work but Synovus has been producing this kind of growth consistently over the past four years.

When selecting high and low price-earnings ratios, it is important to note the consistency of these P/Es on a historical basis. Synovus' high P/E has ranged from 26.7 to 37.0 over the past five years, while the low has been between 14.1 and 24.7. The averages of 31.9 for the high and 19.2 for the low fall virtually right in between the extremes.

Although these figures are somewhat high for the 13 percent growth that Synovus has achieved and might be expected to achieve in the future, it does seem to reflect the consensus in the market as to what the company is worth.

The estimated low price I used in my study of 18.8 *(page 24)* results from two considerations. The low P/E of 19.2 multiplied by the EPS of $0.98 over the latest 12 months suggests a potential low of 18.8. The low price Synovus has actually achieved over the past year is 18.875. This seems like a reasonable consensus.

Of the other low price considerations, the average low over the past five years reflects periods when Synovus' earnings were much lower. The severe market low seems to be an abnormality considering that the previous two years saw higher lows and dividends don't provide any support to Synovus' stock price since the yield is only 1.5 percent. Those are my judgments. How about yours?

# Stock Selection Guide ®

## The most widely used aid to good investment judgment

Company **Synovus Financial**          Date **09/10/01**

Prepared by **Horsburgh**          Data taken from _____

Where traded **NYSE**          Major product/service **Banks, Nati**

CAPITALIZATION --- Outstanding Amounts          Reference _____

| | | % Insiders | % Institution |
|---|---|---|---|
| Preferred ($M) | 0.0 | | |
| Common (M Shares) | 290.7 | 15.3 | 36.6 |
| Debt ($M) | 910.9  % to Tot.Cap. | 38.6  % Potential Dil. | None |

SNV

## 1 VISUAL ANALYSIS of Sales, Earnings and Price

**FY 2001 Q2 (Ended 6/30/2001)**
RECENT QUARTERLY FIGURES

| | SALES ($M) | EARNINGS PER SHARE ($) |
|---|---|---|
| Latest Quarter | 386.6 | 0.26 |
| Year Ago Quarter | 347.1 | 0.22 |
| Percentage Change | 11.4% | 18.2% |

See Chapters 8, 9, and 10 of the NAIC Official Guide for complete instructions.
Use this Guide as working section of NAIC Stock Selection Guide & Report.



2,571.7
1,395.8
411.6
1.70
0.92

1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005

(1) Historical Sales Growth **18.4** %          (3) Historical Earnings Per Share Growth **17.0** %

(2) Estimated Future Sales Growth **13.0** %          (4) Estimated Future Earnings Per Share Growth **13.0** %

## 2 EVALUATING MANAGEMENT

Company **Synovus Financial    (SNV)**          **09/10/01**

| | | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | LAST 5 YEAR AVG. | TREND UP | TREND DOWN |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| A | % Pre-tax Profit on Sales (Net Before Taxes ÷ Sales) | 19.3 | 22.1 | 25.1 | 25.7 | 26.3 | 28.1 | 28.7 | 29.1 | 27.9 | 29.5 | 28.6 | UP | |
| B | % Earned on Equity (E/S ÷ Book Value) | 14.2 | 14.7 | 15.8 | 17.1 | 16.8 | 18.5 | 18.8 | 17.7 | 18.4 | 18.5 | 18.4 | EVEN | |

## 3 PRICE-EARNINGS HISTORY as an indicator of the future

*This shows how stock prices have fluctuated with earnings and dividends.  It is a building block for translating earnings into future stock prices.*

PRESENT PRICE ___ **28.180** ___ HIGH THIS YEAR ___ **34.740** ___ LOW THIS YEAR ___ **18.750**

| Year | A PRICE HIGH | B PRICE LOW | C Earnings Per Share | D Price Earnings Ratio HIGH A ÷ C | E Price Earnings Ratio LOW B ÷ C | F Dividend Per Share | G % Payout F ÷ C X 100 | H % High Yield F ÷ B X 100 |
|---|---|---|---|---|---|---|---|---|
| 1  1996 | 14.8 | 7.8 | 0.55 | 26.7 | 14.1 | 0.187 | 33.7 | 2.4 |
| 2  1997 | 22.4 | 13.1 | 0.65 | 34.6 | 20.3 | 0.213 | 33.0 | 1.6 |
| 3  1998 | 25.9 | 17.3 | 0.70 | 37.0 | 24.7 | 0.290 | 41.4 | 1.7 |
| 4  1999 | 25.1 | 17.3 | 0.80 | 31.4 | 21.6 | 0.360 | 45.0 | 2.1 |
| 5  2000 | 27.4 | 14.0 | 0.92 | 29.8 | 15.2 | 0.440 | 47.8 | 3.1 |
| 6  TOTAL | | 69.5 | | 159.5 | 95.9 | | 200.9 | |
| 7  AVERAGE | | 13.9 | | 31.9 | 19.2 | | 40.2 | |

8 AVERAGE PRICE EARNINGS RATIO    **25.6**        9 CURRENT PRICE EARNINGS RATIO    **28.5**

## 4 EVALUATING RISK and REWARD over the next 5 years

Proj. P/E [25.19] Based on Next 4 qtr. EPS [1.12]        Current P/E Based on Last 4 qtr. EPS [0.99]

*Assuming one recession and one business boom every 5 years, calculations are made of how high and how low the stock might sell.  The upside-downside ratio is the key to evaluating risk and reward.*

**A HIGH PRICE -- NEXT 5 YEARS**

Avg. High P/E ___ **31.9** ___ X Estimate High Earnings/Share ___ **1.70** ___ = Forecast High Price $ ___ **54.2** ___
(3D7 as adj.)                                                                                                (4A1)

**B LOW PRICE -- NEXT 5 YEARS**

(a) Avg. Low P/E ___ **19.2** ___ X Estimated Low Earnings/Share ___ ~~0.92~~ **0.98** ___ = $ ___ **18.8** ___
(3E7 as adj.)

(b) Avg. Low Price of Last 5 Years = ___ **13.9** ___
(3B7)

(c) Recent Severe Market Low Price = ___ **14.0** ___

(d) Price Dividend Will Support   Present Divd. = ___ **0.510** ___ = ___ **16.2** ___
High Yield (H)                   **0.031**

Selected Estimate Low Price ___ = $ ___ **18.8** ___
(4B1)

**C ZONING**

**54.2** High Forecast Price Minus **18.8** Low Forecast Price Equals **35.4** Range.  1/3 of Range = **8.9**
(4A1)                        (4B1)                                (C)                      (4CD)

(4C2) Lower 1/3 = (4B1) **18.8** to **27.7** (Buy)   Note: Ranges changed to 25%/50%/25%

(4C3) Middle 1/3 = **27.7** to **45.3** (Maybe)

(4C4) Upper 1/3 = **45.3** to **54.2** (4A1) (Sell)

Present Market Price of ___ **28.180** ___ is in the ___ **Hold** ___ Range
(4C5)

**D UP-SIDE DOWN-SIDE RATIO (Potential Gain vs. Risk of Loss)**

High Price (4A1) **54.2** Minus Present Price **28.180**
= **26.0** / **9.4** = **2.8** To 1
Present Price **28.180** Minus Low Price (4B1) **18.8**          (4D)

**E PRICE TARGET (Note: This shows the potential market price appreciation over the next five years in simple interest terms.)**

High Price (4A1) **54.2**
= ( **1.923** ) X 100 = ( **192.3** ) - 100 = **92.3** % Appreciation
Present Market Price **28.180**                                      (4E)

Relative Value: 111.3%  Proj. Relative Value: 98.4%

## 5 5-YEAR POTENTIAL

*This combines price appreciation with dividend yield to get an estimate of total return.  It provides a standard for comparing income and growth stocks.*

Note: Results are expressed as a simple rate; use the table below to convert to a compound rate.

**A** Present Full Year's Dividend $ ___ **0.510** ___

Present Price of Stock $ ___ **28.180** ___ = ___ **0.018** ___ X 100 = ___ **1.8** ___ Present Yield or % Returned on Purchase Price
(5A)

**B AVERAGE YIELD OVER NEXT 5 YEARS**

Avg. Earnings Per Share Next 5 Years ___ **1.33** ___ X Avg. % Payout (3G7) **40.2** = ___ **53.5** ___ = ___ **1.9** ___ %
Present Price $ ___ **28.180** ___                                              (5B)

**C ESTIMATED AVERAGE ANNUAL RETURN OVER NEXT FIVE YEARS**

5 Year Appreciation Potential (4E) **92.3** / 5 = **18.5** %

Average Yield (5B) ................................................ **1.9** %

Average Total Annual Return Over the Next 5 Years (5C) = **20.4** %

| | P.A.R. | Tot. Ret. |
|---|---|---|
| Average Yield | 1.6% | 1.3% |
| Annual Appreciation | 8.5% | 13.1% |
| % Compd Ann Rate of Ret | 10.1% | 14.4% |