**How I Analyze Bank Stocks**

By Geoff Gannon

We did a Focused Compounding Podcast episode that was 100% dedicated to bank investing:

https://focusedcompounding.podbean.com/e/ep-96-all-about-investing-in-banks/

In that podcast notice that I analyze banks completely differently than most value investors. I don't believe price-to-book is an especially important metric. I value banks based on the amount of their share price, their deposits per share (so P/Deposits so to speak), their growth in deposits, and finally the profitability of those deposits (how low cost are they, how "sticky" are they).

I spend very little time on the asset side of the bank except to see if I think it is safe enough for me. I just assume - and this assumption isn't 100% correct or anything - that money is a commodity, so banks will make roughly similar amounts over time on whatever they lend out, buy bonds with, etc.

However - at least among U.S. banks - you have banks that pay very different amounts on their deposits (in interest), and even MORE important very, VERY different amounts in terms of non-interest expenses per dollar of deposits. There are banks in the U.S. that have $50 million per branch and pay HIGHER interest on most deposits compared to banks that have $200 million per branch. The bank with 4 times the deposits per branch brought in with MORE non-interest bearing accounts is going to have such a "all-in" cost advantage over the other bank that it can make fewer loans and buy more bonds, it can make safer loans that yield less, it can buy shorter-term bonds that yield less, etc. and it'll still make more money than the bank that has to hustle to make the highest yielding loans, buy the highest yielding bonds, etc.

My belief is that a strong, durable advantage on the deposits side in terms of economies of scale at the customer level and the branch level especially is what creates value in banking.

It's not impossible to create value in other ways. Prosperity Bank has done this. But, taking in a lot of small deposits from a lot of less wealthy people at a lot of different branches means the only way you can succeed would be extreme penny pinching on the deposit side and then really good lending on the asset side. You'd have to be cheaper than the other guys when it comes to running a customer oriented business and/or you'd have to be smarter, more driven, etc. lenders. I think that's tough.

Recently, I also wrote-up **Truxton (TRUX).** You can see the same focus on economies of scale here, because:

1) Truxton operates BOTH a wealth management business and a private bank out of the location that is ALSO ITS HEADQUARTERS

2) Truxton has about 8x more deposits per branch (it only has one branch) than U.S. banks generally

3) Truxton focuses on RICH clients (this means Truxton might get 10x the dollar amount of deposits from each depositor relationship as U.S. banks generally - allowing higher ratio of employees to customer but lower ratio of employees to dollar deposited - so, better customer service and/or lower costs)

4) Truxton "cross-sells" the same families on both depositing with the bank and entrusting assets to the wealth management business

Truxton's actual yield on loans isn't all that high. Its actual interest cost on deposits isn't amazingly low. So, it isn't a really big "net margin" here that drives results.

Most value investors seem to really like a bank to have 3 things:

1) A low P/B ratio

2) A high dividend yield

3) A wide net interest margin

I really want the bank to have:

1) Low non-interest costs per dollar of deposits

2) Low interest costs per dollar of deposits

3) High deposit PER SHARE growth

4) A low P/Deposits ratio

Finally, as far as bank safety I also feel differently than most investors. I think the 2 most important things for a bank's safety are:

1) Being funded as close to 100% by customer (retail relationships NOT wholesale transaction) accounts

2) Earning an acceptable rate of return on its equity even in bad years

Number one is the key to surviving a financial crisis. In the U.S. individual customers - both households and businesses - don't pull money from banks. They keep deposits very stable. There have been very few years where the actual level of deposits of this kind of decline even slightly in the U.S. It's easy to retain these customers if you just roughly match prevailing interest rates. Even a slight interest rate difference between you and competitors would not cause a flood of money in or out the door for typical checking / savings accounts. However, for things like CDs, borrowing from other financial institutions, etc. - that money can move quickly.

Number two is the key to rebuilding an inadequately capitalized balance sheet. I think value investors underestimate this. But, if you have a well-capitalized bank with a 4% ROE in good years - this bank is not in a position to grow itself back out of any capitalization problem. You may look at it and think that the bank can lose 50% of its tangible common equity and still be well capitalized for regulatory purposes. This might be true. But, if a bank with a 4% ROE in a good year gets in a situation where it is just barely well capitalized it will stay just barely well capitalized for quite a few years as growth coming out of some big problem might inch along with an ROE closer to 0% than 4%. On the other hand, if you have a bank with ROE's like Bank of Hawaii, Wells Fargo, Bank of America, etc. in good years - then, as long as a regulator lets the bank continue to operate, it WILL earn back a capital buffer during a couple years of economic recovery simply by not paying a big dividend. That's all it has to do.

So, I think that very stable, low cost funding from the bank's own customers (not from wholesalers) is the key to avoiding trouble during moments of panic and then the way to build back up any underfunded balance sheet and be back in a position where you can operate normally is to have a high degree of profitability in your business model.

But, like I said, my ideas on banks are certainly heterodox and some deep value investors might even say they're outright heretical. I think these ideas are, however, closer to how Buffett thinks about banks:

https://www.aol.com/2013/04/08/buffetts-key-to-valuing-banks/