CENTERSTONE INVESTORS

ARE BANK STOCKS WORTH THE RISK?

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Given the markets recent rotation out of quality names and into bank stocks, below is our case on why Centerstone is not attending the Presidential election after-party.

Market participants currently believe that there is a material chance of interest rate increases by the Federal Reserve and the potential for higher inflation due to the economic stimulus announced by the administration. Along with an easing of the regulatory burden on the industry, the combination is believed to potentially alter the future return profile of the industry.

While the above assumptions may hold, we believe that much of the potential has already been discounted by the stocks themselves and that there is little margin of safety should those assumptions be unfulfilled. For instance, according to S&P Capital IQ, of the top 200 banks in the US with market capitalizations greater than $200 million, the median Price to Earnings (P/E) multiple is 16x 2017 earnings, while the median Price to Book (P/B) ratio is now 1.6x. The “Big 4” (J.P.Morgan, Wells Fargo, Bank of America and Citigroup) do trade for lower multiples (13x on average), but the vast majority of the sector remains much more highly priced.

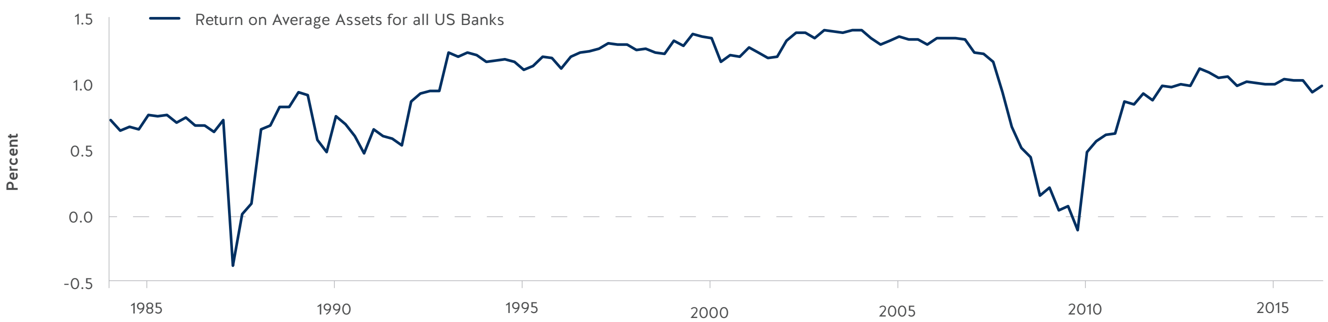
In terms of intrinsic value, we applied the standard bank valuation model (which equates a bank’s intrinsic P/B ratio to the relationship between its return on equity (ROE) and its cost of capital) and currently this valuation tool suggests that either bank stocks are overvalued or that banks will begin to grow their earnings significantly. It is the latter that is noticeably driving bank stock prices. We explored what would need to happen in order to justify current prices.

In our view, there are only a few ways that banks grow their earnings:

- primarily through loan growth (i.e. expanding the balance sheet’s leverage to fund more loans)
- an increase in returns on assets through higher lending spreads
- a combination of both

In order to justify current valuations and assuming that banks maintained their leverage ratios, bank returns on assets would have to go up to 1.5% from 1%, illustrated below. Net interest margins would need to shift dramatically higher, which has historically been accompanied or caused by higher inflation rates. There are many assumptions that would need to hold and in any case, one can see that such returns would be close to the returns during the bubble years.

RETURN ON AVERAGE ASSETS OF ALL US BANKS



Source: Federal Reserve Economic Data

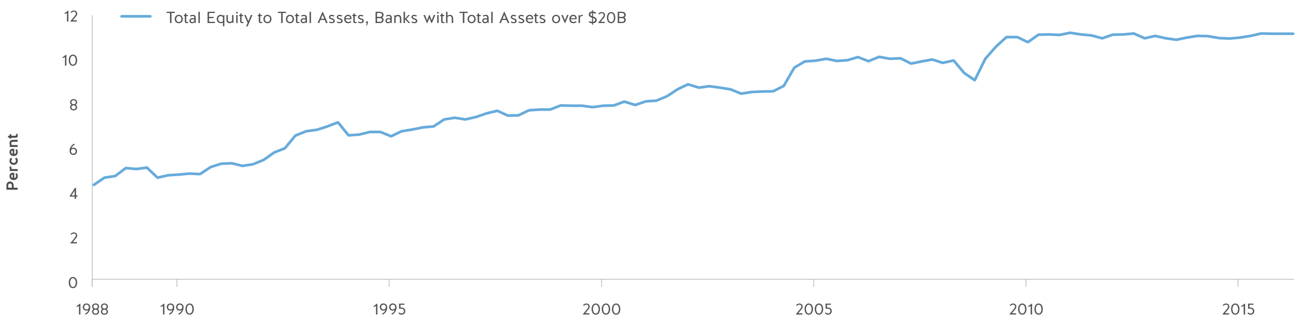
Price To Earnings is the ratio for valuing a company that measures its current share price relative to its per-share earnings. It is calculated by dividing market value per share by earnings per share.

Price To Book is the ratio used to compare a stock’s market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share.

Past performance does not guarantee future results.

On the other hand, if returns kept constant, leverage (equity to assets) would have to drop to 8%, illustrated below. A re-leveraging of bank balance sheets is possible, but US bank loans have grown by 7% annualized over the last three years even under current leverage limits. Additionally, one would need to take a contrary view on the effects of demographics on loan demand. Considering both points, it is hard for us to see a dramatic re-leveraging of bank balance sheets.

TOTAL EQUITY TO TOTAL ASSETS



Source: Federal Reserve Economic Data

The combination of the above leads us to conclude that this euphoria for bank stocks may be unwarranted. Bank stock prices have come to almost exclusively depend on a return to the heady days of the pre-bubble period. There is very little margin of safety and a great risk of disappointment.

We continue to stick to our knitting and invest in businesses that have strong balance sheets, business model durability and management teams with a good track record of capital allocation. The businesses we own such as Air Liquide, ICA Gruppen, EnerSys and Emerson Electric all continue to follow through on their strategic plans and their prospects are more in the hands of management teams rather than the fickle nature of government policy.