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How I Analyze a Bank Stock

A four-part framework to clarify banking.

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Here's the beauty of the banking industry: Banks are similar enough that once you learn how to analyze one, you're pretty much set to analyze 500 of them.

That's about how many banks trade on major U.S. exchanges.

Now, the details get messy when you factor in complicated financial instruments, heavy regulations, byzantine operating structures, arcane accounting rules, the macro factors driving the local economies these banks operate in, and intentionally vague jargon.

But at their core, each bank borrows money at one interest rate and then lends it out at a higher interest rate, pocketing the spread between the two.

And as investors we can get far by focusing on four things:

- What the bank actually does
- Its price
- Its earnings power
- The amount of risk it's taking to achieve that earnings power

To give a concrete example, let's walk through one of the banks I've bought in the banking-centric real-money portfolio I manage for the Motley Fool: **Fifth Third Bancorp** (NASDAQ:FITB).

As quick background, Fifth Third is a regional bank based out of Cincinnati whose 1,300+ branches fan out across 12 states. It's large enough to be in the "too big to fail" group that gets stress tested by the Fed each year but still less than a tenth the size of a **Bank of America** or a **Citigroup** -- and much simpler.

Alright, let's start with...

What the bank actually does

When you read through a bank's earnings releases, it's easy to get sidetracked by management's platitudes and high-minded promises -- guess what, EVERY bank says it's customer-focused and a conservative lender!

Words are nice, but in banking, you are your assets -- the loans you make, the securities you hold, etc. They're the things that will drive future profitability when they're chosen carefully, and they're the things that will force you to fail (or get bailed out) when you get in trouble.

Here's the asset portion of Fifth Third's balance sheet. Take a look, let your eyes glaze over, and then I'll let you know the numbers I focus on (until we get to the "Its price" section, I'm using the financials from Fifth Third's last 10-K because they're more detailed for illustrative purposes).

As of December 31 ($ in millions, except share data)

Assets	
Cash and due from banks	3,178
Available-for-sale and other securities	18,597
Held-to-maturity securities	208
Trading securities	343
Other short-term investments	5,116
Loans held for sale*(d)*	944
Portfolio loans and leases:	
Commercial and industrial loans	39,316
Commercial mortgage loans*(a)*	8,066
Commercial construction loans	1,039
Commercial leases	3,625
Residential mortgage loans*(e)*	12,680
Home equity	9,246
Automobile loans*(a)*	11,984
Credit card	2,294
Other consumer loans and leases	364
Portfolio loans and leases	88,614
Allowance for loan and lease losses	(1,582)
Portfolio loans and leases, net	87,032
Bank premises and equipment	2,531
Operating lease equipment	730
Goodwill	2,416
Intangible assets	19
Servicing rights	971
Other assets*(a)*	8,358
Total Assets	130,443

Loans are the heart of a traditional bank.

In my mind, the greater a bank's loans as a percentage of assets, the closer it is to a prototypical bank.

In this case, two-thirds of Fifth Third's assets are loans (87,032/130,443). This number can range far and wide, but Fifth Third's ratio is pretty typical. For context, note that Fifth Third's loan percentage is double the much more complex balance sheet of JPMorgan Chase.

If a bank isn't holding loans, it's most likely holding securities. You'll notice Fifth Third's various buckets of securities in the balance sheet lines between its cash and its loans. There are many reasons a bank could hold a high percentage of securities. For example, its business model may not be loan-driven, it may be losing loan business to other banks, or it may just be being conservative when it can't find favorable loan terms. In any case, looking at loans as a percentage of assets gives you questions to explore deeper.

The next step of digging into the loans is looking at what types of loans a bank makes. You can see in the balance sheet that Fifth Third neatly categorizes its $88.6 billion in loans.

Clearly, Fifth Third is a business lender first and foremost: When you add up "Commercial and industrial loans," "Commercial mortgage loans," "Commercial construction loans," and "Commercial leases," almost 60% of Fifth Third's loans are business-related. Also, given the almost $40 billion in "Commercial and industrial loans" (as opposed to mortgage loans), a lot of Fifth Third's loans aren't backed up by real estate (though other forms of collateral may be in play).

For simplicity, I'll stop here. The one-line summary: On the assets side, look at the loans.

Let's move on to the rest of the balance sheet:

As of December 31 ($ in millions, except share data)	
Liabilities	
Deposits:	
Demand	32,634
Interest checking	25,875
Savings	17,045
Money market	11,644
Other time	3,530
Certificates - $100,000 and over	6,571
Foreign office and other	1,976
Total deposits	99,275
Federal funds purchased	284
Other short-term borrowings	1,380
Accrued taxes, interest and expenses	1,758
Other liabilities	3,487
Long-term debt	9,633
Total Liabilities	115,817
Equity	
Common stock	2,051
Preferred stock	1,034
Capital surplus	2,561
Retained earnings	10,156
Accumulated other comprehensive income	82
Treasury stock	(1,295)
Total Bancorp shareholders' equity	14,589
Noncontrolling interests	37
Total Equity	14,626
Total Liabilities and Equity	130,443

Just as the loans tell the story on the assets side, the deposits tell the story on the liabilities side. The prototypical bank takes in deposits and makes loans, so two ratios help get a feel for how prototypical your bank is: 1) Deposits/Liabilities 2) Loans/Deposits.

Deposits are great for banks for the same reason you complain about getting low interest rates on your checking and savings accounts. Via these deposit accounts, you're essentially lending the bank money cheaply. If a bank can't attract a lot of deposits, it has to

take on debt (or issue stock on the equity side), which is generally much more expensive. That can lead to risky lending behavior -- i.e. chasing yields to justify the costs.

Fifth Third's deposit/liabilities ratio is 86%, which is quite reasonable and leads to an equally reasonable 89% loan/deposit ratio. All of this confirms what we suspected after looking at the loans on the asset side. Fifth Third is a bank that, at its core, takes in deposits and gives out loans with those deposits. If that wasn't the case, we'd want to get comfortable with exactly what it's doing instead.

We're now ready to take a quick peek at the income statement:

For the years ended December 31 ($ in millions, except per share data)

Interest Income	
Interest and fees on loans and leases	3,447
Interest on securities	520
Interest on other short-term investments	6
Total interest income	3,973
Interest Expense	
Interest on deposits	202
Interest on other short-term borrowings	6
Interest on long-term debt	204
Total interest expense	412
Net Interest Income	3,561
Provision for loan and lease losses	229
Net Interest Income After Provision for Loan and Lease Losses	3,332
Noninterest Income	
Mortgage banking net revenue	700
Service charges on deposits	549
Corporate banking revenue	400
Investment advisory revenue	393
Card and processing revenue	272
Other noninterest income	879
Securities gains, net	21
Securities gains, net - non-qualifying hedges on mortgage servicing rights	13
Total noninterest income	3,227
Noninterest Expense	
Salaries, wages and incentives	1,581
Employee benefits	357
Net occupancy expense	307
Technology and communications	204
Card and processing expense	134
Equipment expense	114
Other noninterest expense	1,264
Total noninterest expense	3,961
Income Before Income Taxes	2,598
Applicable income tax expense	772
Net Income	1,826
Less: Net income attributable to noncontrolling interests	(10
Net Income Attributable to Bancorp	1,836
Dividends on preferred stock	37
Net Income Available to Common Shareholders	1,799

The big thing to focus on here is the two different types of bank income: net interest income and (you guessed it) noninterest income.

Still lost in that mess above? See the lines "Net Interest Income After Provision for Loan and Lease Losses" (3,332, or $3.332 billion) and "Total noninterest income" (3,227, or

$3.227 billion).

I told you earlier that at its core, a bank makes money by borrowing at one rate (via deposits and debt) and lending at another higher rate (via loans and securities). Well, net interest income measures that profit.

Meanwhile, noninterest income is the money the bank makes from everything else, such as fees on mortgages, fees and penalties on credit cards, charges on checking and savings accounts, and fees on services like investment advice for individuals and corporate banking for businesses.

For Fifth Third, it gets almost as much income via noninterest means ($3.2 billion) as it does from interest ($3.3 billion).

Like most of what we've covered so far, that's not necessarily good or bad. It furthers our understanding of Fifth Third's business model. For instance, the noninterest income can smooth interest rate volatility but it can also be a risk if regulators change the rules (e.g. banks can no longer automatically opt you in to overdraft protection...meaning they get less of those annoying but lucrative overdraft fees).

There are many, many line items I'm glossing over on both the balance sheet and the income statement, but these are the main things I focus on when I'm looking over the financial statements. As you'll see, many of the things I've ignored are covered a bit by the ratios we'll look at in the other sections.

Next up is...

Its price

The oversimplified saying in banking is "buy at half of book value, sell at two times book value."

Just as if I told you to "buy a stock if its P/E ratio is below 10, sell if it's over 25" there are many nuanced pitfalls here, but it at least points you in the right direction.

If you're unfamiliar with book value, it's just another way of saying equity. If a bank is selling at book value, that means you're buying it at a price equal to its equity (i.e. its assets minus its liabilities).

To get a little more conservative and advanced than price/book ratio, we can look at the price/tangible book ratio. As its name implies, this ratio goes a step further and strips out a bank's intangible assets, such as goodwill. Think about it. A bank that wildly overpays to buy another bank would add a bunch of goodwill to its assets -- and boost its equity. By refusing to give credit to that goodwill, we're being more conservative in what we consider a real asset (you can't sell goodwill in a fire sale). Hence, the price-to-tangible book value will always be at least as high as the price-to-book ratio.

In Fifth Third's case, it currently has a price-to-book value of 1.3 and a price-to-tangible book value of 1.5. In today's market that's a slight premium to the median bank.

Like any company, the reason you'd be willing to pay more for one bank than another is if you think its earning power is greater, more growth-y, and less risky.

Our first clue on Fifth Third's earnings power is also our last valuation metric: P/E ratio. Fifth Third's clocks in at just 10.7 times earnings. That's lower than its peers. In other words, although we're paying an above average amount for its book value, we're seeing that it's able to turn its equity into quite a bit of earnings.

Let's look further into that...

Its earnings power

I talked a bit about how Fifth Third has a lower than average P/E ratio despite having a higher-than-average P/B ratio. The metric that bridges that gap is called return on equity (ROE). Put another way, return on equity shows you how well a bank turns its equity into earnings. Equity's ultimately not very useful if it can't be used to make earnings.

Over the long term, an ROE of 10% is solid. Currently, Fifth Third is at 12.3%, which is quite good on both a relative and absolute basis.

Breaking earnings power down further, you can look at net interest margin and efficiency.

Net interest margin measures how profitably a bank is making investments. It takes the interest a bank makes on its loans and securities, subtracts out the interest it pays on deposits and debt, and divides it all over the value of those loans and securities. In general, it's notable if a bank's net interest margin is below 3% (not good) or above 4% (quite good). Fifth Third is at 3.3%, which is currently higher than some good banks, lower than others.

While net interest margin gives you a feel for how well a bank is doing on the interest-generating side, a bank's efficiency ratio, as its name suggests, gives you a feel for how efficiently it's running its operations.

The efficiency ratio takes the non-interest expenses (salaries, building costs, technology, etc.) and divides them into revenue. So, the lower the better. A reading below 50% is the gold standard. A reading above 70% could be cause for concern. Fifth Third is at a good 58%.

There are nuances in all this, of course. For instance, a bank may have an unfavorable efficiency ratio because it is investing to create a better customer service atmosphere as part of its strategy to boost revenues and expand net interest margins over the long term.

Meanwhile, ROE and net interest margins can be juiced by taking more risk.

So that brings us to...

The amount of risk it's taking to achieve that earnings power

There are a lot (and I mean a LOT) of ratios that try to measure how risky a bank's balance sheet is. For example, when the Fed does its annual stress test of the largest banks, it looks at these five:

- Tier 1 common ratio
- Common equity tier 1 ratio
- Tier 1 risk-based capital ratio
- Total risk-based capital ratio
- Tier 1 leverage ratio.

If you think that's confusing, you should see their definitions -- they're chockfull of terms like "qualifying non-cumulative perpetual preferred stock instruments."

Personally, I rely on a much simpler ratio: assets/equity.

When you buy a house using a 20% down payment (that's your equity), your assets/equity ratio is at five (your house's value divided by your down payment).

For a bank, I get comfort from a ratio that's at 10 or lower. My worry increases the farther above 10 we go. Fifth Third's is at a reasonable 8.7 after its most recent quarter (8.9 if you're doing the math on the year-end balance sheet above).

We can get more complicated by using tangible equity, but this is a good basic leverage ratio to check out. If you're looking at a bigger bank like Fifth Third, it's also a good idea to check out the results of those Fed stress tests I talked about.

That leverage ratio gives us a good high-level footing. Getting deeper into assessing assets, we need to look at the strength of the loans. Let's focus on two metrics for this:

- Bad loan percentage (Non-performing Loans/Total Loans)
- Coverage of bad loans (Allowance for non-performing loans/Non-performing loans)

Non-performing loans are loans that are behind on payment for a certain period of time (90 days is usually the threshold). That's a bad thing for obvious reasons.

Like most of these metrics, it really depends on the economic environment for what a reasonable bad loan percentage is. During the housing crash, bad loan percentages above five percent weren't uncommon. In general, though, I take notice when a bank's bad loans exceed two percent of loans. I get excited when the bad loan percentage gets below one percent (so Fifth Third's 0.8% is looking good).

Banks know that not every loan will get paid back, so they take an earnings hit early and

establish an allowance for bad loans. As you've probably guessed, banks can play a lot of games with this allowance. Specifically, they can boost their current earnings by not provisioning enough for loans that will eventually default. That's why I like to see the coverage of bad loans to be at least 100%. Fifth Third's is at a conservative-looking 202%.

Finally, I use dividends as an additional comfort point. In an industry that has periods that incent loose lending, I like management consistently taking some capital out of its own hands. I like to see banks paying at least a two percent dividend. A bigger dividend isn't a foolproof way to gauge riskiness, but I get warm fuzzies from a bank that can commit to a decent-sized dividend. As for Fifth Third, it pays out about a quarter of its earnings for a dividend yield of 2.3%.

Putting it all together

I've tried to simplify analyzing a bank as much as I can. I've left out many metrics and concepts, but you've still been bombarded with a lot of potentially boring information.

What's important to remember is that a bank (through its management) is telling you a story about itself. It's our job to figure out whether we believe the tale enough to buy it at current prices.

Because most banks share similar business models, the numbers will go a long way to help you determine if those stories hold water.

If a bank says it's a conservative lender, but half of its loans are construction loans, it has a 10% bad debt ratio, and it's leveraged 20:1, I'm trusting the numbers not the words.

Look at the numbers over the last decade or two and you'll see many clues. When a bank has been able to deliver large returns across a few economic cycles while keeping the same general business model, that's a very good thing. Even better if the same management team has been there the whole time or if the bank clearly has a conservative culture in place that stays in place between management teams.

It's easy to get lost in the minutiae of analyzing a bank, but going in with a framework helps you keep your eyes on the big picture. What I've shared today are the four tenets of my basic framework...I hope it helps clarify yours.

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