Bank Peer Analysis
How Far Do You Hit the Golf Ball and How High Is Your ROAE?

Some might find it boring to watch golf. Last weekend, we didn’t watch any of the Ryder Cup. By now you know the match wasn’t close. The Europeans steamrolled the Americans 17½ to 10½. What’s funny about saying “the Europeans” is that most of them live in the U.S. and play on the PGA Tour. If you watched any of the coverage, you know that the Europeans showed great respect to the Americans because they will soon be back in the U.S. playing side by side with them. Aside from Patrick Reed, they’re all friends. The Europeans don’t want to tick off their American counterparts, although we’re sure they love the fact that they made the American team look like a bunch of hacks!

While last week’s Ryder Cup golf was boring to watch, have you seen the Long Drive World Series, where the guys try to drive the ball as far as they can? Now that’s exciting to watch! Guys with arms bigger than Popeye’s hit the drives as far as they can. Sometimes their drives are more than 400 yards! Yet none of these long ball hitters are playing on the PGA Tour. To find success on the Tour, a golfer needs to have not only great driving, but also a great iron game and superb putting. If we relate hitting the longest drive to banking, it’s not whether you have the highest return on average assets (ROAA) or return on average equity (ROAE). You have to have a complete “game” to be the top performer in banking. In golf, the statistic that summarizes it the best is your handicap or stroke average, not how far you hit your drive.

When it comes to banking, there’s a competition going on in real time every day. So, which bank is the better bank? For customers, they want great service, low loan rates, and high deposit rates. They want it all! While bank managers need to do their best to please their customers, their main focus should be on the shareholder. Without the shareholders, there is no bank! In the August 2018 edition, American Banker announced its top 65 banks in the $10 billion to $50 billion asset range. We always find these rankings interesting. The number one bank is Bank of Hawaii Corp. (NYSE: BOH), with a three-year ROAE of 15.30% from 2015 to 2017, while the number two bank is Western Alliance Bancorp. (NYSE: WAL), with a three-year ROAE of 15.00%. Nearly identical.

The problem is, American Banker is using the wrong statistic for its ranking! Just like your driving distance on the golf course not telling us how good a golfer you are, ROAE doesn’t tell us how good your bank is. What counts is total return. What total return does your institution produce for shareholders? That’s what really matters.

One problem with ROAE is that it’s an accounting measure that doesn’t capture risk. We in finance know that the overarching paradigm for analyzing performance is risk versus return. But it’s hard to quantify risk. While Bank of Hawaii and Western Alliance look nearly identical in terms of ROAE, their three-year total returns are remarkably different. First, consider a reasonable benchmark – the SNL Bank Index for banks greater than $10 billion. For the same 2015 to 2017 three-year period, the total return on the Index is 50.3%. Pretty good. You’d expect the top two banks to deliver higher total returns, and they do. Bank of Hawaii’s total return, including dividends, is 56.5% while Western Alliance’s is 103.7%. Wait a minute. If these two banks’ ROAEs are so similar, why would Western Alliance’s total return be almost double Bank of Hawaii’s?

When you dig deeper into the numbers, you see that the two banks are vastly different. In terms of risk, Bank of Hawaii’s equity multiplier is 13.9, based on its most recent ROAA (1.10%) and ROAE (15.27%). In stark contrast, Western Alliance’s equity multiplier is 9.1, based on its most recent ROAA (1.72%) and ROAE (15.65%). This 53% higher equity multiplier is evidence that Bank of Hawaii is taking more financial risk. We certainly aren’t suggesting that they are taking too much risk, but if all else is equal, if a bank is taking more risk, the market will expect a higher return on equity. When ranking banks, the American Banker survey ignores risk.
As evidenced by Bank of Hawaii’s lower ROAA, the bank’s core profitability is less than Western Alliance’s. Bank of Hawaii has a lower net interest margin (2.93% FTE) than Western Alliance (4.65% FTE). This 172 basis point difference is huge. Nevertheless, we see a lot of dispersion between banks’ margins, and a low margin isn’t necessarily a negative. It appears that Bank of Hawaii is balancing higher financial risk with lower credit risk. Each institution has to decide how much risk to take in the different categories of risk, such as financial, credit, interest rate, and liquidity. But when we see a bank taking on less credit risk and producing such a lower margin, we often in turn see greater efficiency at the bank. But for Bank of Hawaii, that’s not the case. Its efficiency ratio (55.60%) is 34% higher than Western Alliance’s (41.48%). The deeper we dig into the numbers, the more we question if the number one bank in the American Banker ranking is deserving of that honor.

Finally, all valuation models – whether valuing a firm’s equity or overall enterprise value – are driven by growth assumptions. Typically, we see higher growth assumptions in the earlier years that then level off at a more realistic level. Again, we like what we see for the second-place bank versus the top bank. Western Alliance’s year-over-year net income growth is 25.29% versus Bank of Hawaii’s 1.77%, and its core deposit growth is 17.18% versus 0.90%. No surprise, Western Alliance is growing noninterest expenses (13.31%) faster than Bank of Hawaii (1.05%), but the adage “you need to spend money to make money” applies in this case. As long as Western Alliance can grow net income faster than noninterest expense, we don’t care how fast they grow expenses.

Yes, rankings are interesting; so are long drive competitions. But we take rankings with a grain of salt. We recognize that there’s a lot of controversy about corporations being too shareholder centric. But without capital, there is no corporation. And with no corporation, there are no great products and services. And without great products and services, there are no happy customers! So while bank executives and board members might like to hit long drives and see their banks produce high ROAEs, they need to find a game that produces a low handicap and peer-beating total returns, consistently over time. The professionals at Ambassador Financial Group are dedicated and have the expertise to help you find the business model that will maximize shareholder returns at your bank. And, some of our colleagues at the firm are pretty good golfers too!

John S. Walker, Ph.D, CFA
Chief Economist
Ryan J. Walker
Senior Vice President