Is bank C&I loan growth structurally hampered?

Industry Overview

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United States
US Banks

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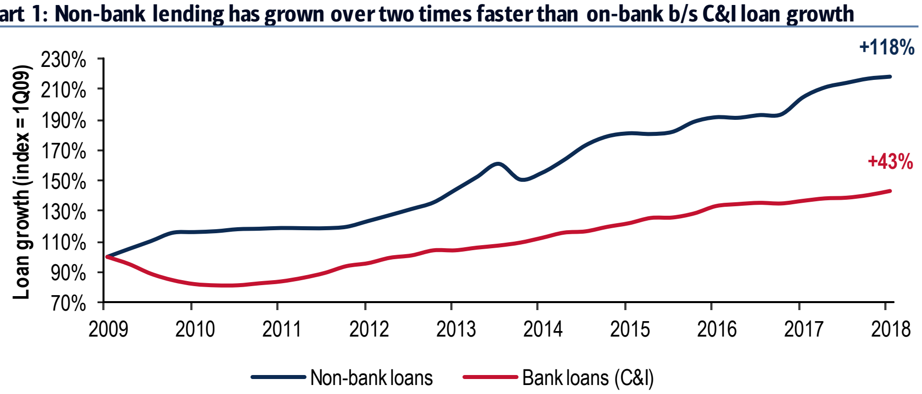
Non-bank lenders taking share

The great hope for bank stocks is that a solid US economy will drive accelerating loan growth, and, consequently, higher spread revenues. Heading into the year, tax reform was expected tounlock business activity like a coiled spring; however, on bank balance sheet C&I loan growth has started the year off at a slower pace (+1.4% YTD vs. +2.3% historical avg. through 2Q). Banks of all sizes (from mega to mid) have cited strong levels of client cash, and, more notably, increased competition from non-banks.

In week's *Chart of the Week*, we look at the increase in competition from lending extended by non-bank players. In order to estimate the size the non-bank lending market, we exclude IG/HY corporate bonds and bank balance sheet loans from a known debt universe as defined by the Fed's flow of funds report. Since 2009, non-bank lending has grown at an 8% CAGR, nearly two times that of on bank balance sheet commercial loan growth over that same period. Said another way, non-bank C&I lending has grown 118% since the cycle vs. 43% for bank loans. While it is easy to point to the smaller balances of the non-bank players as a reason for this faster growth, as a percent of GDP, we observed similar trend. Non-bank loans have increased their share by ~260bp since 2009 while bank lending has only increased ~110bp. The aggregate size of the market for non-bank C&I lending is $1.7tn vs. $2.1 for bank C&I loans.

Bottom line for the stocks: Bank stocks have underperformed the broader market by 680bp YTD amid slower-than-expected loan growth coupled with an anticlimactic deregulatory backdrop. Although most banks we cover appear to have chosen to maintain underwriting discipline over growth, with funding costs expected to pick up many investors are concerned spread income growth will likely slow following subsequent rate hikes. As such, we highlight banks that are best positioned to benefit from rising rates (on the asset side) as well as those with solid operating deposit bases to defend against margin cannibalization. On this theme, we prefer: **CMA**, **ZION**, **RF**, **CFR**, and **SIVB**. Meanwhile, players that are growing organically and carefully into new markets may outperform revenue expectations. In this vein, we highlight **JPM** and YTD underperformer **PNC**.

Chart 1: Non-bank lending has grown over two times faster than on-bank b/s C&I loan growth



Source: BofA Merrill Lynch Global Research, Federal Reserve, FDIC
Note: Non-bank loans consist of leveraged loans and private-direct middle market loans. Bank loans consist of C&I loans

Refer to important disclosures on page 6 to 8. Analyst Certification on page 3. Price Objective Basis/Risk on page 2.

11915851

Timestamp: 23 September 2018 07:00PM EDT

Stocks mentioned

BofAML Ticker	Bloomberg ticker	Company name	Price	Rating
CMA	CMA US	Comerica	US$ 94.63	B-1-7
CFR	CFR US	Cullen/Frost	US$ 109.43	B-1-7
JPM	JPM US	JP Morgan Chase	US$ 117.85	B-1-7
RF	RF US	Regions Financial	US$ 19.44	B-1-7
SIVB	SIVB US	SVB Financial	US$ 324.09	B-1-9
PNC	PNC US	The PNC Financial	US$ 144.01	B-1-7
ZION	ZION US	Zions	US$ 52.57	B-1-7

Source: BofA Merrill Lynch Global Research.

Price objective basis & risk

Comerica Incorporated (CMA)

We use a three-factor valuation framework (P/E, P/TBV, DCF) to arrive at our $109 PO and assign a 2.4x multiple to 2019E TBV and 14x multiple on 2019E EPS due to below peer balance sheet growth. We have weighted the P/E and P/TBV factors equally at 33%, and our DCF analysis by 33%. Our DCF assumes a two-stage cost of capital of 12.3% and 10.5% and a terminal growth rate of 5% and Tier 1 common of 8% at termination.

Downside risks to our PO are a more severe than expected impact from lower energy prices and/or a slower-than-expected rate of Fed hikes/faster rising deposit costs.

Cullen/Frost Bankers Inc (CFR)

Our $125 PO is based on a three-factor M&A valuation methodology that assumes: a 15x P/ 2019e EPS and a target P/TBV of 2.8x to 2018 tangible book, multiples that are a slight premium to peers given stronger return profile . The third factor reflected an estimated takeout value based on our proprietary M&A scorecard. A bank that scores above average will receive a higher target multiple in line with historical deal valuations.

Upside risks to our PO: continued strong economic activity in TX which should drive better than expected loan growth, continued balance sheet optimization to drive further margin growth and better than expected credit performance of CFR's energy loan portfolio.

Downside risks: A worse than expected decline in Texas economic growth that impacts CFR's balance sheet growth, a slower than expected pace or rate hikes and a worse than expected sell off in oil prices

JPMorgan Chase & Co. (JPM)

We use a three-factor valuation framework (P/E, P/TBV, DCF) to arrive at our $132 PO, assigning a 2.25x multiple to 2019E TBV and 13x multiple on 2019E EPS given the bank's earnings potential and benefit from de-regulation. We have weighted the P/E and P/TBV factors equally at 40%, and our DCF analysis by 20%.

Near term, we view JPM's current market P/E multiple as trading at a premium, but expect the bank to continue to trade at a discount to the regionals. Our 13x multiple is in line with our median multiple as we believe in the near future, money centers will continue to trade at a discount to regional peers. Our DCF assumes a two-stage cost of capital of 10% and a terminal growth rate of 4%.

Risks to our price objective are macro risks such as slower-than-expected rate increases, additional regulatory requirements, and scrutiny of the financials industry. Specific to

JPM, risks are enhanced regulatory and capital standards as a Global SIFI, mortgage putback risk, material decline in investment banking/trading profitability, and increased litigation.

Regions Financial (RF)

We use a three-factor valuation framework (P/E, P/TBV, DCF) to arrive at our $22 price objective. We assign a 2.5x multiple to 2018E TBV. Regional banks currently trade at a tangible book multiple that is 0.5x higher than its ROTCE (return on tangible common equity), and we project RF to earn a 16% ROTCE in 2018. We assign a 13.8x multiple on 2019E EPS in line with our forward assumptions for large regional peers. Our DCF assumes a cost of capital of 10% and a terminal growth rate of 2% and Tier 1 common of 9.5% at termination.

Downside risks to our PO are a slower-than-expected pace of Fed interest rate hikes and higher expense growth.

SVB Financial Group (SIVB)

Our $400 PO is based on a three-factor M&A valuation methodology that assumes: a 18.5x P/ 2019e EPS (previously 19.5x) and a target P/TBV of 3.2x to 2018E tangible book, in line with other high growth peers. The third factor reflected an estimated takeout value based on our proprietary M&A scorecard. A bank that scores above average will receive a higher target multiple in line with historical deal valuations.

Downside risks are a longer than expected low rate environment and a slowdown in the technology sector and related IPO activity. Upside risks are sooner than expected rate hike, or better than expected pickup in the tech sector.

The PNC Financial Services Group, Inc. (PNC)

We use a three-factor valuation framework (P/E, P/TBV, DCF) to arrive at our $168 PO and assign a 2.2x multiple to 2018E TBV and 15x multiple on 2019E EPS, in line with target multiples for the median large regional banks under coverage. We have weighted the P/E and P/TBV factors equally at 40%, and our DCF analysis by 20%.

A superior profitability profile suggests an above peer multiple - however, a challenging macro backdrop and specific industry headwinds restrain our P/E target. Our DCF assumes a two-stage cost of capital of 9.6% and 11.2% and a terminal growth rate of 4%.

Downside risks to our PO are macro risks such as a lower for longer rate environment, the implementation of a strict liquidity coverage ratio and further regulation on overdraft income that restricts bank profitability.

Zions Bancorp (ZION)

We use a three-factor valuation framework (P/E, P/TBV, DCF) to arrive at our $62 price objective and assign a 1.7x multiple to 2018E TBV (in line with historical averages). Our 16x P/E multiple, which we apply on 2018E EPS, reflects a 2x premium to peers (in-line with post-crisis average) due to better revenue prospects from higher interest rates. Our DCF assumes a two-stage cost of capital of 16.1% and 11.6% and a terminal growth rate of 8%.

Downside risks are a deterioration in energy prices and/or an interest rate shock that drives higher debt service costs, potentially creates a credit issue.

Analyst Certification

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North America - Banks Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
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	BankUnited, Inc.	BKU	BKU US	Ebrahim H. Poonawala
	BB&T Corporation	BBT	BBT US	Erika Najarian
	Byline Bancorp, Inc	BY	BY US	Ebrahim H. Poonawala
	Citigroup Inc.	C	C US	Erika Najarian
	Comerica Incorporated	CMA	CMA US	Erika Najarian
	Cullen/Frost Bankers Inc	CFR	CFR US	Ebrahim H. Poonawala
	East West Bancorp, Incorporated	EWBC	EWBC US	Ebrahim H. Poonawala
	First Bancorp Puerto Rico	FBP	FBP US	Ebrahim H. Poonawala
	First Hawaiian Inc.	FHB	FHB US	Ebrahim H. Poonawala
	First Republic Bank	FRC	FRC US	Erika Najarian
	Great Western Bancorp Inc	GWB	GWB US	Ebrahim H. Poonawala
	Hancock Whitney	HWC	HWC US	Ebrahim H. Poonawala
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	IBERIABANK Corp	IBKC	IBKC US	Ebrahim H. Poonawala
	JPMorgan Chase & Co.	JPM	JPM US	Erika Najarian
	KeyCorp	KEY	KEY US	Erika Najarian
	New York Community Bancorp	NYCB	NYCB US	Ebrahim H. Poonawala
	Regions Financial	RF	RF US	Erika Najarian
	Royal Bank of Canada	RY	RY US	Ebrahim H. Poonawala
	Royal Bank of Canada	YRY	RY CN	Ebrahim H. Poonawala
	Signature Bank	SBNY	SBNY US	Ebrahim H. Poonawala
	SunTrust Banks, Inc.	STI	STI US	Erika Najarian
	SVB Financial Group	SIVB	SIVB US	Ebrahim H. Poonawala
	Synovus Financial Corp.	SNV	SNV US	Ebrahim H. Poonawala
	TCF Financial Corp.	TCF	TCF US	Ebrahim H. Poonawala
	Texas Capital Bancshares Inc.	TCBI	TCBI US	Ebrahim H. Poonawala
	The PNC Financial Services Group, Inc.	PNC	PNC US	Erika Najarian
	Toronto-Dominion Bank	TD	TD US	Ebrahim H. Poonawala
	Toronto-Dominion Bank	YTD	TD CN	Ebrahim H. Poonawala
	UMB Financial Corporation	UMBF	UMBF US	Ebrahim H. Poonawala
	Wells Fargo & Company	WFC	WFC US	Erika Najarian
	Zions Bancorp	ZION	ZION US	Erika Najarian
NEUTRAL				
	Associated Banc-Corp	ASB	ASB US	Ebrahim H. Poonawala
	Bank of Montreal	BMO	BMO US	Ebrahim H. Poonawala
	Bank of Montreal	YBMO	BMO CN	Ebrahim H. Poonawala
	Bank of Nova Scotia	YBNS	BNS CN	Ebrahim H. Poonawala
	Bank of Nova Scotia	BNS	BNS US	Ebrahim H. Poonawala
	Fifth Third Bank	FITB	FITB US	Erika Najarian
	First Horizon National Corp.	FHN	FHN US	Ebrahim H. Poonawala
UNDERPERFORM				
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	Bank of Hawaii Corp.	BOH	BOH US	Ebrahim H. Poonawala
	Canadian Imperial Bank of Commerce	CM	CM US	Ebrahim H. Poonawala
	Canadian Imperial Bank of Commerce	YCM	CM CN	Ebrahim H. Poonawala
	Citizens Financial Group	CFG	CFG US	Erika Najarian
	Commerce Bancshares Inc.	CBSH	CBSH US	Ebrahim H. Poonawala
	M&T Bank	MTB	MTB US	Erika Najarian
	Prosperity Bancshares Inc	PB	PB US	Ebrahim H. Poonawala
	U.S. Bancorp	USB	USB US	Erika Najarian
RSTR				
	FCB Financial Holdings, Inc	FCB	FCB US	Ebrahim H. Poonawala

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Equity Investment Rating Distribution: Banks Group (as of 30 Jun 2018)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	103	51.50%	Buy	87	84.47%
Hold	39	19.50%	Hold	34	87.18%
Sell	58	29.00%	Sell	49	84.48%

Equity Investment Rating Distribution: Global Group (as of 30 Jun 2018)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1639	55.35%	Buy	1044	63.70%
Hold	615	20.77%	Hold	390	63.41%
Sell	707	23.88%	Sell	340	48.09%

* Issuers that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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