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Banking on energy

You'd be hard-pressed to find a comelier collection of regional banking statistics than the ones assembled in the accompanying table. Each datum—capital adequacy, loan quality, net charge-offs or market-assigned valuation—rings a bullish bell. As for the institutions that stand behind the figures, we're bearish on the lot.

The long-drawn-out consequences of the oil and gas bust is the subject under discussion. The corporate cast of characters features Texas Capital Bancshares, Inc. (TCBI), Cullen/Frost Bankers, Inc. (CFR), BOK Financial Corp. (BOKF) and Hancock Holding Co. (HBHC). The conclusion, already tipped, is that the worst is yet to come. You can't blame the banks for the macro- and microeconomic scrapes in which they find themselves. But you could sell them.

The four share the salient feature of heavy exposure to oil and gas production. Each bank shows energy loans—to servicers and to exploration and development companies—approximately equal to its tangible equity. Each bank is likewise exposed to the knock-on effects of contracting business activity in energy-intensive regional economies. The banks are valued as if it were otherwise; only Hancock trades much below the KBW Regional Banking Index valuation average.

BOK Financial, the only one of the four that would talk to our inquiring reporter, Evan Lorenz, speaks up for its credit policy. Consider, says Joseph J. Crivelli, BOK's investor-relations man, that funds advanced to E&P borrowers customarily take the form of senior, reserve-based credits. Such loans are adjusted twice annually for changes in the price of oil. "It is the best-performing asset class in our loan portfolio over any time period you pick," Crivelli tells Lorenz. Over the past 15 years, gross losses on E&P credits at BOK have averaged a trifling 0.08% per annum. Then, again, most of this experience (BOK and its predecessors have been at it for a century) antedates the shale revolution.

Price is ever the key, as it almost goes without saying, and one might argue that energy prices are even now scraping bottom. Or one might insist that "lower for longer" is the money forecast. If the former, the risk-reward calculus would seem to favor an investment in the stricken energy borrowers themselves rather than in the still fully valued energy lenders. If the latter, the share prices of even the better-financed E&P companies are likely to come under new pressure—and so, too, might the shares of the banks that lend to them.

While the four banks do business from Florida to Arizona, and as far north as Colorado, each does most of its lending in the oil- and gas-patchy states of Oklahoma, Texas and Louisiana. Texas Capital and Cullen/Frost are headquartered in Dallas and San Antonio, respectively. Texas Capital manages a national mortgage-finance business (27% of loans as of Sept. 30), but otherwise confines its lending to Texas. Cullen/Frost lends strictly within the borders of its home state. BOK, headquartered in Tulsa, lends principally in Oklahoma and Texas (73% of the Sept. 30 loan portfolio). In the securities side of its business, BOK heavily emphasizes fixed-rate investments (the better to neutralize interest-rate risk, says Crivelli). Hancock Holding, which hails from Gulfport, Miss., does business in six states, including (besides its home state) Florida, Alabama, Louisiana, Tennessee and Texas; 68% of its assets take the shape of loans, 21% of securities.

Banks in the oil patch

	mkt. cap ($ mns.)	SI/ float	price/ earnings	P/tang. book	div. yield
BOK Financial Corp.	$4,659	17.4%	16.1	1.7	2.5%
Cullen/Frost Bankers, Inc.	4,402	10.5	15.7	2.0	3.0
Texas Capital Bancshares, Inc.	2,752	10.7	20.1	1.8	0.0
Hancock Holding Co.	2,274	8.6	15.3	1.3	3.3

	energy/loans ($ mns.)	tang./equity ($ mns.)	ann. net charge-offs	NPL ratio	loss reserves/ loans
BOK Financial Corp.	$2,838	$2,947	0.05%	0.8%	1.4%
Cullen/Frost Bankers, Inc.	1,789	2,241	0.11	0.5	1.0
Texas Capital Bancshares, Inc.	1,100	1,570	0.06	0.7	0.8
Hancock Holding Co.	1,661	1,719	0.09	1.4	1.0

sources: company reports; the Bloomberg

This analysis would be simpler if the forward oil-and-gas price curve foretold the future. What it rather seems to reflect is the present. Thus, on June 20, 2014, when the spot price of West Texas Intermediate crude oil peaked at $107.26 a barrel, the December 2021 contract changed hands at $86.36 a barrel. The quote today is less than $60 a barrel, a level which, if realized, would consign most shale producers to bankruptcy. So let us liberally sprinkle grains of salt on Mr. Market's out-year soundings.

Assume, however, that current readings are approximately correct. Breakeven prices of natural gas, though they vary from producer to producer, in no case are as low as the currently quoted Henry Hub price of $2.20 per million Btu. Consider that six million Btu translate into the energy equivalent of a barrel of oil, that is, into a $13.20 barrel of oil. The not-entirely clairvoyant futures market currently projects that gas prices will reach $4 per million Btu—equivalent to $24 per-barrel WTI—in January 2025.

Energy-sensitive loans come in two basic flavors: advances to producers, i.e., E&P companies, and to non-producers, i.e., servicers. As a percentage of tangible equity as of Sept. 30, loans to E&P companies amount to 82% for BOK, 57% for Cullen/Frost, 50% for Texas Capital and 35% for Hancock. As a percentage of tangible equity, also as of Sept. 30, loans to servicers amount to 14% for BOK, 22% for Cullen/Frost, 20% for Texas Capital and 61% for Hancock. Not for no reason is Hancock the cheapest of our four stocks. Without a profitable E&P business, service companies would have nothing to service.

"Let us drill down into the details of the banks' respective energy lending books, each as of the third quarter," Lorenz proceeds. "Here, too, disclosure is non-uniform. Hancock provides the best break-out: $1.7 billion of the Hancock energy portfolio consisted of non-drilling services (41% of total loans), exploration and production companies (37%), drilling services (16%) and midstream, i.e., pipelines and related infrastructure (6%).

"The others, in sum: BOK, 85% to oil and gas producers, 8% to energy service companies, 4% to midstream companies, and 3% to wholesale/retail energy borrowers. Cullen/Frost: 72% to oil and gas producers, 15% to service companies, 3.4% to private plant ('that means rich people,' the chairman and CEO, Richard W. Evans, explains), 4% to manufacturing-related companies, 3.7% to energy transporters, 1% to traders and 0.4% to refiners. Texas Capital: five-sevenths to oil and gas producers, one-seventh to service companies, one-seventh to the universal category called 'other.'"

Some producers hedge themselves, from which it follows that some portion of a bank's energy exposure is likely to be protected against the ravages of price decline. Which banks are so shielded, and what is the thickness of their financial armor?

Disclosure is spotty, and portfolio protection is generally far from ironclad. Cullen/Frost says that 6% of its energy borrowers have hedged. Hancock says that its "E&P customers," i.e., 37% of its energy loan book, have hedged, and that "many" of these borrowers have done so with an average tenor of 2½ years. You may ask, What portion of production is thereby protected? Hancock doesn't say. BOK is entirely mum on the subject: "We don't disclose that, because it is a very misleading number," Crivelli tells Lorenz. Texas Capital says that more than half of its "oil-weighted borrowers" have "accretive" hedges covering at least half of 2016 production. "Whatever this might mean," Lorenz remarks, "it's evidently less than meets the eye. As E&P credits at Texas Capital are tilted 61% to oil and 39% to gas, we are talking about half of 61%."

Compounding the risk of energy-related defaults are the secondary effects of weakening business activity in the oil and shale regions. "I think that the ancillary effects are probably the bigger credit risk for any of these guys with geographic exposure," Emlen Harmon, the Jefferies LLC analyst who covers Cullen/Frost, Hancock and Texas Capital, tells Lorenz. "It is always hard to predict what, exactly, asset classes or credits will be affected and whose business will be most impacted. The most notable area of concern outside of direct energy exposure is construction. . . . Anyone who is actually in some of those oil-heavy geographies, like a local retail complex or hospitality, in places where a lot of people were previously employed by the energy industry—discretionary income is falling. There is any number of ways that the ancillary effects can play out, but those are the areas of greater concern."

One might add that the effects will play out eventually. It's a slow-moving regional energy recession. Unemployment in Texas and Oklahoma, at 4.4% and 4.3%, respectively, remains below the national average of 5% (Louisiana is higher at 6.2%). Cullen/Frost, in its third-quarter call, reported that economic growth in Texas is still positive, though its pace has slowed. "Everyone is waiting to see [an oil-driven contraction in activity] and, to date, it is a non-event," Crivelli says. "We talked about on the call that, compared with last year, total non-farm payrolls are up both in Oklahoma and Texas despite losing 15% of the E&P jobs in Oklaho-

Oil companies at risk

	mkt. cap ($mns.)	SI/float	6/20/14	11/24/15	% chg.
Ultra Petroleum Corp.	636	16.4	$29.84	$4.15	-86%
Carrizo Oil & Gas, Inc.	2,367	8.4	68.25	40.58	-41
Oasis Petroleum, Inc.	1,725	26.2	53.63	12.40	-77
Range Resources Corp.	5,213	14.1	87.96	30.78	-65
Chesapeake Energy Corp.	3,651	39.1	29.22	5.49	-81

	S&P rating	cash ratio	current ratio	quick ratio	net debt /EBITDA
Ultra Petroleum Corp.	B+	0.08	0.45	0.08	4.81
Carrizo Oil & Gas, Inc.	B+	0.01	0.57	0.20	3.07
Oasis Petroleum, Inc.	BB-	0.03	0.87	0.27	3.13
Range Resources Corp.	BB+	0.00	0.91	0.24	4.56
Chesapeake Energy Corp.	BB-	0.39	0.79	0.67	3.84

source: The Bloomberg

ma and 10% of the E&P jobs in Texas. The overall economies in both states continue to perform very well, even in markets that you would think of as more energy-exposed, such as Houston and Oklahoma City."

Perhaps it's no small thing that 15% of Oklahoma's E&P jobs have vanished; Chad Wilkerson, a vice president of the Kansas City Fed's Oklahoma City Branch, finds that energy and support industries accounted for 16% of total Oklahoma household earnings in 2013. Which is to say that Oklahoma will miss those high-wage energy jobs, and BOK Financial, which has 38% of its loan portfolio in the Sooner State, might especially miss them.

Lorenz undertook a survey of business activity in the oil- and gas-producing portions of the Southwest by scanning the transcripts of some relevant third-quarter earnings calls. He finds no smoking gun but rather a kind of cyclical six-shooter with the hammer cocked.

Thus, fast-food chain Sonic Corp. is upbeat on Texas. Home Depot, ditto. "We looked at all the major markets in Texas, and they actually performed above the company average in total," Home Depot CEO Craig A. Menear told the Nov. 17 conference-call audience.

Denny's Corp. (casual diner), Brinker International, Inc. (which owns the Chili's and Maggiano's Little Italy chains), BJ's Restaurants, Inc. (casual diner) and Del Frisco's Restaurant Group (steakhouse chain) are downbeat.

Aaron's and Rent-A-Center ("rent-to-own" consumer goods) are likewise downbeat, and so is Haverty Furniture, whose CEO Clarence H. Smith had this to say on Oct. 29: "San Antonio and Austin . . . were great markets. They are performing okay, not like they used to. In other words, Texas was the hottest state we had, and now it is a bit of a drag." Group 1 Automotive says that, while its Oklahoma clientele is shifting to used vehicles from new, Texas remains strong.

"Now I'm from Texas," Tempur Sealy chairman and CEO Scott L. Thompson told dialers-in to the mattress-maker's third-quarter earnings call, "so I've been through at least three major downturns in the oil business. And look, you don't feel it immediately, it takes a while. So, although the third quarter, that area came in strong, I would expect going forward that we would begin to feel some weakness in those marketplaces over the next few quarters."

In sum, we find our quartet of energy banks slightly overvalued for present-day conditions and acutely overvalued for the persistence of present-day conditions. We find them uninteresting for a reversion to pre-2014 energy conditions. Lots of potential downside, little potential upside.

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