Reflections On A Year That Changed Everything

While enjoying the holidays with my family, I like to reflect on the prior year and begin to shape my commentary around the year ahead. The year that just passed was certainly a unique one. The Cavaliers and Cubs both won championships in the same year, ending mythological droughts for a city and a franchise. Closer to our hearts, Penn State won the Big 10 college football championship and had a wonderful Rose Bowl. Probably most surprising, on election night, the State of Pennsylvania not only voted Republican for the first time since 1988, but provided Donald Trump the electoral votes necessary to put him over the top and secure the presidency.

You can't talk about the last year without the election being front and center. Heading into the election, the headwinds in the banking environment were significant. Interest rates were low, the yield curve was flat and growth was stagnant. Regulators were focused on cybersecurity and commercial real estate concentrations, cap rates were stressed and competition for the limited credit opportunities was severe. The long, slow recovery showed no signs of speeding up. After the Trump victory, following a brief Brexit-type panic which came and went before the market opened the next day, the dialog shifted to growth, deregulation, corporate tax reform and a rising rate and steepening yield curve environment. Domestic-based industries not affected by the protectionist rhetoric of the incoming administration, with financials in the spotlight, rose to new highs, and after stopping to catch its breath at year-end heading into the inauguration, the market continued higher with the Dow crossing 20,000 in late January. With a Republican House, Senate and White House, a business-friendly environment was sure to come.

On Election Day, the median price-to-tangible book value for Pennsylvania-based banks of $1 billion in assets or greater was 138 percent, and by the end of the year, that had risen to 173 percent. The five highest-valued banks in the state were, on average, valued at 198 percent of tangible book value on Election Day, and that rose to 261 percent of tangible book value by the end of the year. On a price-to-earnings basis, Pennsylvania-based banks went from 16 times earnings to 19 times earnings. Fundamentals hadn't changed, but expectations were sky high. The only thing that was certain was uncertainty, which continues to be rolled out 140 characters at a time. Incoming calls from my banking clients went from "How do I get my stock price higher?" to "Why is my stock price so high?"

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Richard Quad is a trusted advisor to banking executives and Boards of Directors of community banks throughout the Eastern United States. He provides investment banking services to financial institution clients, including sell-side M&A, buy-side M&A, capital markets and related strategic and valuation services.

Rich has more than 25 years of experience in both investment banking and commercial banking in the Northeast. As a senior investment banker, he has successfully completed over 60 assignments for more than 40 community bank clients including common, convertible, preferred stock and subordinated debt offerings, buy-side, sell-side and FDIC receivership transactions, as well as strategic and general advisory assignments.

Prior to joining Griffin, Rich was most recently Head of U.S. Financial Institutions M&A at RBC Capital Markets. During his 11-year tenure at RBC, he also served as Co-Head of U.S. Depository Institutions. He joined RBC in 2001 following its acquisition of Tucker Anthony Sutro, where he was a Vice President in the Financial Institutions Group.

Rich's prior experience includes tenures with regional broker-dealer Advest, Inc., where he also worked in financial institutions investment banking, as well as with Banknorth Group, Inc., at the time a $2 billion bank holding company headquartered in Vermont, where he founded the company's internal M&A function and coordinated the bank's first two acquisitions.

Rich received a B.S., *magna cum laude,* in Business Administration with a concentration in finance from the University of Vermont and an MBA with distinction from Cornell University. He holds Series 7 and 63 licenses from FINRA.

Did the banking environment really change that radically overnight, or have the expectations and euphoria of a business-friendly administration gone too far, too fast? Were the headwinds we all felt in October a thing of the past by November, or just forgotten about in the volatility of the moment? Banks wasted no time thinking too hard about where they were and rushed to the equity markets to raise capital at lofty valuations. The M&A market, however, took a pause to assess the situation. While buyers were eager to use their newly inflated currencies, sellers showed caution over accepting a new and premium-priced currency in a volatile market and began to examine whether the forthcoming environment made going at it alone more viable.

So where do we go from here? Not surprisingly, much like the politics of the day, I have found that bankers' views of the market are just as polarizing as the election itself. The bullish scenario seems as much relief as euphoria. From the day the Dow crossed 10,000 in 1999 until it crossed 20,000 in January of this year, an increase of 100 percent, the S&P Bank Index is down 11 percent over the same period, so financials are primed to outperform. A higher GDP should stimulate loan growth, and rising rates and a steepening yield curve will create more profitability for banks along the way. Deregulation is music to the ears of bankers everywhere, and if corporate tax reform could take hold, not only will banks themselves pay lower taxes, enabling more earnings to be levered into higher growth, but bank clients will also pay lower taxes, allowing them to borrow more.

Not so fast, say the bears. A polar opposite and equally vocal view says that bank valuations have come too far, too fast, that the market is priced

to perfection and that the headwinds in the market before the election have not gone away. Valuations are even higher than they were before the most recent downturn, consumer credit is stretched and keeping interest rates lower for longer has inflated asset values that will come down as interest rates go up. While deregulation is one of the pillars of the Trump platform, banking regulation is least likely to be affected, as Dodd-Frank is embedded into the fabric of financial institutions, with the Consumer Financial Protection Bureau and mortgage banking reform, given the background of Treasury Secretary Mnuchin, likely to receive most attention. A comprehensive tax package can't be done by Executive Order and needs to wrap in the border tax or other equivalent to help pay for the revenue shortfall, so timing is uncertain at best.

As with our politics, the answer is almost certainly somewhere in between, and timing plays a big role. Can infrastructure spending, job creation and other growth-oriented measures offset the impact of rising interest rates on asset values and debt service? Will an economically favorable environment after years of slow recovery breathe new life into the community banking market that fights with the idea of being too small to succeed? What we know for sure is that the environment in Washington will have a more immediate and meaningful impact on the world in which we live more so than perhaps at any point in our lifetimes, and while the volatility around day-to-day news and events is enormous, the economy seems far more likely to improve than not. I look forward to exploring these views, their impact on our industry and the outlook for our future in more detail with you at the Annual Convention in Marco Island in May.