Bird’s Eye View of Bank Analysis (Citizens First Republic)

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Dave

0:00

All right, folks, welcome to Investing for Beginners Podcast. Today we are going to take a bird's eye view at a bank and walk through a bank statement and how to kind of analyze a bank because we got this great question that we thought would kind of help spur this conversation. So I'll go ahead and read the question. And we'll go ahead and start with our analysis of a bank. So here we go. Hey, Andrew, and Dave, I wanted to ask you about citizens Financial Group, C, F. G, I looked at the stock on finviz.com.

And also glimpse the recent earnings report. Everything looks very good. With all the reason bank fear now seems to be like a great time to get into this company, as Buffett is says, and you all have repeated be fearful when others are greedy and greedy when others are fearful. Is this stock a good to be true case? Is there something I'm missing in the financials, I would greatly appreciate any help you can provide? And thanks for all you do. I'm 20. New to investing Berkshire, your research wetter, and you always podcast has been super helpful and giving me the confidence to create a financial plan to support my future family. Thanks so much Best regards, Samuel. Well, Jamie, it's our pleasure. And you're obviously you're from the south with all the y'all.

So I appreciate the shout out from the south. So, Andrew, let's talk about banks. So this is something we've not really done much on in quite some time. So maybe we could talk to people about banks and how to utilize them.

Andrew

1:17

But love to and Thanks for writing in St. mil, I enjoyed this question. And hopefully it's helpful. Do we want to kind of run down some context on what just happened in the banking world just from a 30,000 foot view? So people understand why I feel like in regular life, nobody really even knows what's going on with banks. But certain pockets of finance and technology are really shook up from what happened with a couple banks in California. So we can talk about that real quick.

Dave

1:47

Yeah, so for those of you who might have missed, there's been three big banks in the news recently, that have all experienced a lot of turmoil and upheaval, because not necessarily that things are horrible, with banks in general, but just in with these three particular banks and possibly a fourth. So the first one is Silicon Valley Bank, which is a bank out in California, ran into some trouble.

And over a kind of a long weekend, there was a lot of back and forth between people that bank there and the government ended up having to take over the bank because they had gotten to do a bank run. And they had liquidity problems from poor decisions made by management over the last few years, that really led to some problems with the bank. And that caused a lot of fear in the banking industry and other banks started to struggle in the stock market, not in the banks themselves, but just in the stock market because of fears of a wide spread like a contagion, so to speak. And then there was another bank in New York synchrony bank, that also went through some shake ups as well. And this was more related to deposits and crypto. And again, not bashing crypto, but it was they were related.

And there were some issues with that. And that caused a bank run which caused some fear of a bank failure. And overseas, there was another bank, Credit Suisse, who has been on the struggle bus for quite some time since I was working in the banking industry, which was five or six years ago. So it's been a long time coming, they started to experience a lot of problems with their liquidity as well. And UBS, a bank in Europe also ended up buying them out. And so those three stories all kind of happened around the same time period, which caused a lot of people, especially in the stock market, to think that there could be problems systemically with banks, it's turning out to not be the case. And there was a lot of fear and greed in the market.

So a lot of bank stocks started to fall, which is what prompted Samuel to look at probably citizens financial. And so that's why I think maybe in the context of why he's asking this question, people can understand now, I don't want people to think that banks are in trouble that banks are bad, that your accountant, your local bank, you're doing fine. So they'll if we want to analyze bank stocks, there's there are a lot of things you want to think about. So understanding the overall context can help a little bit. I love

Andrew

4:11

that that's perfect. And maybe we can start with that kind of Black Swan risk. Where what makes a bank, there's many things that make banks different from your regular business. But one of the big ones is that not only can they run into trouble if they have too much debt, but they can also run into trouble if they lose a bunch of depositors. So maybe talk just briefly about like the basics of banks and deposits and where the risk is there and how investors can look at the bank and and analyze if they have that risk more than somebody else.

Dave

4:47

Yeah, so a lot of this stuff is all kind of interconnected, but the basic function of banks is to take deposits and make out and put out loans. So when you and I go to our bank and put our paycheck in The bank, the bank has the ability to take that money and then loan it out to someone else to buy a car or a home, whatever, what have you. And we have this system in the United States called fractional banking, which basically means that they can take $1 and in one and out into $4, and possibly in four different ways. And what happens is those deposits are considered liabilities, because that's money that the bank owes us. That's our money.

And so when I come to ask for my $10 back, that the bank has loaned out, they have to give me the $10. And if they don't have it, then they have to figure out a way to generate liquidity to generate that $10 To give it back to me if they have loaned out too much money. And Silicon Valley Bank, that's what ended up happening to them is that so many people came to ask for the deposits back the cash, that they didn't have the cash to give it back because they loaned it out. Or they in this particular case, they put it in investments that had gone south, they had invested in different stocks, not stock, but different bonds, and treasury bills and things of that nature that the bond market had turned south, and so they weren't worth as much.

And so when they went to sell their $100 bond for $50, they don't generate as much money and they don't have as much money to give back to the depositors who are requesting their money. So that's in essence, I guess, kind of what happened with Silicon Valley Bank, and also an overview of kind of how banks work.

Andrew

6:27

And I think what's key there is, for the vast majority of time, and the vast majority of banks, there's plenty of money that go around, there's just there can be stress in the system of a particular bank, when everybody wants their money out at the same time. And so there are guardrails in place, like the FDIC, which keeps people's money saved, but if you are, let's say, a startup or a venture business, and you have more money in a bank than the FDIC covers, then you're gonna be more freaked out and want to pull your money out because up, some of that money is not insured.

And that's kind of what happened there is Silicon Valley Bank was basically all startups, right? Who are probably over that limit. The bottom line is they all got made whole, the depositors did Silicon Valley Bank, shareholders lost everything. So that is maybe a good place to start thinking about a bank, is you have the deposits on one side, you have the loans on the other side. And if you can understand how a bank's deposits are comprised, I think that can really help with really the risks that everybody forgets until the tide comes out every once in a while. Yeah, this is actually a specific risks to banks that you don't see in other industries or companies. So I guess for me, I think it could be helpful to kind of go through some of the key parts of a bank, like citizens Financial Group, as a learning exercise.

So Sammy, I might disappoint you, I'm not gonna give an opinion or against citizens in particular, I will say I am invested in two different big banks. And I'm so far beating the market with one and losing to the market with the other. So you can, you know, take that for what it's worth. But you know, I think, I think with a general understanding, a lot of people can get their hands around some of the differences in some of the different banks, and you definitely don't want to paint it with a paintbrush, broad strokes and say, Yeah, this is endemic of all banks. Needless to say, this is probably going to be one of our more complex episodes. And if you get overwhelmed by all the bank talk, just stick to regular companies, and you should be fine.

So I'm pulling up citizen financial group's 10k, which is their publicly filed annual report, and I'm using BAM sec.com. So if you happen to be home at your computer, and you can sneak a peek at their annual report, you can follow along. But I'm skipping to Item eight, which is where the financial statements are. And this financial report lets you click down to skip. And then there's all these different notes that gives you more information over the financials. So I'm just going to start on the income statement. And what I want to look for is how does this bank generate money.

So you have what's called interest income and non interest income for this bank, they generate about 7 billion in interest income, and about 2 billion and non interest income. So what that tells me is that this is more of your traditional bank, like Dave was saying, they take deposits, they loan it out, and they make interest on those loans. Because if you look inside their interest income of that 7 billion, almost 6 billion comes from loans and leases. So that tells us that this is a pretty hot and dry, more standard bank. In contrast to some of the big banks like JPMorgan Bank of America, Wells Fargo, who have all these other things that they make money from, which makes it so much more complex. So this is actually a great example, because we can make it a lot more simpler. And so the first place I would go is the income statement so that I can see, generally, how does this bank make their money? And then from there, you can kind of laser in and to Okay, now I know where they make their money. Let me focus on that part of the business.

Dave

10:29

Yeah, yeah, exactly. And when you look at Citizens income statement, you can see the, you know, the two main income streams as well as the expenses. And just understand that the income is going to be offset by the expenses. And terminology that you would use for with Apple is not always going to apply with a company like citizens financial, or banks, just in general, one of the things that is harder than make more challenging with banks is because they speak air, quote, a different language, their accounting is different than apples. And so terminology, like gross margin, or operating margin are things that aren't really going to come into play.

When you're looking at banks, you're really looking at more like net interest margin, which is the the margin that they make based compared to the overall revenue, and you want to see what that is. And then you also want to see what kind of non interest income they make. And also compare that to the overall revenue. And that will also give you an idea of what kind of net margin they get. So you know, banks have the same kinds of expenses that Apple does, you know, they have to pay for the employees, they have to pay for the rent.

And, you know, they have to pay for equipment, and you know, all those kinds of things, but they don't have the same kinds of, you know, r&d, and they won't have the same kinds of depreciation and amortization, they will have them, but it's different. And so just some of those things will help you kind of get past like, if you first look at the income statement go. And we'll get this, you know, especially if you're used to look into Coca Cola, and McDonald's or Walmart, and Apple, and all these air, quote, regular companies, and then you look at a bank, you go.

So once you kind of get past that little, that little hurdle and understand the different components of how it is, you know, net income, for example, or net interest income for a bank is really based on what Andrew was talking about where the money they generate from loans, and the interest that they make compared to the expense of generating that money. And that expense comes from the deposits that they have to pay to entice people to deposit money in their bank. So when you get a notification saying the Ally Bank has raised their savings rate to 4.2%, that's an expense to Ally Bank. And the idea is that they can generate a spread between the rates that they charge people to buy a car versus the rates that they have to do to entice me to deposit my money in the bank. Because the two work together, you can't have one without the other, if they don't have deposits, they can't lend out money for cars. And they can't make money if they can't have a big enough spread.

And that's where the whole interest expense interest rates that they charge come into play. And you don't have to understand all the nitty gritty of it. But if you just understand the overview of that's how, you know, most banks generate the majority of their money in in Citizens Bank, that's very evident, just by looking at that you can already tell that they are going to be very big lender, versus having services and things of that nature, just by looking at their income statement,

Andrew

13:28

it's really a great way to look about it and think about it. And getting through looking at a bank can be really complex. But if you can simplify as much as you can, and just think, big picture and zoom out as much as you can. So to think about that spread they're making between the loans and the deposits, something you have to consider when Ally Bank makes a car loan to somebody is there's a chance that person doesn't pay back the car loan. And so what that happens for Ally Bank is they would lose money on that loan. So when you're comparing banks, some of them are going to make safer loans than others.

And in general, I don't want to say that this is true for everybody. But in general, the riskier loans they make, the higher margin they can make, the bigger that spread is because the more risky loan is, the higher your interest rates going to be for that, but also the higher risk for the bank that you default. So what I like to do kind of being really safe and then trying to think of how can I invest in a bank that's going to be I can sleep at night knowing that in 10 years, they should still be around as I like to go to that loan book and just kind of see in general, does it look safe? So going back to the financial statements for citizens financial, if we go back to those notes, like I mentioned, and I'm sorry that not every bank is going to have it in the same spot so you might have to do some digging. But for citizens It was no five has loans and leases.

So I'm gonna click on that. And then inside of the section that's going to tell you what kind of loans they're making. And I think that also helps paint a pretty good picture. So they've got about half of their loans are commercial and half are retail what retail means it's everyday Joe's, like you and I were mortgages for cars, for home equity for student loans. So knowing that, and then you can dig through the different line items, and maybe start with something that's a bigger line item. And then usually, these banks will have disclosures about how risky they think those loans are, or sometimes there's even more objective measures.

So for example, one of the banks I own has a decent amount of exposure to residential mortgages. And so a lot of times when there's mortgage exposure or credit card exposure, the banks will actually tell you what percent of their loans are what FICO score, so I can see, okay, you know, their credit score for the people they're loaning money to, you know, maybe 80% of people have a 700 credit score or higher. So you can use that information and then compare it to other banks. So they're doing similar loans. And that's where you can start to get a good sense of is this bank on the riskier side or is on the cheaper or not cheaper, is on the riskier side, or is on the safer side as it refers to their loans. And that can really help reduce the risk and holding some of these companies and stocks for the long term.

Dave

16:30

Yeah, those are some great little nuggets and tips to assess the credit quality of the loans that the company has. And that's going to go a long ways towards determining how safe a bank is, because those are for the most banks, that's where they're going to generate a vast majority of their income or a very large part of their income. Like Andrew said, some of the more money center banks like JP Morgan, or Bank of America that have so many different branches of revenue, it's going to be a little more diluted, but particularly when you get into smaller banks or regional banks, you're going to find a lot more loan based companies that are going to generate a lot of money from them.

And another little cheat code that I have found, along with looking at the notes, which is a great idea. Every company does quarterly calls. And a lot of companies will put out they will put out slides that describe a lot of the things that they talk about in the earnings calls. And if you have some, you know, gumption, you can open those and look at those in some of the slides will define what kinds of credit scores their portfolios have. And I'm going to give you an example, Fifth Third Bank, for example, every quarter, when they report their earnings, they put slides in there that will tell you this commercial loan has, you know, an average of 720 credit score, and these auto loans have an average of 740 credit score. So they'll give you numbers to give you an idea of how strong the people are that they're lending to. And vice versa. I read recently that Ally Bank, who does a lot of auto loans, those tend to be air quote, riskier loans than more secured loans, like a mortgage, for example. And so their credit scores that they offer are around the 640 to 650 range. And that's kind of the average for loans that they're giving out to people for cars. And I'm not saying those are bad credit scores. So if you're sitting there with the, you know, a score like that, that's horrible, it's not, but it indicates the strength of the loan portfolio that they have. And then you can compare that to Fifth Third Bank. And you can compare that to Citizens Bank, if they reveal that information. Unfortunately, not every bank is going to reveal that information, which is a bit of a bummer. But it is a neat little trick that you can use to help you get a sense of without having to look at all the numbers all the time, sometimes just something like that can give you an overview of hey, this is they have a pretty decent loan portfolio just by the credit score that they're giving to people.

Andrew

19:00

That's very well said.

Dave

19:03

So let's move on to we talked about loans. And we talked about how they kind of generate money. And we kind of look at the I guess the balance sheet because composed compared to most companies, we generally look at income statements and cash flow statements, where as the income statements important cash flow statements important, but for banks, the balance sheet is like the everything. So like if you're looking at a balance sheet, to think about how to analyze a bank stock, what are a few things that you would pick out, there'll be something that you want to kind of dig deeper into.

Andrew

19:37

I mean, as soon as you ask that question, my mind automatically goes to some of the finer details and I don't want to lose people. So maybe you would, could you start on maybe something fundamental that that would be easy to grasp for a beginner.

Dave

19:52

I think the two places that I look are things that we've already talked about that relate back to the income statement and one would be the loan the loan portfolio and the other one would be the deposit portfolio. And so both of those are on the balance sheet, you can find them in that information, they will state whether the loans are assets. So these are, those will be under the asset section under the long term assets. And then the deposits will be under the current liabilities is, and that's where you can find those. And generally, you want to see those going up, you want to see those improving. And that's a sign of a healthy bank. Because when you see those kinds of numbers going up, it means that they're taking more money.

And so they're attracting people to help generate more revenue for them. And they're also being effective in loaning out the money, which is also going to generate revenue for them. So they're kind of interconnected. But again, it goes back to this as an asset. And this is a liability. And you can kind of look at how that how those compare to the overall assets for the business, as well as the overall liabilities for the business as well. And that can give you a good sense of how financially stable the bank is. And so that's, that's like the first two things I generally look

Andrew

21:04

at. That's really, really good. We can take a step further and just in general, look at the debt picture. Because while yes, you can have things fall apart for a bank, because of deposits, yes, you can have a fall apart because of the loans defaulting. But you can also have it happen because too much debt comes due actually, one of the things I found out when I was researching into Washington Mutual, remember that whole story from like, over a decade ago, was, I felt like it wasn't talked about much. But they had a huge, they had a huge debt come due for the bank itself. So even if even if the whole fiasco didn't happen, I wonder if they would have even stayed solvent because they had this huge debt that roll through and were able to, you know, if they weren't able to refinance it, then that could have been what took them out.

So for this bank, in particular systems Financial Group, we can look at their long term debt. And what I see here is a long term debt that went from 6.9 billion to 15.8. So more than doubled. That kind of gives some alarm bells to me. And it's like, I would want to see why did that happen. And they went from a net cash position to a net debt position. So they used to have around close to 10 billion in cash versus the 6.9 billion in long term debt. Now they have around 10 billion in cash to close to 16 billion in debt. It's just a different situation. And so it would be a situation where maybe if I look at a company like JP Morgan, and they have net cash, plenty of it, and the long term debts not that big of a deal, then I probably don't look at it as closely as I would a bank that says, that tells me okay, maybe I need to pay closer attention. Yeah,

Dave

22:51

that's a great insight. And those are, again, all parts of figuring out how financially secure and strong the bank is. And understanding of that relationship between the debt and how it works. For the bank. The thing that always pops into my mind when Andrew was talking about that is, we want to ask ourselves questions when we're looking through these financial statements.

And you're kind of looking at that particular situation where you see that the debt has gone up? That's a question I would ask myself why I need to know why this is. Because if you just look at the number, there may not be any legitimate reason that you can deduce. But then once you start reading through the management commentary, you may discover that they did that too by another bank, for example. And I'm not saying that that's justified, but it at least gives you an idea of like, okay, now I understand why they did that. And then you can go about analyzing whether that's a good price to pay, and whether that's a good thing for the bank to do, and all those things. But whether you will come at the income statement, the balance sheet, or the cash flow statement, it's always good to look at it through the lens of asking questions. So you can dig deeper into things not just taking it at surface value.

For example, we were talking about loans and deposits earlier, you want to know why they're going up, you know, what's driving is the company have some sort of promotion that's going on, that maybe could eat into their profits on the income statement versus what they're doing with trying to to grow deposits. We were talking about Ally Bank earlier a moment ago. That cost of raising their savings rate also comes at the expense of possibly damaging their income for the business. And so it's just a good idea to understand all the kind of context of all of this but it all comes back to just kind of understanding the overall basic of the business and then understanding how everything interrelates in interrelates excuse me, and how we can ask ourselves questions. And the more you do this, the better questions you're gonna ask, and the more logical a lot of things will look to you as you do more of it.

At first, it's gonna be like anything else, you're gonna be overwhelmed with technology or term analogy and not really understanding all this. But like anything else, the more that you do it, the more it'll become second nature to you, and you'll understand all that. But the asking questions is, for me is always something I really try hard to do.

Andrew

25:12

It's advice that all beginners shouldn't really consider, and hopefully not get too overwhelmed about, it took me a long time to get to finally wade in the bank territory. I remember taking several very large bites, and then having to put it down and just kind of walk away and, and coming back to it when I learned more and kind of got a fresh perspective. So there's totally nothing wrong with doing that at all. It's not like you're completely waving a white flag, countless times researched something and put it down and come back to it later with a fresh perspective. And keep being curious, always asking questions, rather than trying to make a decision right away, I think can go a long way to becoming a better investor. Yeah, totally agree.

Dave

25:59

I think that's sound advice. All right. So we've talked a lot about the income statement, the balance sheet and talked about some of the things that you can look for in those particular areas. Is there anything else that you think might be pertinent for investors, especially newer or more immediate investors that are really wants to start looking at banks or any other I guess, red flags or potential pitfalls that you could that people could fall into? A

Andrew

26:23

great question. I would say it might change, you know, five years from now, it might be a different red flag. So you just kind of have to keep an open mind. And just try to, like you said, question everything. One thing I will say is, I noticed the last couple years, when I was looking at a lot of different banks, you mentioned growing deposits, and how you can kind of do that too aggressively by maybe sacrificing too much bank, paying too high of a rate, something I noticed is a lot of the banks, a lot of the smaller ones that were growing really, really fast. Were also basically gobbling up other banks. And I'm not saying that one bank, buying another bank is always a bad move.

There's definitely times when banks can take advantage of that. blood in the streets, the fear in the market, kind of an idea. But I just I felt like there were a lot of banks that seemed like they're being very aggressive. And they were fueling their growth by buying a lot of smaller banks, and diluting their shareholders as they were doing it, which means they're giving away more parts of the company. Now you're owning less. So I will just watch out for that, in today's environment, that if you see a growth rate, that seems too good to be true. It probably is. And you want to make sure that these banks aren't overpaying to buy other banks to turbocharge their growth. Yeah,

Dave

27:49

well said most. I think that's a great final tip for people when they're analyzing banks to kind of take into the whole picture as they're kind of thinking about these different opportunities that will present themselves in a market. And hopefully today's show is helped you to help you realize that, yeah, you can invest in banks. And it's not, it's not an overcome over insurmountable mountain that you can you can get over it once. I think once you start to understand the terminology, I think being able to analyze a bank becomes a lot simpler. It's just a matter of learning the language and then kind of moving on from there. Yeah. All right. Well, with that, everyone, we'll go ahead and wrap up today's show.

Thanks. Again, Samuel, for sending us such a fantastic question. That was a lot of fun to talk about. And hopefully, everybody got some good warnings out of that. So everyone, don't forget to subscribe to our show on your preferred podcast app if you enjoyed our little podcast. If you would kindly consider giving us a review. It greatly helps the show. And don't forget to browse the incredible materials that we created for you and E investing for beginners.com particularly related to banks with today's show. And lastly, consider growing your knowledge as an investing for beginners insider with insights and educational tips delivered right to your inbox for free sign up today.

And with that, I'll go ahead and wrap us up you guys go out there and invest with a margin of safety, emphasis on the safety. Have a great week and we'll talk to you all next week.