



INTEREST RATES PUMMEL BANKS, YET TRUXTON REMAINS RESILIENT



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After a rough 2022, stock investors have experienced a modest recovery in 2023 through mid-July. The broad big-cap index, the S&P 500, has rallied 10% since we rang in the New Year.

The gains have left out some sectors, however. Including ours: The Banks. We monitor an index with the symbol KRE, an index of regional banks, all far larger than Truxton, but below the size of the global giants. That index was down 17% in 2022 and is down a further 32% in 2023. This analysis leaves out dividends, but that won't have eased the pain very much against these declines. Truxton shares have done far better but remain below all-time highs. TRUX started 2022 at \$64 per share and closed today at \$59. Now, you've received over \$2.14 in dividends during that period, but the stock is still below the highs.

What has the investor base so grouchy about banks?

The **first problem** is rising rates. Often, bank profitability benefits from rising rates, but not this time. Rates have risen too far too fast, and the wrong parts of the yield curve have risen the most. The Prime rate was 3 ¼% scarcely over a year ago, now 8.5%. When rates rise slowly, banks typically see the rates charged on floating rate loans rise a bit faster than what the bank must pay for deposits. Banks' longer maturity, fixed rate loans and bonds lose value when rates rise, but these mature in time and are renewed or re-invested at higher rates. But when rates rise very far, very fast, the increase in the cost of deposits can swamp the benefit of the rising yield on assets, resulting in a lower net interest margin (NIM). Net interest income is by far the largest contributor to earnings at most banks. A falling NIM almost always hampers earnings growth, even if the assets of the bank continue to grow. A very simple example. A bank with \$1 billion in assets and a 3% NIM makes \$30 million of net interest income. If it grows to \$1.1 billion in assets but NIM falls to 2.5%, the net interest income falls to \$27.5 million, even though the bank grew nicely.

Almost all small and mid-sized banks have seen some decline in NIM and Wall Street expects further pressure as more customers bellyache about what

they are being paid on deposits. This works itself out over time as fixed rate assets mature and re-price, but the pain can last several years depending on how a given bank is “situated”.

The **second problem** for bank valuation is bad loans. Here’s the odd part. Most banks today have almost no bad loans but worries about the future have put a lid on valuations and stock prices. There is some likelihood of a recession in 2024 which would push more consumers and businesses into distress. Also, certain businesses, people, and properties are doing fine paying interest today because their fixed rate borrowings are still very cheap. But many will see their rates double when their current loan matures. The rising rates are great for the bank UNLESS...unless the borrower can’t pay the higher rates and defaults. That’s the specter haunting bank stocks: one of these days, banks are going to have some bad loans. No one knows when and how many, but the prospect puts fear into value investors who might otherwise “dabble” in the banks.

So what about Truxton Corporation and its wholly-owned bank Truxton Trust Company? We are not immune to interest rate and credit concerns, but we have some very strong pillars on which to rest. First, almost half our revenue comes from our wealth management business. There, the rising value of the broad market is a big help. Our NIM fell by 29 basis points from the December 2022 quarter to the one we reported on July 20, but our earnings rose to an all-time high, in part because wealth management revenue rose 8% over the referenced period. Second, we are in Nashville and most of our credit exposure is in Nashville. Nashville’s economy remains very strong and our

job growth and wage gains support asset values and liquidity and therefore loan quality. That may change, but in recent years, it has been hard to make a bad real estate loan in Nashville. Famous last words? Time will tell.

For now, Truxton Corporation shares still trade at over 2x our book value per share and at more than 10x our trailing four quarters’ earnings per share. Both are far higher than typical banks below \$10 billion in assets. ■

**All financials are as of 10/03/23*