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Closing this book

Still a high quality bank – but two things concern me

16 February 2023 *Research Report* ***Update 2***

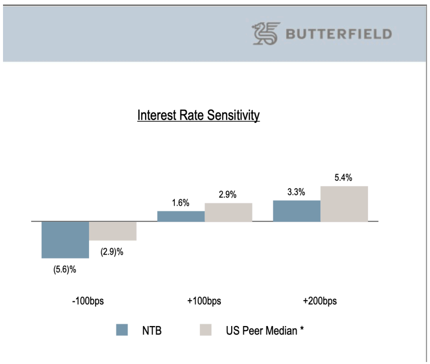
AFTER ITS MOST RECENT RESULTS, WE HAVE A GOOD OPPORTUNITY TO TAKE MONEY OF THE TABLE.

To be clear: neither were the results bad, nor is the bank suddenly low quality. The Management even announced a new share repurchase program of the equivalent of 6% of stock outstanding. I think this is the main driver for the strong pop of its stock – from the low 30s now to the high 30s.

In my last update from November, I wrote that Butterfield *(NTB)* is strengthening within the rising interest rates environment, due to a strong loan portfolio with mostly variable rates. They posted strong and improving results, even record numbers on some metrics again.

But this advantage compared to other banks is diminishing. NTB already started in the prior quarter to switch to fixed-rate loans. This continued in the last quarter with a decreasing interest rate sensitivity *(see the screenshot below)*. In its earnings presentation, NTB even shows that other competing banks are due to benefit way more than NTB itself.

At the same time, deposit costs are rising. It seems as if NTB were already approaching its net interest margin top.



Source: Butterfield Q4 2022 results presentation

This locking in and smoothing of the otherwise very volatile business cycle for Butterfield is not a bad thing per se, but it takes steam out of the boiler concerning the upside. New business is slowing down due to macroeconomic uncertainty and way higher interest rates. Organic growth will be more difficult.

Together with the valuation of more than 2.3x tangible book value – which is not low for a bank, maybe okay for a higher quality bank – I miss the clear upside and margin of safety. The PE ratio is ca. 9x which isn't high. But an exotic bank with no growth will likely have a depressed earnings multiple.

Besides slowing growth, we have Butterfield's investment portfolio that I don't like. With rising interest rates, the long-term bonds NTB mainly holds, suffered massively in price. That's okay for so long as the bonds will be paid back. The accounting losses will only be temporary. But they locked in low returns, while the accounting losses lower the capital ratios of the balance sheet. This is holding back the bank from higher distributions. That's also the reason why the dividend isn't growing.

With an inverted yield curve, i.e. short-term bonds offering more yield than long-term bonds, they lost their attractiveness. It goes even so far that China and Japan – the two biggest holders of US bonds which NTB mainly also holds – are selling their holdings. Bid for long-term bonds is shrinking!


REUTERS
World Business Legal Markets Breakingviews Technology Investigations
U.S. Markets
3 minute read · June 16, 2022 5:42 AM GMT+2 · Last Updated 8 months ago
China's holdings of U.S. Treasuries skid to 12-year low; Japan also cuts holdings
By Gertrude Chavez-Dreyfuss

Source: Reuters

With this, I'd close this chapter.

The price return since my report is +12.1%, the total return including one dividend payment +13.5%.

All the best,

Alan Gałecki

Alan Gałecki

Founder of Financial-Engineering.net

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