Achieving Record Return, A Financial Analysis

TRUXTON TRUST
A PRIVATE BANK

Andrew L. May
President and
Chief Financial Officer

Very few banks earn a 20% return on their average equity capital (ROAE). In the latest *American Banker* list of smaller, publicly-traded banks ranked by ROAE, only ten banks averaged a 20% return over the last three years out of about 700 in the sample.

In the first half of 2022, Truxton Corporation earned 21.5% on equity, by far our highest ever. How did this happen? Answer: a combination of enduring fundamental qualities of our business and some special circumstances, perhaps transitory.

1 **Business mix**

Truxton gets nearly half its revenue from our wealth management business, fee income that requires minimal equity capital. Most banks derive almost all their income from interest margin – the gap between what they pay depositors and what they charge borrowers for loans. Problem is, the regulators require banks to have very substantial equity capital in case some of those loans go bad. Remember, ROAE is a ratio – the denominator is the bank's equity capital. The bigger that equity base must be, the harder to create above normal returns. Because Truxton earns fees from a business that requires minimal equity capital, high returns are possible.

2 **Operating leverage**

Earning higher margins as the business grows through thrifty practices. Truxton rents the same number of square feet of mediocre real estate as we did seven years ago when the business was less than half its current size. Truxton ended 2016 with 55 employees. Today we have 62. The business has doubled in size. Our people are working harder and earning more but the payroll cost per dollar of revenue has fallen substantially. That's operating leverage. Employee cost plus occupancy were 44% of revenue in 2016; for 2022 (annualized), 37%.

3 **A quirk related to rising interest rates**

A little bank accounting inside baseball, bear with me. As interest rates rise, bond prices fall. Truxton owns about $300 million in bonds out of $900 million in assets. Banks mark their bond portfolios to market every quarter, but not their loans. A decline in the bonds is offset on the balance sheet by a decline in shareholders equity. Remember, that's the denominator in the ROAE calculation. Our book equity was $84 million last December; at June 30, it was $71 million. That helps ROAE!

4 **A little interest rate good luck that won't last**

When interest rates started to rise this winter, depositors had spent years earning almost nothing on their short-term money. Banks paid nothing; money market funds paid nothing. For the first several small moves by the Federal Reserve, not much changed. Truxton got the benefit of rising yields on our floating rate bonds and loans but paid minimally higher interest resulting in a rising interest margin. Our interest margin rose by 14 basis points in the quarter ending June 30, 2022 compared to the September 30 quarter a year ago. With accelerating rate increases, that's changing. We're paying more for deposits so that we can maintain that funding and our interest margin is likely to decline a bit, at least for the short term.

For now, our ROAE is higher than we ever imagined it could be. That allows us to grow the bank and pay very significant dividends without having to raise new capital. Shareholders should rejoice but be humble in knowledge that success is not permanent. ▪