SN VALUATION
SN CAPITAL SN CONSULTING SN ENGLISH

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Loan Loss Provision

Loan loss accounting does not require a separate cash reserve to be held for the loan provision. Additional provisions are expensed, but cash is not moved from the cash balance to a particular reserve account. The cash stays in cash. A loan loss provision is essentially a write down of a loan receivable, an asset account. It is likened to a depreciation in the value of an asset, which has no bearing on cash. However, this book price adjustment is reflected as an expense. The expense will hit the net income and as a result, will decrease the retained earnings, offsetting each sides of the balance sheet. This is why the loan loss expense is added back into the operating cash flow, as it was not a cash outflow.

So, during the Great Recession, when banks were posting large loan loss provision expenses, it didn't impact the cash flow, dollar for dollar, although the collectable interest would have been reduced. I.e. if a bank recorded a $500MM loan loss provision, the write-down would have reduced the book value by the amount, but wouldn't have drained the banks of $500MM in cash at that very moment. However, most banks' loans are funded by the depositors' money, so the bank would have had to raise that $500MM somehow since the deposit would be redeemed by the depositors' sometime in the future. With the recession affecting both the equity and credit market, banks would have been tied up, unable to raise additional capital to return depositor money, making them technically insolvent, should there be a run on the bank.

Aside from loan hits, interest rate movements, and overexpansion/bloated SG&A expenses, banks should not have a difficult time making money. It's a relatively safe business and the valuation is attractive as most banks trade near book, and distributes dividends.

It is important to develop a fine comb understanding of the loan loss account, as it is in our opinion, the biggest mover of the bank value and stock value. Others may argue for interest rate movements. We envision the business model like a driver who goes on a unhurried, serene weekend drive along the Pacific Coast Highway. There may be a few tight turns along the road (interest rate movement), but for the most part, it is a peaceful drive (stable earnings). However, ever 100 miles or so, land mines are laid along the road (loan loss provision) and activating one of those mines will be enough to blow up the car and the passengers. In other words, interest rate movements reduce earnings quality, but loan loss provisions blow up the bank.

SN Valuation FIG Portfolio

As of 2013-09-11

Buy

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)
Premier Financial	PFBI	11.81	12.61	08/07/2013	-6.34%
Microfinancial	MFI	7.69	7.75	09/06/2013	-0.77%
EZCORP	EZPW	17.81	16.98	09/02/2013	4.89%

Average Total Return -0.74%

Follow

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)

*Intraday Market Price