PNC FINANCIAL SERVICES GROUP, INC.
Form 10-Q
August 02, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2017

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 001-09718

The PNC Financial Services Group, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania	**25-1435979**

(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

The Tower at PNC Plaza, 300 Fifth Avenue, Pittsburgh, Pennsylvania 15222-2401

(Address of principal executive offices, including zip code)

(888) 762-2265

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer , accelerated filer , smaller reporting company , and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of July 21, 2017, there were 479,206,546 shares of the registrant s common stock ($5 par value) outstanding.

THE PNC FINANCIAL SERVICES GROUP, INC.

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FINANCIAL REVIEW

THE PNC FINANCIAL SERVICES GROUP, INC.

This Financial Review, including the Consolidated Financial Highlights, should be read together with our unaudited Consolidated Financial Statements and unaudited Statistical Information included elsewhere in this Report and with Items 6, 7, 8 and 9A of our 2016 Annual Report on Form 10-K (2016 Form 10-K). We have reclassified certain prior period amounts to conform with the current period presentation, which we believe is more meaningful to readers of our consolidated financial statements. For information regarding certain business, regulatory and legal risks, see the following: the Risk Management section of this Financial Review and of Item 7 in our 2016 Form 10-K; Item 1A Risk Factors included in our 2016 Form 10-K; and the Legal Proceedings and Commitments Notes of the Notes To Consolidated Financial Statements included in Item 1 of this Report and Item 8 of our 2016 Form 10-K. Also, see the Cautionary Statement Regarding Forward-Looking Information section in this Financial Review and the Critical Accounting Estimates And Judgments section in this Financial Review and in our 2016 Form 10-K for certain other factors that could cause actual results or future events to differ, perhaps materially, from historical performance and from those anticipated in the forward-looking statements included in this Report. See Note 14 Segment Reporting in the Notes To Consolidated Financial Statements included in this Report for a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a generally accepted accounting principles (GAAP) basis. In this Report, PNC , we or us refers to The PNC Financial Services Group, Inc. and its subsidiaries on a consolidated basis. References to The PNC Financial Services Group, Inc. or to any of its subsidiaries are specifically made where applicable.

Table 1: Consolidated Financial Highlights

Dollars in millions, except per share data	Three months ended June 30		Six months ended June 30	
Unaudited	2017	2016	2017	2016
Financial Results (a)				
Revenue				
Net interest income	$ 2,258	$ 2,068	$ 4,418	$ 4,166
Noninterest income	1,802	1,726	3,526	3,293
Total revenue	4,060	3,794	7,944	7,459
Provision for credit losses	98	127	186	279
Noninterest expense	2,479	2,360	4,881	4,641
Income before income taxes and noncontrolling interests	$ 1,483	$ 1,307	$ 2,877	$ 2,539
Net income	$ 1,097	$ 989	$ 2,171	$ 1,932
Less:				
Net income attributable to noncontrolling interests	10	23	27	42
Preferred stock dividends	55	42	118	105
Preferred stock discount accretion and redemptions	2	1	23	3
Net income attributable to common shareholders	$ 1,030	$ 923	$ 2,003	$ 1,782
Less:				
Dividends and undistributed earnings allocated to nonvested restricted shares	4	6	10	12
Impact of BlackRock earnings per share dilution	1	3	5	6
Net income attributable to diluted common shares	$ 1,025	$ 914	$ 1,988	$ 1,764
Diluted earnings per common share	$ 2.10	$ 1.82	$ 4.05	$ 3.49
Cash dividends declared per common share	$ .55	$ .51	$ 1.10	$ 1.02
Effective tax rate (b)	26.0%	24.3%	24.5%	23.9%
Performance Ratios				
Net interest margin (c)	2.84%	2.70%	2.81%	2.73%
Noninterest income to total revenue	44%	45%	44%	44%
Efficiency	61%	62%	61%	62%
Return on:				
Average common shareholders equity	9.88%	8.87%	9.69%	8.66%
Average assets	1.19%	1.11%	1.19%	1.09%

(a) The Executive Summary and Consolidated Income Statement Review portions of this Financial Review section provide information regarding items impacting the comparability of the periods presented.

(b) The effective income tax rates are generally lower than the statutory rate due to the relationship of pretax income to tax credits and earnings that are not subject to tax.

(c) Calculated as annualized taxable-equivalent net interest income divided by average earning assets. To provide more meaningful comparisons of net interest margins, we use net interest income on a taxable-equivalent basis in calculating net interest margin by increasing the interest income earned on tax-exempt

assets to make it fully equivalent to interest income earned on taxable investments. This adjustment is not permitted under generally accepted accounting principles (GAAP) in the Consolidated Income Statement. The taxable-equivalent adjustments to net interest income for the three months ended June 30, 2017 and June 30, 2016 were $54 million and $48 million, respectively. The taxable-equivalent adjustments to net interest income for the six months ended June 30, 2017 and June 30, 2016 were $106 million and $96 million, respectively. For additional information, see Statistical Information (Unaudited) section in Item 1 of this Report.

Table 1: Consolidated Financial Highlights (Continued) (a)

Unaudited	June 30 2017	December 31 2016	June 30 2016
Balance Sheet Data (dollars in millions, except per share data)			
Assets	$ 372,190	$ 366,380	$ 361,335
Loans	$ 218,034	$ 210,833	$ 209,056
Allowance for loan and lease losses	$ 2,561	$ 2,589	$ 2,685
Interest-earning deposits with banks (b)	$ 22,482	$ 25,711	$ 26,750
Investment securities	$ 76,431	$ 75,947	$ 71,801
Loans held for sale	$ 2,030	$ 2,504	$ 2,296
Equity investments (c)	$ 10,819	$ 10,728	$ 10,469
Mortgage servicing rights	$ 1,867	$ 1,758	$ 1,222
Goodwill	$ 9,163	$ 9,103	$ 9,103
Other assets	$ 28,886	$ 27,506	$ 29,127
Noninterest-bearing deposits	$ 79,550	$ 80,230	$ 77,866
Interest-bearing deposits	$ 179,626	$ 176,934	$ 171,912
Total deposits	$ 259,176	$ 257,164	$ 249,778
Borrowed funds	$ 56,406	$ 52,706	$ 54,571
Total shareholders equity	$ 46,084	$ 45,699	$ 45,558
Common shareholders equity	$ 42,103	$ 41,723	$ 42,103
Accumulated other comprehensive income (loss)	$ (98)	$ (265)	$ 736
Book value per common share	$ 87.78	$ 85.94	$ 85.33
Common shares outstanding (in millions)	480	485	493
Loans to deposits	84%	82%	84%
Client Assets (in billions)			
Discretionary client assets under management	$ 141	$ 137	$ 135
Nondiscretionary client assets under administration	125	120	117
Total client assets under administration (d)	266	257	252
Brokerage account client assets	46	44	44
Total client assets	$ 312	$ 301	$ 296
Capital Ratios			
Transitional Basel III (e) (f)			
Common equity Tier 1	10.3%	10.6%	10.6%
Tier 1 risk-based	11.6%	12.0%	11.9%
Total capital risk-based	13.7%	14.3%	14.3%
Leverage	9.9%	10.1%	10.2%
Pro forma Fully Phased-In Basel III (Non-GAAP) (f)			
Common equity Tier 1	9.8%	10.0%	10.2%
Common shareholders equity to assets	11.3%	11.4%	11.7%
Asset Quality			
Nonperforming loans to total loans	.90%	1.02%	1.08%
Nonperforming assets to total loans, OREO, foreclosed and other assets	.99%	1.12%	1.20%
Nonperforming assets to total assets	.58%	.65%	.70%
Net charge-offs to average loans (for the three months ended) (annualized)	.20%	.20%	.26%
Allowance for loan and lease losses to total loans	1.17%	1.23%	1.28%
Allowance for loan and lease losses to total nonperforming loans	131%	121%	119%
Accruing loans past due 90 days or more (in millions)	$ 674	$ 782	$ 754

(a) The Executive Summary and Consolidated Balance Sheet Review portions of this Financial Review provide information regarding items impacting the comparability of the periods presented.

(b) Amounts include balances held with the Federal Reserve Bank of Cleveland (Federal Reserve Bank) of $22.1 billion, $25.1 billion and $26.3 billion as of June 30, 2017, December 31, 2016 and June 30, 2016, respectively.

(c) Amounts include our equity interest in BlackRock.

(d) As a result of certain investment advisory services performed by one of our registered investment advisors, certain assets were previously reported as both discretionary client assets under management and nondiscretionary client assets under administration. Effective for the first quarter of 2017, these amounts are only reported as discretionary assets under management. Prior periods were adjusted to remove amounts previously included in nondiscretionary assets under administration of approximately $9 billion at both December 31, 2016 and June 30, 2016.

(e) Calculated using the regulatory capital methodology applicable to PNC during each period presented.

(f) See Basel III Capital discussion in the Capital Management portion of the Risk Management section of this Financial Review and the capital discussion in the Banking Regulation and Supervision section of Item 1 Business in our 2016 Form 10-K. See also the Transitional Basel III and Pro forma Fully Phased-In Basel III Common Equity Tier 1 Capital Ratios (Non-GAAP) 2016 Periods table in the Statistical Information section of this Report for a reconciliation of the 2016 periods ratios.

Executive Summary

The PNC Financial Services Group, Inc. is one of the largest diversified financial services companies in the United States and is headquartered in Pittsburgh, Pennsylvania.

We have businesses engaged in retail banking, including residential mortgage, corporate and institutional banking and asset management, providing many of our products and services nationally. Our primary geographic markets are located in Pennsylvania, Ohio, New Jersey, Michigan, Illinois, Maryland, Indiana, Florida, North Carolina, Kentucky, Washington, D.C., Delaware, Virginia, Georgia, Alabama, Missouri, Wisconsin and South Carolina. We also provide certain products and services internationally.

Key Strategic Goals

At PNC we manage our company for the long term. We are focused on the fundamentals of growing customers, loans, deposits and revenue and improving profitability, while investing for the future and managing risk, expenses and capital. We continue to invest in our products, markets and brand, and embrace our commitments to our customers, shareholders, employees and the communities where we do business.

We strive to expand and deepen customer relationships by offering a broad range of deposit, fee-based and credit products and services. We are focused on delivering those products and services to our customers with the goal of addressing their financial objectives and putting customers needs first. Our business model is built on customer loyalty and engagement, understanding our customers financial goals and offering our diverse products and services to help them achieve financial wellbeing. Our approach is concentrated on organically growing and deepening client relationships across our businesses that meet our risk/return measures.

Our strategic priorities are designed to enhance value over the long term. One of our priorities is to build a leading banking franchise in our underpenetrated geographic markets. We are focused on reinventing the retail banking experience by transforming the retail distribution network and the home lending process for a better customer experience and improved efficiency, and growing our consumer loan portfolio. In addition, we are seeking to attract more of the investable assets of new and existing clients and we continue to focus on expense management while investing in technology to bolster critical business infrastructure and streamline core processes.

Our capital priorities are to support client growth and business investment, maintain appropriate capital in light of economic conditions and the Basel III framework and return excess capital to shareholders, in accordance with the currently effective capital plan included in our Comprehensive Capital Analysis and Review (CCAR) submission to the Board of Governors of the Federal Reserve System (Federal Reserve). For more detail, see the Capital Highlights portion of this Executive Summary and the Liquidity and Capital Management portion of the Risk Management section of this Financial Review and the Supervision and Regulation section in Item 1 Business of our 2016 Form 10-K.

Income Statement Highlights

Net income for the second quarter of 2017 was $1.1 billion, or $2.10 per diluted common share, an increase of 11%, compared to $1.0 billion, or $1.82 per diluted common share, for the second quarter of 2016.

- Total revenue increased $266 million, or 7%, to $4.1 billion.
- Net interest income increased $190 million, or 9%, to $2.3 billion.
- Net interest margin increased to 2.84% compared to 2.70% for the second quarter of 2016.
- Noninterest income increased $76 million, or 4%, to $1.8 billion.
- Provision for credit losses decreased to $98 million compared to $127 million for the second quarter of 2016.
- Noninterest expense increased $119 million, or 5%, to $2.5 billion, reflecting overall higher levels of business activity.

For additional detail, see the Consolidated Income Statement Review section in this Financial Review.

Balance Sheet Highlights

Our balance sheet was strong and well positioned at June 30, 2017 and December 31, 2016.

- Total loans increased $7.2 billion, or 3%, to $218.0 billion.
  - Total commercial lending grew $7.8 billion, or 6%.
  - Total consumer lending decreased $.6 billion, or 1%.
- Total deposits increased $2.0 billion, or 1%, to $259.2 billion.
- Investment securities increased $.5 billion, or 1%, to $76.4 billion.

For additional detail, see the Consolidated Balance Sheet Review section of this Financial Review.

Credit Quality Highlights

Overall credit quality remained stable at June 30, 2017 compared to December 31, 2016.

- Nonperforming assets decreased $221 million, or 9%, to $2.2 billion at June 30, 2017 compared with December 31, 2016.
- Overall loan delinquencies decreased $250 million, or 16%, as of June 30, 2017 compared with December 31, 2016.
- Net charge-offs of $110 million in the second quarter of 2017 decreased 18% compared to net charge-offs of $134 million for the second quarter of 2016.

For additional detail, see the Credit Risk Management portion of the Risk Management section of this Financial Review.

Capital Highlights

We maintained a strong capital position and continued to return capital to shareholders.

- The Transitional Basel III common equity Tier 1 capital ratio was 10.3% at June 30, 2017 compared to 10.6% at December 31, 2016.
- Pro forma fully phased-in Basel III common equity Tier 1 capital ratio, a non-GAAP financial measure, was an estimated 9.8% at June 30, 2017 compared to 10.0% at December 31, 2016 based on the standardized approach rules.
- In the second quarter of 2017, we returned $1.0 billion of capital to shareholders through repurchases of 5.7 million common shares for $.7 billion and dividends on common shares of $.3 billion, completing our common stock repurchase program for the four quarter period ending in the second quarter of 2017.
- In June 2017, we announced share repurchase programs of up to $2.7 billion for the four-quarter period beginning in the third quarter of 2017, including repurchases of up to $.3 billion related to employee benefit plans.
- In July 2017, our board of directors raised the quarterly cash dividend on common stock to 75 cents per share, an increase of 20 cents per share, or 36%, effective with the August 2017 dividend.

See the Liquidity and Capital Management portion of the Risk Management section of this Financial Review for more detail on our 2017 capital and liquidity actions as well as our capital ratios.

Our ability to take certain capital actions, including plans to pay or increase common stock dividends or to repurchase shares under current or future programs, is subject to the results of the supervisory assessment of capital adequacy undertaken by the Federal Reserve as part of the CCAR

process. For additional information, see the Supervision and Regulation section in Item 1 Business of our 2016 Form 10-K.

Business Outlook

Statements regarding our business outlook are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Our forward-looking statements are subject to the risk that economic and financial market conditions will be substantially different than those we are currently expecting and do not take into account potential legal and regulatory contingencies. These statements are based on our current view that the U.S. economy and the labor market will grow moderately in 2017, boosted by stable oil/energy prices, improving consumer spending and housing activity, and some federal fiscal policy stimulus as a result of the 2016 elections. Short-term interest rates and bond yields are expected to continue rising in 2017; inflation has slowed in the first half of 2017, but should gradually accelerate into 2018. Specifically, our business outlook reflects our expectation of continued steady growth in GDP, one 25 basis point increase in short-term interest rates by the Federal Reserve in December of 2017, and an announcement from the Federal Reserve that it will begin to reduce the size of its balance sheet in the fall of 2017. We are also assuming that long-term rates rise at a slower pace than short-term rates. See the Cautionary Statement Regarding Forward-Looking Information section in this Financial Review and Item 1A Risk Factors in our 2016 Form 10-K for other factors that could cause future events to differ, perhaps materially, from those anticipated in these forward-looking statements.

For the full year 2017 compared to full year 2016, we continue to expect:

- Loans to increase by mid-single digits, on a percentage basis;
- Revenue growth in the upper end of the mid-single digit range, on a percentage basis;
- Noninterest expense to increase by low single digits, on a percentage basis; and
- The effective tax rate to be between 25% and 26% absent the impact of any tax reform.

For each remaining quarter of 2017, we expect other noninterest income to be between $250 million and $300 million.

For the third quarter of 2017 compared to the second quarter of 2017, we expect:

- Modest loan growth;

Net interest income to increase by low single digits, on a percentage basis;
Fee income to be stable. Fee income consists of asset management, consumer services, corporate services, residential mortgage and service charges on deposits;
Provision for credit losses to be between $75 million and $125 million; and
Noninterest expense to be stable.

CONSOLIDATED INCOME STATEMENT REVIEW

Our Consolidated Income Statement is presented in Part I, Item 1 of this Report.

Net income for the second quarter of 2017 was $1.1 billion, or $2.10 per diluted common share, an increase of 11% compared to $1.0 billion, or $1.82 per diluted common share, for the second quarter of 2016. For the first six months of 2017, net income was $2.2 billion, or $4.05 per diluted common share, an increase of 12% compared to $1.9 billion, or $3.49 per diluted common share, for the first six months of 2016.

Net income increased in both comparisons driven by a 7% increase in revenue from higher net interest income and noninterest income and a lower provision for credit losses, partially offset by a 5% increase in noninterest expense.

Net Interest Income

Table 2: Summarized Average Balances and Net Interest Income (a)

Three months ended June 30	2017			2016		
Dollars in millions	Average Balances	Average Yields/ Rates	Interest Income/ Expense	Average Balances	Average Yields/ Rates	Interest Income/ Expense
Assets						
Interest-earning assets						
Investment securities	$ 75,352	2.71%	$ 511	$ 70,194	2.68%	$ 472
Loans	216,373	3.82%	2,077	208,330	3.56%	1,860
Interest-earning deposits with banks	22,543	1.04%	58	26,463	.51%	33
Other	9,748	3.38%	82	7,449	3.59%	67
Total interest-earning assets/interest income	$ 324,016	3.35%	2,728	$ 312,436	3.10%	2,432
Liabilities						
Interest-bearing liabilities						
Interest-bearing deposits	$ 179,012	.32%	143	$ 171,847	.24%	104
Borrowed funds	57,524	1.89%	273	53,633	1.57%	212
Total interest-bearing liabilities/interest expense	$ 236,536	.70%	416	$ 225,480	.56%	316
Net interest margin/income (Non-GAAP)		2.84%	2,312		2.70%	2,116
Taxable-equivalent adjustments			(54)			(48)
Net interest income (GAAP)			$ 2,258			$ 2,068

Six months ended June 30	2017			2016		
Dollars in millions	Average Balances	Average Yields/ Rates	Interest Income/ Expense	Average Balances	Average Yields/ Rates	Interest Income/ Expense
Assets						
Interest-earning assets						
Investment securities	$ 75,800	2.69%	$ 1,019	$ 70,232	2.70%	$ 950
Loans	214,324	3.75%	4,018	207,757	3.58%	3,735
Interest-earning deposits with banks	23,363	.92%	107	25,998	.50%	65
Other	9,076	3.46%	156	7,606	3.61%	137
Total interest-earning assets/interest income	$ 322,563	3.29%	5,300	$ 311,593	3.13%	4,887
Liabilities						
Interest-bearing liabilities						
Interest-bearing deposits	$ 177,947	.30%	263	$ 170,335	.25%	209
Borrowed funds	56,241	1.82%	513	53,629	1.54%	416
Total interest-bearing liabilities/interest expense	$ 234,188	.66%	776	$ 223,964	.56%	625
Net interest margin/income (Non-GAAP)		2.81%	4,524		2.73%	4,262
Taxable-equivalent adjustments			(106)			(96)
Net interest income (GAAP)			$ 4,418			$ 4,166

(a)

Interest income calculated as taxable-equivalent interest income. To provide more meaningful comparisons of interest income and yields for all interest-earning assets, as well as net interest margins, we use interest income on a taxable-equivalent basis in calculating average yields and net interest margins by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income earned on taxable investments. This adjustment is not permitted under GAAP on the Consolidated Income Statement.

Changes in net interest income and margin result from the interaction of the volume and composition of interest-earning assets and related yields, interest-bearing liabilities and related rates paid, and noninterest-bearing sources of funding. See the Statistical Information (Unaudited) Average Consolidated Balance Sheet And Net Interest Analysis section of this Report for additional information.

Net interest income increased by $190 million, or 9%, and $252 million, or 6%, for the second quarter and first six months of 2017, respectively, compared to the same periods in 2016. The increase in both comparisons was attributable to higher loan yields and loan growth, as well as increased securities balances, partially offset by an increase in borrowing and deposit costs. Net interest margin increased in both comparisons largely reflecting the benefit from higher interest rates in the 2017 periods.

Average investment securities increased $5.2 billion, or 7%, and $5.6 billion, or 8%, in the quarterly and year-to-date comparisons, respectively. The increase in both comparisons reflected net purchases of agency residential mortgage-backed securities and U.S Treasury securities, partially offset by declines in average commercial mortgage-backed securities and non-agency residential mortgage-backed securities. Total investment securities increased to 23% of average interest-earning assets compared to 22% in the quarterly comparison and was 23% in both of the year-to-date periods.

Average loans grew $8.0 billion, or 4%, and $6.6 billion, or 3%, in the quarterly and year-to-date comparisons, respectively. The increase in average loans in both comparisons was driven by broad growth across our businesses within our Corporate & Institutional Banking segment, as well as higher residential mortgage loans within our Retail Banking segment. Both comparisons also reflected the impact of our acquisition of a commercial and vendor finance business with $1.0 billion of loans and leases. These increases were partially offset by decreases in consumer loans driven by runoff in the non-strategic consumer loan portfolios of brokered home equity and government guaranteed education loans. Loans remained stable at 67% of average interest-earning assets in the quarterly comparison and 66% for the first six months of 2017 compared to 67% for the same period in 2016.

Average total deposits of $256.4 billion for the second quarter of 2017 grew $8.8 billion, or 4%, over the second quarter of 2016, and average year-to-date deposits grew $8.8 billion, or 4%, over the same period of 2016, largely due to growth in average interest-bearing deposits, which increased $7.2 billion and $7.6 billion in both comparisons. This growth was driven by higher average savings deposits, which reflected a shift from money market deposits to relationship-based savings products, as well as higher average interest-bearing demand deposits. Average interest-bearing deposits represented 76% of average interest-bearing liabilities in both the quarterly and year-to-date comparison.

Noninterest Income

Table 3: Noninterest Income

	Three months ended June 30				Six months ended June 30			
			Change				Change	
Dollars in millions	2017	2016	$	%	2017	2016	$	%
Noninterest income								
Asset management	$ 398	$ 377	$ 21	6%	$ 801	$ 718	$ 83	12%
Consumer services	360	354	6	2%	692	691	1	
Corporate services	434	403	31	8%	827	728	99	14%
Residential mortgage	104	165	(61)	(37)%	217	265	(48)	(18)%
Service charges on deposits	170	163	7	4%	331	321	10	3%
Other	336	264	72	27%	658	570	88	15%
Total noninterest income	$ 1,802	$ 1,726	$ 76	4%	$ 3,526	$ 3,293	$ 233	7%

Noninterest income as a percentage of total revenue was 44% for the second quarter of 2017 compared to 45% for the same period in 2016. The comparable amounts for the year-to-date periods were both 44%.

Asset management revenue increased in both comparisons driven by higher earnings from BlackRock and the impact of higher average equity markets in our asset management business. Discretionary client assets under management increased to $141 billion at June 30, 2017 compared with $135 billion at June 30, 2016.

Corporate services revenue increased in both comparisons largely reflecting higher merger and acquisition advisory fees and other capital markets-related revenue, including both higher loan syndication fees and treasury management fees.

Residential mortgage revenue decreased in both the quarterly and year-to-date comparisons as a result of lower loan sales revenue and a lower benefit from residential mortgage servicing rights valuation, net of economic hedge.

Other noninterest income increased in both comparisons largely driven by higher revenue from private equity investments reflecting positive impacts from valuation adjustments on equity investments subject to the Volcker Rule provisions of the Dodd-Frank Act and higher revenue from credit valuations on customer-related derivative activities. These increases were partially offset by the impact of 2016 net gains on the sale of Visa Class B common shares. The quarterly comparison also reflected higher revenue from commercial mortgage loans held for sale activities and higher operating lease income.

Provision For Credit Losses

The provision for credit losses decreased $29 million to $98 million in the second quarter of 2017 compared to the second quarter of 2016 and decreased $93 million to $186 million for the first six months of 2017 compared to the same period in 2016. The decrease in both periods was due to lower provisions for certain energy related loans in the oil, gas and coal sectors partially offset by an initial provision for a loan and lease portfolio obtained through the acquisition of a commercial and vendor finance business in the second quarter of 2017.

The Credit Risk Management portion of the Risk Management section of this Financial Review includes additional information regarding factors impacting the provision for credit losses.

Noninterest Expense

Table 4: Noninterest Expense

	Three months ended June 30				Six months ended June 30			
			Change				Change	
Dollars in millions	2017	2016	$	%	2017	2016	$	%
Noninterest expense								
Personnel	$ 1,263	$ 1,226	$ 37	3%	$ 2,512	$ 2,371	$ 141	6%
Occupancy	202	215	(13)	(6)%	424	436	(12)	(3)%
Equipment	281	240	41	17%	532	474	58	12%
Marketing	67	61	6	10%	122	115	7	6%
Other	666	618	48	8%	1,291	1,245	46	4%
Total noninterest expense	$ 2,479	$ 2,360	$ 119	5%	$ 4,881	$ 4,641	$ 240	5%

Higher noninterest expense in both the quarterly and year-to-date comparisons reflected overall higher levels of business activity and ongoing investments in technology and business infrastructure as PNC continued to focus on disciplined expense management.

As of June 30, 2017, we were on track to achieve our full-year 2017 goal of $350 million in cost savings through our continuous improvement program, which we expect will fund a significant portion of our 2017 business and technology investments, including our Retail branch strategy, enhanced digital capabilities and our home lending transformation.

Effective Income Tax Rate

The effective income tax rate was 26.0% in the second quarter of 2017 compared to 24.3% in the second quarter of 2016 and 24.5% in the first six months of 2017 compared to 23.9% in the same period of 2016. The increases in both comparisons were primarily related to higher pretax earnings, and in the year-to-date comparison, partially offset by the impact of higher tax deductions related to stock-based compensation in the first quarter of 2017.

Consolidated Balance Sheet Review

Table 5: Summarized Balance Sheet Data

	June 30	December 31	Change	
Dollars in millions	2017	2016	$	%
Assets				
Interest-earning deposits with banks	$ 22,482	$ 25,711	$ (3,229)	(13)%
Loans held for sale	2,030	2,504	(474)	(19)%
Investment securities	76,431	75,947	484	1%
Loans	218,034	210,833	7,201	3%
Allowance for loan and lease losses	(2,561)	(2,589)	28	1%
Mortgage servicing rights	1,867	1,758	109	6%
Goodwill	9,163	9,103	60	1%
Other, net	44,744	43,113	1,631	4%
Total assets	$ 372,190	$ 366,380	$ 5,810	2%
Liabilities				
Deposits	$ 259,176	$ 257,164	$ 2,012	1%
Borrowed funds	56,406	52,706	3,700	7%
Other	10,423	9,656	767	8%
Total liabilities	326,005	319,526	6,479	2%
Equity				
Total shareholders equity	46,084	45,699	385	1%
Noncontrolling interests	101	1,155	(1,054)	(91)%
Total equity	46,185	46,854	(669)	(1)%
Total liabilities and equity	$ 372,190	$ 366,380	$ 5,810	2%

The summarized balance sheet data in Table 5 is based upon our Consolidated Balance Sheet in Part 1, Item 1 of this Report.

Our balance sheet was strong and well positioned at both June 30, 2017 and December 31, 2016.

- Total assets increased as loan growth was partially offset by lower deposits held with the Federal Reserve Bank;
- Total liabilities increased due to higher borrowed funds and deposit growth;
- Total equity decreased due to a decline in noncontrolling interests related to the redemption of Perpetual Trust Securities in the first quarter of 2017.

The following discussion provides additional information about the major components of our balance sheet. Information regarding our capital and regulatory compliance is included in the Liquidity and Capital Management portion of the Risk Management section of this Financial Review and in Note 18 Regulatory Matters in the Notes To Consolidated Financial Statements included in our 2016 Form 10-K.

Loans

Table 6: Details of Loans

	June 30	December 31	Change	
Dollars in millions	2017	2016	$	%
Commercial lending				
Commercial				
Manufacturing	$ 20,533	$ 18,891	$ 1,642	9%
Retail/wholesale trade	18,101	16,752	1,349	8%
Service providers	15,111	14,707	404	3%
Real estate related (a)	12,179	11,920	259	2%
Health care	9,541	9,491	50	1%
Financial services	8,493	7,241	1,252	17%
Other industries	24,599	22,362	2,237	10%
Total commercial	108,557	101,364	7,193	7%
Commercial real estate	29,489	29,010	479	2%
Equipment lease financing	7,719	7,581	138	2%
Total commercial lending	145,765	137,955	7,810	6%
Consumer lending				
Home equity	29,219	29,949	(730)	(2)%
Residential real estate	16,049	15,598	451	3%
Credit card	5,211	5,282	(71)	(1)%
Other consumer				
Automobile	12,488	12,380	108	1%
Education	4,751	5,159	(408)	(8)%
Other	4,551	4,510	41	1%
Total consumer lending	72,269	72,878	(609)	(1)%
Total loans	$ 218,034	$ 210,833	$ 7,201	3%

(a) Includes loans to customers in the real estate and construction industries.

Growth in commercial lending was broad based across our lending businesses and included the acquisition of a commercial and vendor finance business with $1.0 billion of loans and leases. Lower consumer lending was driven by declines in home equity and education loans, partially offset by higher residential real estate loans. The decreases in home equity and education reflected runoff in the non-strategic brokered home equity and government guaranteed education loan portfolios.

See the Credit Risk Management portion of the Risk Management section of this Financial Review and Note 1 Accounting Policies, Note 3 Asset Quality and Note 4 Allowances for Loan and Lease Losses in our Notes To Consolidated Financial Statements included in this Report for additional information regarding our loan portfolio.

Investment Securities

Table 7: Investment Securities

	June 30, 2017		December 31, 2016		Ratings (a) As of June 30, 2017				
Dollars in millions	Amortized Cost	Fair Value	Amortized Cost	Fair Value	AAA/ AA	A	BBB	BB and Lower	No Rating
U.S. Treasury and government agencies	$ 13,570	$ 13,750	$ 13,627	$ 13,714	100%				
Agency residential mortgage-backed	39,522	39,428	37,319	37,109	100				
Non-agency residential mortgage-backed	3,004	3,254	3,382	3,564	11		4%	76%	9%
Agency commercial mortgage-backed	2,683	2,676	3,053	3,046	100				
Non-agency commercial mortgage-backed (b)	3,768	3,798	4,590	4,602	86	3%	1	1	9
Asset-backed (c)	6,287	6,349	6,496	6,524	87	4	3	6	
Other debt (d)	6,583	6,803	6,679	6,810	74	15	8		3
Corporate stock and other	491	489	603	601			(19,035)		

Interest and other income, net	120	62	297	150
Loss before income taxes	(10,329)	(5,765)	(24,539)	(18,885)
Income tax benefit	—	(131)	(1,826)	(760)
Loss from continuing operations	(10,329)	(5,634)	(22,713)	(18,125)
Income from discontinued operations, net of tax	—	429	—	429
Net loss	$(10,329)	$(5,205)	$(22,713)	$(17,696)

The following table sets forth certain financial data as a percentage of revenue for the periods indicated:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net revenues				
Streaming	96.1 %	93.4 %	95.6 %	92.1 %
DVD subscription and other	3.9 %	6.6 %	4.4 %	7.9 %
Total net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues				
Cost of streaming	12.2 %	12.8 %	12.3 %	12.8 %
Cost of DVD subscription and other	0.8 %	1.0 %	0.8 %	1.1 %
Total cost of revenues	13.0 %	13.8 %	13.1 %	13.9 %
Gross profit	87.0 %	86.2 %	86.9 %	86.1 %
Expenses:				
Selling and operating	166.0%	143.4%	152.5%	160.1%
Corporate, general and administration	12.8 %	20.3 %	13.4 %	21.8 %

Total operating expenses	178.8%	163.7%	165.9%	181.9%
Loss from operations	(91.8)%	(77.5)%	(79.0)%	(95.8)%
Interest and other income, net	1.1 %	0.8 %	0.9 %	0.8 %
Loss before income taxes	(90.7)%	(76.7)%	(78.1)%	(95.0)%
Income tax benefit	0.0 %	(1.7)%	(5.8)%	(3.8)%
Loss from continuing operations	(90.7)%	(75.0)%	(72.3)%	(91.1)%
Income from discontinued operations, net of tax	0.0 %	5.7 %	0.0 %	2.2 %
Net loss	(90.7)%	(69.3)%	(72.3)%	(88.9)%

Three months ended September 30, 2018 compared to three months ended September 30, 2017

Net revenues. Net revenues increased $3.9 million, or 52.0%, to $11.4 million during the third quarter of 2018, compared to $7.5 million during the third quarter of 2017. Net revenues from streaming increased $3.9 million, or 55.7%, to $10.9 million during the third quarter of 2018 from $7.0 million during the third quarter of 2017. The increase in streaming revenues was primarily driven by our growth in the number of paying subscribers.

Cost of revenues. Cost of revenues increased $0.5 million, or 50.0%, to $1.5 million during the third quarter of 2018, from $1.0 million during the third quarter of 2017 and, as a percentage of net revenues, cost of revenues decreased to 13.0% during the third quarter of 2018 from 13.8% during the third quarter of 2017 primarily due to an increase in cost of streaming revenues. Cost of streaming revenues increased $0.4 million, or 40.0%, to $1.4 million during the third quarter of 2018 from $1.0 million during the third quarter of 2017 and, as a percentage of streaming revenues, cost of streaming revenues decreased to 12.8% during the third quarter of 2018 compared to 14.3% during the third quarter of 2017 primarily due to the relatively fixed streaming costs offset by our higher volumes and an increase in revenues.

Selling and operating expenses. Selling and operating expenses increased $8.1 million, or 75.0%, to $18.9 million during the third quarter of 2018 from $10.8 million during the third quarter of 2017 and, as a percentage of net revenues, increased to 166.0% during the third quarter of 2018 from 143.4% during the third quarter of 2017 primarily due to increased revenues, increased spending on customer acquisition efforts focused on our highest value subscriber segments and costs incurred to launch our new alternative healing channel and upcoming premium subscription offering.

Corporate, general and administration expenses. Corporate, general and administration remained unchanged at $1.5 million during the third quarter of 2018 compared to the same period of 2017 and, as a percentage of net revenues, decreased to 12.8% during the third quarter of 2018 from 20.3% during the third quarter of 2017, due to increased revenues in 2018.

Net loss. As a result of the above factors net loss was $10.3 million, or $0.58 per share, during the third quarter of 2018 compared to a net loss of $5.2 million, or $0.34 per share, during the third quarter of 2017.

Nine months ended September 30, 2018 compared to nine months ended September 30, 2017

Net revenues. Net revenues increased $11.6 million, or 58.3%, to $31.5 million during the first nine months of 2018, compared to $19.9 million during the first nine months of 2017. Net revenue from streaming increased $11.8 million, or 64.5%, to $30.1 million during the first nine months of 2018 from $18.3 million during the first nine months of 2017. The increase in streaming revenues was primarily driven by our growth in the number of paying subscribers.

Cost of revenues. Cost of revenues increased $1.3 million, or 46.4%, to $4.1 million during the first nine months of 2018, from $2.8 million during the first nine months of 2017 primarily due to an increase in cost of streaming revenues. Cost of streaming revenues increased $1.4 million, or 56.0%, to $3.9 million during the first nine months of 2018 from $2.5 million during the first nine months of 2017 and, as a percentage of streaming revenues, cost of streaming revenues decreased to 13.0% in the first nine months of 2018 compared to 13.7% in the first nine months of 2017 primarily due to relatively fixed streaming costs offset by our higher volumes and an increase in revenues.

Selling and operating expenses. Selling and operating expenses increased $16.2 million, or 50.9%, to $48.0 million during the first nine months of 2018 from $31.8 million during the first nine months of 2017, primarily due to the planned increase in spending on customer acquisition efforts, and, as a percentage of net revenues, decreased to 152.5% during the first nine months of 2018 from 160.1% during the first nine months of 2017 primarily due to increased revenues.

Corporate, general and administration expenses. Corporate, general and administration expenses decreased $0.1 million or 2.3%, to $4.2 million during the first nine months of 2018 from $4.3 million during the first nine months of 2017 and, as a percentage of net revenues, decreased to 13.4% during the first nine months of 2018 from 21.8% during the first nine months of 2017, due to increased revenues in 2018.

Net loss. As a result of the above factors, net loss was $22.7 million, or $1.33 per share, during the first nine months of 2018 compared to a net loss of $17.7 million, or $1.17 per share, during the first nine months of 2017.

Seasonality

Our subscriber base growth reflects seasonal variations driven primarily by when consumers buy internet-connected devices and, as a result, tend to increase their viewing, like those of traditional TV and cable networks. Our subscriber growth is generally greatest in the fourth and first quarter (October through March), and slowest in May through August. This drives quarterly variations in our spending on customer acquisition efforts, but does not drive a corresponding seasonality in net revenues.

Liquidity and Capital Resources

Our capital needs arise from working capital required to fund operations, capital expenditures related to acquisition and development of media content, development and marketing of our digital platforms, acquisitions of new businesses and other investments,

replacements, expansions and improvements to our infrastructure, and future growth. These capital requirements depend on numerous factors, including the rate of market acceptance of our offerings, our ability to expand our customer base, the cost of ongoing upgrades to our offerings, our level of expenditures for marketing, and other factors. Additionally, we will continue to pursue opportunities to expand our media libraries, evaluate possible investments in businesses and technologies, and increase our marketing programs as needed. At September 30, 2018, our cash balance was $30.8 million, we had no debt and an undrawn $13.0 million line of credit secured by our real estate. We estimate that our capital expenditures, including investments in our media library, product enhancements and corporate campus, will total approximately $4.0 million to $6.0 million for the remainder of 2018, which will be funded through our available cash balance.

Since 2007, we have had an active shelf registration with the Securities and Exchange Commission for 5,000,000 shares of our Class A common stock. In March 2018, we completed an underwritten public offering of 2,683,333 shares of our Class A common stock under the shelf registration, which included 350,000 shares of Class A common stock issued pursuant to the over-allotment option granted to our underwriters, at a public offering price of $15.00 per share. We received net proceeds of approximately $37.1 million after deducting underwriting discounts and commissions and offering costs.

In the normal course of our business, we investigate, evaluate and discuss acquisition, joint venture, minority investment, strategic relationship and other business combination opportunities in our market. For any future investment, acquisition or joint venture opportunities, we may consider using then-available liquidity, issuing equity securities or incurring indebtedness.

While there can be no assurances, we believe our cash on hand, cash expected to be generated from operations, cash that could be raised by the sale of our stock, and current and potential borrowing capabilities should be sufficient to fund our operations on both a short-term and long-term basis. In addition, we own our corporate headquarters and could enter into a sale/leaseback transaction to provide additional funds. However, our projected cash needs may change as a result of acquisitions, product development, unforeseen operational difficulties or other factors.

Cash Flows

The following table summarizes our primary sources (uses) of cash during the periods presented:

	For the Nine Months Ended September 30,	
(in thousands)	2018	2017
Net cash provided by (used in):		
Operating activities - continuing operations	(13,142)	(14,956)
Operating activities - discontinued operations	—	429
Operating activities	(13,142)	(14,527)
Investing activities	(13,753)	(9,472)
Financing activities	24,930	79
Net increase (decrease) in cash	$(1,965)	$(23,920)

Operating activities. Cash flows used in operations improved $1.4 million during the first nine months of 2018 compared to the same period in 2017. The improvement was primarily due to changes in working capital during the period.

Investing activities. Cash flows used in investing activities increased $4.3 million during the first nine months of 2018 compared to the same period in 2017 primarily due to increased investments in our media library, product enhancements, and our corporate campus.

Financing activities. Cash flows provided by financing activities increased $24.9 million during the first nine months of 2018 compared to the same period in 2017 primarily due to the net proceeds of $37.1 million from the sale of Class A common stock in March 2018, offset by the repayment of the line of credit.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are a smaller reporting company as defined in Rule 12b-2 of the Securities Exchange Act of 1934 and are not required to provide the information under this item.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) and Rule 15d-15(e) promulgated under the Securities Exchange Act of 1934. Based upon its evaluation as of September 30, 2018, our management has concluded that those disclosure controls and procedures are effective.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors.

We are a smaller reporting company as defined in Rule 12b-2 of the Securities Exchange Act of 1934 and are not required to provide the information under this item.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits

Exhibit No.	Description
31.1*	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2*	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1**	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF	XBRL Taxonomy Extension Definition Linkbase.
101.LAB	XBRL Taxonomy Extension Label Linkbase.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.

*Filed herewith
**Furnished herewith

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

		Gaia, Inc.
		(Registrant)
November 6, 2018	By:	/s/ Jirka Rysavy
Date		Jirka Rysavy
		Chief Executive Officer
		(authorized officer)
November 6, 2018	By:	/s/ Paul Tarell
Date		Paul Tarell
		Chief Financial Officer
		(principal financial and accounting officer)

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