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Why Are Community and Sub-regional Banks an Attractive Asset Class?

The refrain that "banking is boring" is heard often in the institutional equity world. Why? It's because banks produce homogeneous returns on assets and equity that are relatively uninspiring versus, for example, the technology and health care sectors. Banks are subject to intense public scrutiny via the regulatory and political entities that grant them the license to operate and the FDIC insurance that underpins depositor confidence. Further, the banking industry growth in profitability is more or less directly correlated to the economic conditions in and GDP growth of the United States. So why would a savvy investor consider investing in the banking sector today?

Let us try to make the case.

Too many banks still in the United States

There are 6,589 banks in the United States today versus (81) in Canada, (307) in the United Kingdom, (792) in Germany, (281) in France, (211) in Japan, and (72) in Australia, to name a few large and familiar developed economies. The math works to the United States having 3.8 times the sum of all banks at these six countries, while the U.S. economy is roughly the same as the aggregate of those same countries.

The United States has so many banks because of restrictive state laws that existed until the early '80s. These laws historically prohibited or inhibited cross border branch banking and multi-bank holding companies. As the laws were modernized across the country the number of banks dropped from more than 15,000 to approximately 6,600 today. The consolidation continues, as it is clear that the cost of operating the banking industry in aggregate is massively too high. For example, on a micro level in an acquisition today, the buyer realistically expects to take out 25-35% of expenses almost immediately from the acquired entity to make a premium-priced transaction earnings accretive. In addition, regulators recognize that banking consolidation at the community or regional level supports the prospect of enhanced safety and soundness as a greater level of core deposit funding becomes available to support asset generation.

The value of core deposits will rise again

Core deposits are the desired fuel for asset generation because of their "stickiness" or presumed permanence. When banks do not have enough core deposit funding available to fund their asset generation, they tend to rely on brokered deposits, large corporate deposits or other short-term borrowings that are more likely to disappear in times of economic distress. Regulators have identified this potential imbalance, particularly with the largest banks, as a potential systemic risk. Consequently, the largest banks, who rely more on non-core deposits, are being required to maintain a higher degree of liquidity and capital to protect against a funding deficiency. The liquidity requirement has a negative impact on profitability and the deleveraging as a result of increased capital reduces returns on equity. One might conclude that large banks having the capability to grow assets will find core deposits franchises of community and sub-regional banks to be of increasing value. Similarly, many typical community and sub-regional banks have difficulty in generating assets to achieve maximum utilization of their valuable deposit franchise. This disequilibrium presents an industry wide consolidation framework. Take out excess costs, collect core deposits and generate assets.

Banks need scale to survive --- the "Too Big to Fail" public policies have also created the "Too Small to Succeed" *fatigue factor*

Further, regulatory oversight and market requirements have pushed a disproportionate cost structure onto the smaller banks and have contributed to the "fatigue factor" at many banks. Regulatory compliance and cyber-security are two examples of where banks have or are being asked to make ongoing investment in personnel and technology. Other developments that might create a threat to deposit franchises of the smaller banks include mobile banking and other technological advancements giving the retail depositor easy access to the product lineups of the larger banks. The smaller banks cannot afford to develop and maintain competitive wealth management products or innovative lending and payments products.

A strong dollar and rising interest rates will improve banking profitability

Another current development in the banking industry is the strong dollar and the likelihood of its continuing strength in the next several quarters, if not years. The U.S. economy is continuing to show signs of relative strength to those of other major developed countries. As mentioned before, community and sub-regional bank performance is tied exclusively to the domestic or even local economy. If the U.S. economy continues to grow the profitability of U.S. focused banks will grow. When interest rates rise, the demand for low cost core deposits will grow. The result --- an unabated market based rationalization of the banking sector.

How should an investor approach the smaller bank stock market (sub $250 million market capitalization)?

The number of banks will continue to decline dramatically over the next 5-10 years. The total number of banks will likely be reduced to about 2,000 banks or a third of what it is today. If you own a community bank stock, you should hope that the management and board of that bank is constantly evaluating whether it makes sense to be a consolidator or be a target. There will be many winners in the industry. Some will be short to intermediate term acquirers capable of aggregating banks to build an attractive, profitable footprint with some scale. Others will be those who determine that they are not large enough to have access to capital to be a buyer or lack other ingredients to grow, but who are vigilant in identifying the optimal acquirer stock into which they can reposition their investment. <u>The objective</u>: capture pro forma multiples on earnings and market to tangible common equity, which will produce a net present value for investors well in excess of that in a standalone model.

Buyers will be the winners… and so will Sellers if they have good core deposit franchises

Make no mistake about it. Buyers will be winners in the consolidation of the banking industry. They will benefit by the massive, industry-wide cost take out and the ability to increase revenues through a broader product offering to customers. That doesn't mean sellers are losers because they will get it both ways: a premium to market on sale (due to the valuation disparity between small and large banks); and, a stock in a consolidator that will have access to capital markets, scale and management depth.

BayBoston's objective is to invest in companies that could be buyers or sellers with the clear objective of providing its investors an optimal participation in the industry consolidation. We expect to engage our portfolio companies regularly to answer these questions:

- What are the model inputs that you are using to justify continued independence?
- What is the case that further acquisitions will produce a higher rate of return in the next 3-5 years for investors?
- What is the best course of action to thrive in your mission and mind as well your shareholders' best interest?

The macro economic picture for U.S. bank consolidation is compelling. The industry profitability will increase dramatically through better efficiency ratios that are achieved with scale and better technology. More consumers should benefit from access to such better technology. The key for investors is to choose the investments that will take advantage of the system-wide rationalization that is coming.

Sources:
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