***E*-Memo**

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Scott McCallum
DATE: June 29, 2017
SUBJECT: **Revisiting the Key Driver of Franchise Value**

As we talk with bank executives these days about franchise value—What makes your bank of value to its shareholders—the response we get is surprising to us. The responses we hear are a mixed bag, most of which indicate to us that our memories are a lot shorter than we believed.

We hear responses such as location as in a growing market or high traffic office locations; great asset generation ability; friendly employees who treat customers like family; community involvement but what we don't hear very often is "our ability to maintain and increase core deposits" or, especially, "non-interest bearing deposits".

Earlier this month Chris Vanderpool and Kiah Lau Haslett wrote on the "Funding Mix of Recent Sellers Trends Toward Noncore Deposits" in a blog at SNL's *Data Dispatch*. They noted that mid-sized sellers (banks with assets in the $1 billion to $5 billion range) have had a few things in common such as good loan growth and high sale valuations but they also share a "surprising similarity: an above peer amount of noncore deposits." The 20 banks cited in the study (deals announced since January 1, 2015 to May 23, 2017) had a median core deposit funding of slightly more than 78% while the industry median is just shy of 90%. Not surprisingly, these banks also held a higher median of time deposits and wholesale funds compared to the industry, the latter source showing the greatest disparity to the median of the industry with 15% for the group of 20 against the industry median of just under 4%.

We've observed that during the last 10 years, bankers have become increasingly cavalier about funding, especially in an environment where attractive loan assets were hard to obtain and borrowers were paying off higher priced loans with balance sheet cash. Bankers have successfully rolled over higher rate retail CDs to lower rate and shorter term instruments because depositors had nowhere else to turn, apparently unconcerned about the potential that these CDs will need to be renewed at a higher rate going forward, squeezing margins as the Fed moves to increase rates and moving from QE (Quantitative Easing) to QT (Quantitative Tightening).

How quickly many of us have forgotten our scramble for low cost and non-interest bearing deposits in this historically low rate environment. The position of treasury manager as a part of a commercial lending function has in many cases been all but forgotten. As to the Vanderpool/Haslett blog, the recent decade was characterized by a lack of differentiation between a bank that was funded by core deposits and one that was funded with noncore deposits. So this lack of value differentiation led to the lackadaisical attitude of bankers toward the enhancement of their core deposit franchise. It caused one analyst, KBW's Christopher McGratty, to observe that "sellers with high growth strategies may be more agnostic about funding sources" but while high cost funds can be quickly matched up against loans, this tactic will also "drive up cost of funds [and] compress margins." He also pointed out that sellers may be "'[getting] out while the getting is good.'" While commenting that buyers will buy "for synergies or [as a] complement to [their] own company. Buying your weakness [is] not a bad strategy." To which we would add, yes, provided that your low cost core deposit strength is sufficient to neutralize the weakness you are buying so that it becomes a mere blip in your net interest margin or in your cost of funds.

Our good acquaintance, Lee Burrows of Banks Street Partners, also weighed in on this topic observing that the deposit mix of many of the sellers of the past three years is the result of active acquisition strategies without paying close attention to "strategically assembl[ing]" their deposit mixes to match loan demand.

So where do we go from here? Has there been a paradigm shift? Have low cost core deposits as a critical part of a growing bank's strategy been jettisoned in favor of the wholesale funding of rapid growth? We don't think so. We don't think there has been such a paradigm shift. We continue to believe that our core deposit mantra, a paraphrase of the oath taken by public officials swearing allegiance to the US Constitution, to "preserve, protect and defend the core deposit franchise" should be the mantra of every community bank seeking to increase shareholder value. Why? Two reasons: 1) Monetary policy has shifted from QE to QT, and 2) Banks with riskier asset profiles still run the risk of deposit runs, whether core or not.

Just ask Home Capital Group (a Canadian subprime mortgage originator) to which Warren Buffett recently came to the rescue on extremely lucrative terms (for Buffett). The "opportunity" arose out of a nearly Cdn$2 Billion run on Home Capital's deposits, constituting 95% of its high rate savings deposits. Buffett's equity stake will be 40% of economic and 25% of voting interest. It will also provide a Cdn$2 Billion line of credit at a rate of 9.5%, plus a 1.75% fee on the unused portion.

Low cost core deposits will soon return to the role of the premier funding source of high value community banks—banks focused on deep relationships with clients who reward their bank with non-interest bearing deposits and low cost transaction accounts. Those banks that have not been attentive to their core deposit base but have instead pursued rapid loan growth funded by wholesale funding and retail CDs will find their franchise value diminished as the economy normalizes and monetary policy leans toward tightening. These banks must now pay attention to replacing high cost CDs and wholesale funding with relationship driven core deposits.

As the screw continues to turn in QT, community banks that continued to pursue a strategy of maintaining and growing their core deposit base will be rewarded by investors who understand that the key driver of franchise value—a strong and growing low cost core deposit base—helps assure a steady and growing net interest margin which, in turn drives shareholder returns.

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