FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Ed Depenbrok
DATE: December 21, 2018
SUBJECT: Is Community Bank Financial Performance *Relevant*?

In our October *E*-Memo we asked the question—really of bank managers and bank directors—"Is Your Bank a *Relevant* Community Bank?" We focused our attention on bank managers and bank directors because they are directly responsible for relevancy as we described the issue. We received a lot of comments on our October note from bankers and bank directors, both active and retired. We dated that note, October 20, 2018. On that day, the NASDAQ Bank Index had declined through the year by -6.18% while our benchmark index, the SNL Micro Cap US Bank Index has still gained +4.63% through the year. Interestingly, NASDAQ Bank had gained +5.67% for the year through September 20 and SNL Micro Caps had gained +8.25%—at its peak for the year.

The September-October decline was to our minds an adjustment possibly because the market thought that our banks had "gotten ahead" of themselves that the headwinds caused by tariff wars and Fed interest rate hikes would also have a negative impact on banks. Since October 20, the date of our last *E*-Memo community banks have taken an additional beat down with the NASDAQ banks declining a total of -15.76% since the beginning of the year while the SNL Micro Cap Banks have fallen only a total of -2.16%.

Whats going on? We asked ourselves, doesn't the financial performance of banks mean anything? Well apparently not—at least to the computer driven trading that is taking place in the markets today based on trip-wire algorithm-created selling waves (https://learn.alphadroid.com/blog/algorithmic-trading-strategies/common-types-of-algorithmic-trading-strategies).

The facts of banking industry and especially community bank performance have apparently alluded the algorithms because we see a far different picture of bank performance, now and in the future. Recognizing that we risk "talking our book" we always look to those individuals in our industry whose opinions have stood the test of time—Chris Marinac who has been hanging his hat at FIG Partners in Atlanta and periodically finds himself quoted in the Wall Street Journal or interviewed by Fox Business News or CNBC.

On December 13th in a piece entitled "Defending Banks and Bank Stocks" he made the following points:

- Bank stocks are now extraordinarily inexpensive relative to growing tangible book value, strong capital and ongoing consolidation
- 4Q18 EPS reports are expected to be solid with low estimate hurdles. ***[I]t is a tremendous error to shun and avoid Banks given a lack of proof that the economic cycle has turned south.*** (Emphasis ours.)
- Rumors and inuendo of a pending credit problem in the Banking industry are incorrect and unproven. . .we highly encourage investors to watch current trends in loans rated Substandard and Special Mention**.** *Both of these credit categories have been stable and the percentage of Banks with deteriorating Substandard and Special Mention ratios is minuscule.*
- Catalysts to higher Bank stock prices (and less fear of an economic decline with pending credit issues) should be found in EPS reports in mid [to late] January.

Further, in support of his and his firm's position, Chris and his staff created an approach to adjust EPS and P/E multiples for a 1% point drop in loan growth and a 10 basis point lower Net Interest Margin (NIM). The result? Based on an analysis of the 118 bank members KRE S & P Bank ETF [*half of which are trading below their pre-November 2016 election price to tangible book value ratios (P/TBV)*], the median P/E is

11.3x using the 2019 Bloomberg Street consensus and the *adjusted* P/E is 12.2x after haircut on 2019 loan growth (1% point reduction) and NIM (10 bps lower).

CONCLUSION: We think the foregoing research provided this past week by Chris Marinac supports the relevancy of community bank financials and community bank performance!

Equally as respected by Fox, CNBC and the Wall Street Journal is **Robert (Bob) Albertson**, Principal & Chief Strategist at Sandler O'Neill + Partners whose piece earlier on December 11, "Frantic Market/Enduring Economy" made the following points:

- We are in the longest recovery in decades. . .also the slowest
  - No material weakening in the economy except housing, among the most interest rate sensitive sectors
  - Most investors think in end-of-cycle or late-in-cycle terms. Financials are cyclicals ergo. . .
  - The economic cycle will likely continue to lengthen but possibly decelerate. . .but a recession seems improbable in the near term.
- The valuation reset for equities is largely interest rate related
  - The decline in the S&P 500 of 10% below its 2018 high is approximately what a 100 basis point rise in long interest rates should take from equity valuations.
  - The NASDAQ Bank Index cited earlier has declined almost 24% from its 2018 high in June

CONCLUSION: Absent severe economic deterioration, according to Albertson, bank stocks are ***exceptional values*** (emphasis ours).

- Regional and Community Banks have reclaimed their primary lending role. . .with sold deposit access
  - Since 2013 the gap in loan growth between large banks and small banks has widened in favor of small banks (this according to the Fed's H.8 series for large and small banks
  - Since 2015, small bank deposit growth has outpaced the large by half and have cumulatively grown +18.3% as of the end of Q3-2018 compared to only +12% at large banks

CONCLUSION: In absolute numbers the comparision, according to Sandler O'Neill, is more dramatic. Small banks gained a disproportionate $634 billion in deposits compared to $771 billion at large banks for this period, yet the H.8 "large" banks hold twice the assets! Same disproportion in lending. Regional and community banks have actually become the dominant lenders in 2018, growing 2.4 times more loans year-to-date than the largest 25 in absolute terms!

We believe the data and narrative from both FIG Partners' Chris Marininac and Sandler O'Neill + Partners' Bob Albertson appear to conclusively support that community bank financial performance is relevant!

Now its up to bank CEOs, CFOs and directors to tell that story to the public.

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