FORTRESS PARTNERS

E-Memo

TO: INVESTOR/MEMBERS, BANKERS AND FRIENDS
FROM: Jon Bruss and Ed Depenbrok
DATE: August 29, 2020
SUBJECT: Investor Sentiment vs. What We Know

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In our last edition, Independence Day 2020, we examined the travails of Alexander Hamilton, Founding Father of Banking in the United States. We are today reminded that the banking system founded by Hamilton, a diverse and competitive banking system, has been key to the resilience of our national economy. As we have often repeated in these pages, *the FOUNDATION of a strong and free economy is a diverse and competitive banking system.*

While the pandemic has impacted the finances of most enterprises, many businesses entered into February and March of 2020 with sufficient financial resources to avoid having to make use of Paycheck Protection Program (PPP) loans. Some of these businesses accepted their bank's offer of deferral of payment terms and now, as those deferrals are coming due, we are hearing reports of up to 75% of deferring businesses bringing their obligations current. This is good news for the economy, good news for Community Banks and good news for bank investors. While investor sentiment is shunning all banks, especially Community Banks, their day in the sun will return and investor sentiment will view them favorably. Right now, however, they are on sale for discounts of 30% or more.

In the meantime, as we await the sunshine to return, we have been talking with Community Bankers and thinking about and analyzing our industry. We have become convinced that this post-economic lockdown environment has profound short term and longer term implications. This edition of our *E*-Memo examines what we see as those implications and how they might impact the planning process at Community Banks in which we invest.

First, a note about planning. While it often seems intuitive during periods of rapid change and uncertainty to throw up our hands in frustration avoiding to start a planning process. The old bromide of "failing to plan is planning to fail" immdediately comes to mind. In fact, these times of dramatic change are the points in time when planning becomes even more crucial to survival and to success. If we are to identify the changes that create either risks or opportunities to our business model, a full planning process—strategic planning, operating plans, and forecasts—is an absolute necessity! And, we think there is a lot to evaluate in that planning process right now.

We recently read a piece by Bill Streeter, the Editor at The Financial Brand, entitled "Open Banking Gets a Big Jump Start from COVID". In addition to some specific observations about the topic of Open Banking (more about that below), the article also addressed some of the more dramatic, and accelerating, changes in our industry. The lockdowns of lobbies and other implications on banking have caused a reassessment of how we will interact with our clients in the future. Streeter quotes Brandon Dewitt, Co-Founder and CTO of digital banking provider MX, "The pandemic has made financial institutions realize that the future of the industry is not going to be dependent on in-person interactions. And so financial institutions must have more and faster digital connectivity and more data availability to serve their customers."

On the shorter term planning horizon, we will continue to see a focus on asset quality issues, margin compaction, and the resolution of the large book of PPP loans. These issues will continue absorb the attention and resources of banks over the next several quarters. However, while they are important, we also should not lose sight of other key trends that will dramatically change how we do business over the coming years. Here are what we see as the types of issues that should be evaluated and addressed in strategic plans:

Margin Compaction. While this is an immediate impact as we have seen margins tightening during the first two quarters of this year (due to the impact of thin spread PPP loans, but also due to competitive loan pricing and a return to the cost of funds floor that starts squeezing margins as we again move towards zero interest rates), it is also a trend that will have implications in the coming years. While the competitive pressures will be fierce, we believe every bank needs to have its own margin management strategy to best maximize its loan yields and its cost of funding. And, distancing your bank from its competitors is of critical importance. Here are four ways[1] we believe can help you can give your bank significant pricing advantages over its competitors:

- ***Responsiveness*:** Community Banks have a clear response advantage against most of its competitors. Banks should benchmark the times allotted for each internal approval procedure to assure that the prospective borrower recognizes this advantage.
- ***Influencer*:** Community Banks encourage borrowers to advocate for their borrowing needs. Your borrower can actually sit down with your bank's decision maker to discuss their needs. Community Banks excel at leveraging their proximity to their borrowers by demonstrating their understanding of borrower needs.
- ***Flexibility*:** Community Banks work with their borrowers even when a borrower does not exactly fit into the bank's business model or when adverse credit issues arise such as the issues created by government shut-downs. Community Banks cannot afford lose this fundamental attribute!
- ***Continuity*:** Community Banks own consistency in the relationships between their borrowers and their bank's decision maker. There are few stressors more annoying than to have to educate a new lender/decision maker every few years. Community Banks must assure the certainty of their relationships as this creates great value for borrowers, especially in times of economic and financial stress.

Industry Consolidation. One of the short term side effects of government shutdowns of the past several months has been a temporary hiatus in M&A activity. We said in our quarterly update to our investors that M&A activity "fell off a cliff", dropping **-84%**! While it may take a couple of quarters to gear up again before buyers and sellers come to grips with new approaches for the conduct of bank transactions and the impact new channels such as digital banking channels moving to the forefront as bank customers eschew in-branch transactions for drive-up, mobile and digital banking. We believe it is just a matter of time until the economics starts driving deals again. Leveraging the cost structures of larger organizations, mergers of equals to attain size enabling cost saves, providing liquidity to long-time shareholders, and addressing succession planning issues in bank and board leadership will all be key reasons deals will get done again. And, the virus-created pull-back in bank stock pricing also will provide more room for deals to get done at acceptable pricing to buyers.

It should be noted that M&A has two sets of impacts to Community Banks. First of all, the deals themselves either provide economic value to sellers (and if priced correctly and executed well, to buyers), but it also provides opportunities to other banks in the market. Often when a deal is announced in a market, competitor banks (especially Community Banks) are able to take advantage of the "disruption" in the market through the addition of customers and/or key displaced staff.

Mix of Digital/Physical—Role of the Branch. With the shut down of lobbies and a very fast migration to remote work, we learned a lot in the past few months about digital solutions and how receptive

[1] From CenterState Bank, Correspondent Division, August 24, 2020

customers are to other channels of delivery for their banking products, and even, customer service. This is certainly accelerating a trend that has been underway for some time. Around the country, bank branches continue to be closed faster than opening. In addition, the closure of lobbies and shift of transactions to drive-ins and digital has caused many banks to reassess the role of lobby staff. The long-awaited shift to "Phygital" seems to be moving very quickly now and will be create a full reassessment of bank branches and their staffs as well as the digital tools to provide similar interaction with products and services. As we pointed out in the previous section on **Industry Consoldiation**, this full reassessment of branch banking will have an impact on the economic value of bank consolidation.

Open Banking. Business Insider defines Open Banking as "a system under which banks open up their application programming interfaces (APIs) for third parties to develop new apps and services." It not only can revolutionize the tools and capabilities that banks can provide to their customers, but it also can level the playing field for all sizes of banks and leverages off the strengths of the banks themselves.

Kieren Hines, Senior Banking Analyst with Celent and author of a report on open banking and open finance, was quoted in The Financial Brand article, "The first, and most pertinent message for financial institutions is that open banking is arguably a far greater opportunity for banks than it is for (third party providers) or other market entrants. Incumbent financial institutions have the products, customer bases, and—most importantly—the ***trust*** of these customers."

We have often spoken of the importance of trust in Community Banking. When your customer passes through the portal (door) to your bank, they enter completly **TRUST**ing the fairness with which they will be dealt within the four walls of your building. The word TRUST is the keystone above the door through which they entered, even though it may not be a part of your name.

As banks, bankers and bank investors navigate the next several months we hope that our thoughts have been helpful.

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