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For the personal account

Evan Lorenz writes:

"There are nine reasons to sell banks right now and one to buy them," says Ben Mackovak. That one reason? Because they're cheap. Skipping down to the bottom line, *Grant's* is bullish on select American community banks.

Anyone who reads a newspaper can recite the litany of banking woes. Losses on commercial real estate loans loom large. Rising deposit costs and wrong-way bets on low-yielding bonds are crimping net interest margins. Online banking is destabilizing deposit bases, and private credit is eroding legacy lending franchises.

You can see it in the KBW Nasdaq Bank Index, which has underperformed the S&P 500 by a whopping 26% since the start of 2022. "The sector tends to trade in lockstep," Abbott Cooper, founder and managing member of bank-focused Driver Management Co., LLC, tells me. "So all bank valuations generally go up and down together. There are just not that many bank-focused investors anymore because it's proven to be a bad business.... It's index funds that are buying based on their own fund flows."

Bank profits have held up better than bank stocks. Each of America's six-largest depository institutions by asset size met or surpassed Wall Street earnings estimates in the first quarter. As a group, they generated $35.6 billion in net income in the first three months of 2024, a 3% decline from the same period in 2023 as strength in stock and bond trading offset drops in net interest income.

"The latest H.8 data showed [that] aggregate reserves were closer to $129 billion, up from year-end '23 levels of $128.8 billion (i.e., mostly unchanged)," an April 14 report by Portales Partners, LLC, points out. "This implies that the reserve releases that we saw in [JPMorgan's] and [Wells Fargo's] reports, as well as the very modest reserve build reported by Citigroup, were not unique, but will be repeated by the regional banks." Here is evidence for a "soft landing" and for the proposition that "banks are adequately reserved" for credit losses, Portales finds, at least for this year.

Commercial real estate is a problem for mid-sized regional banks, but not necessarily for smaller ones. "When a community bank says, 'We have an office loan,'" Mackovak, co-founder and managing member of Strategic Value Bank Partners, tells me, "it's a two-story suburban office building where the owner has their small business on the second floor and maybe there's a dentist on the first floor. It's not the 40-story building that sells for 10% of replacement cost."

Oddly enough, the fact that most community banks are living on borrowed time is another element of the bullish narrative. Forty years ago, 17,885 commercial banks of all sizes did business in America. Today, there are just 4,587, "and the number shrinks by 2%–5% every year," Joseph Stilwell, founder and eponym of the Stilwell Group, activist investors in community bank shares, tells me. "We're probably headed down to 250 to 450" based on comparisons to other Western countries, he continues. "We're going to lose 90% of our banks, most of which will be through sales and mergers."

The upside lurch in interest rates has made the acquisition of one bank by another more problematic. The rules of purchase accounting require the acquiring bank to mark its target's loans and held-to-maturity bonds to market, i.e., nowadays, lower. But a new kind of buyer has stepped into the M&A breach.

"Credit unions—those differently regulated and differently motivated deposit takers and loan makers—have grown steadily from being an afterthought in the banking system," Stilwell relays. "They now comprise just shy of 10% of the total banking assets in the United States! And why wouldn't they? Credit unions don't pay corporate taxes and have no shareholders, hence they don't pay dividends (leaving aside the slightly increased interest they pay depositors but refer to as 'dividends'). Further, credit-union managements are generally paid not on profitability, not on returns to members, but rather on size."

Back to the opportunity in small lenders: "There are two ways to be an outstanding bank," says Cooper. "One is that you are really good in a niche area where you're the bank of choice for people who know what they're doing and, for whatever reason, you can command a premium for the services that you charge."

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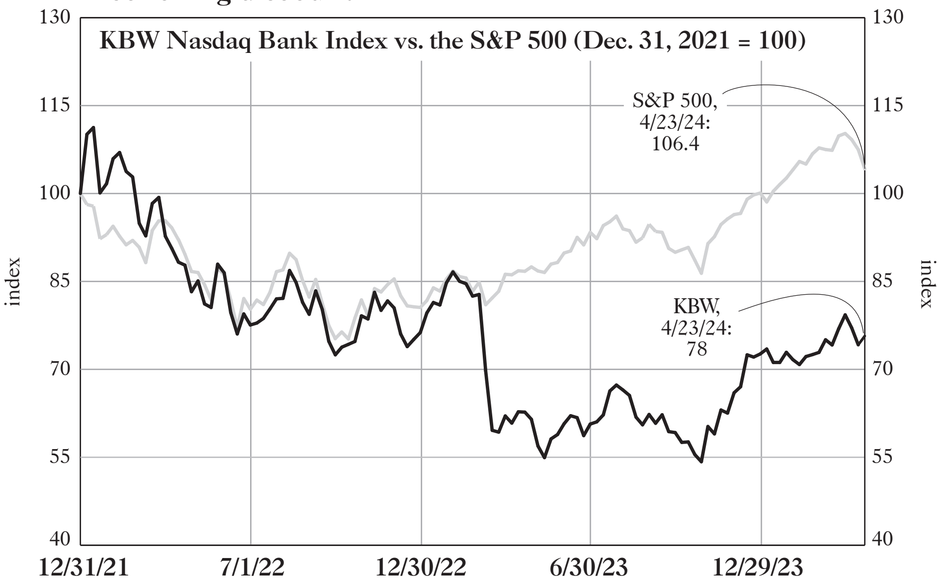
Esquire Financial Holdings, Inc., of Jericho, N.Y. (ESQ on the Nasdaq), a community bank that serves law firms in 29 states and processes and clears credit-card transactions for some 84,000 small businesses, is one such example.

Plaintiffs' lawyers, who typically work on a contingency basis, need

Beckoning discount



source: The Bloomberg

working capital to sustain them as the wheels of justice slowly grind. Class-action lawsuits, like the one filed in Cook Country, Ill., last month alleging that Target Corp. is illegally collecting and storing customers' biometric data, are especially costly, given the time required to gather plaintiffs, conduct research and go to trial.

In the lawyer-finance business, it helps to be a bank. Esquire collects deposits, including longer-duration escrow and claimant trust settlement deposits, from the very lawyers to whom it lends.

The loans earn an average of 10%, a fancy rate of interest for bank credit today, but less than the rates that non-bank competitors charge. And Esquire funds those credits with cheap deposits—interest expense averaged 0.66% last year. In addition, because Esquire is federally chartered, it can lend nationally at rates over and above what some state banking laws allow.

Litigation-related credits made up 51% of Esquire's $1.2 billion loan portfolio as of Dec. 31, 2023. Multifamily (29%), other commercial loans (10%), commercial real estate (7%) and consumer lines (3%) comprised the remainder. The apartment-lending business is focused on the five boroughs of New York City, with their gothic mix of rent-stabilized units and free-market units. Deposits of $1.4 billion fund the portfolio.

Credit experience has been good though lumpy—case loads vary with the ebb and flow of the national suing spirit. At the end of 2023, 0.9% of the loan book was nonperforming (in the prior two years, the figure was at zero). Reserves cover nonperforming loans by 152%. Tier 1 common equity amounts to 14.1% of risk-weighted assets.

Operationally, too, Esquire has excelled. In 2023, it reported an industry-leading net interest margin of 6.1%, a return on equity of 21.5% and growth in earnings per share of 31.4% (figures are adjusted for a nonrecurring gain on investments in 2023). Since 2019, loans, measured in compound annual rates, have expanded by 21%, deposits by 20% and tangible book value per share by 13.4%.

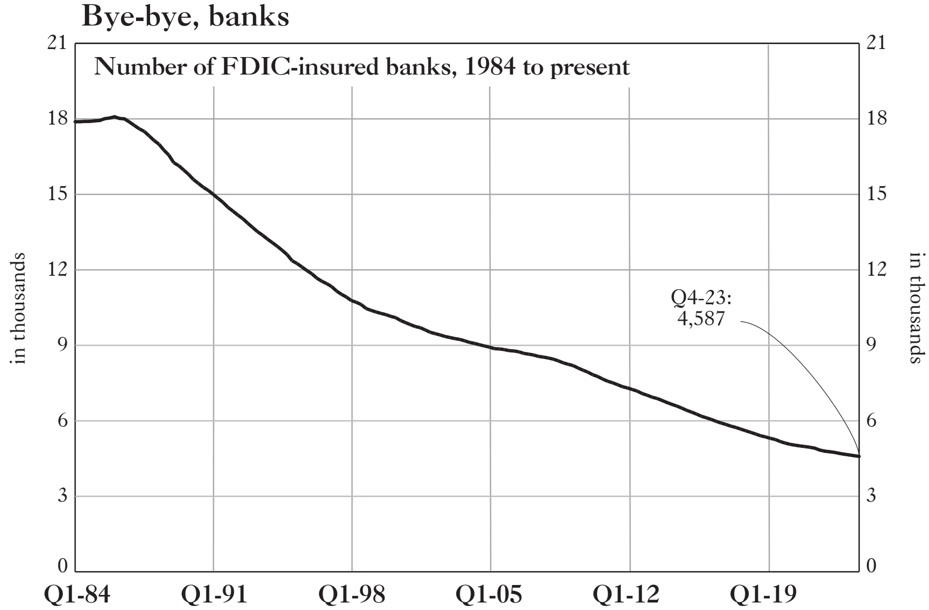
This strong performance notwithstanding, Esquire trades at 9.3 times trailing earnings, cheap for a fast-growing, high-margin lender. For comparison, the KBW Nasdaq Bank Index trades at 11.6 times trailing earnings. As a multiple of tangible book value, Esquire changes hands at 2.0, compared with 1.2 for the index. The three analysts who cover ESQ unanimously say buy, and short interest amounts to 3.5% of the float. While insiders have sold 60,450 shares for proceeds of $2.8 million over the past 12 months, Selig Zises, age 82, an Esquire director and cofounder, was responsible for 98% of those transactions. In aggregate, insiders still own 18.9% of shares outstanding.

There's another way to succeed at lending, as Cooper reminds me: Just be "very good at being a banker" and "really disciplined in terms of pricing, business selection, expenses, etc."

Naturally, few banks, especially small ones, could afford to hire Jamie Dimon. On the Oct. 13, 2020 earnings call, when the 10-year Treasury was priced to yield 0.73%, an analyst asked the JPMorgan Chase & Co. top man if he would "move some of that cash into things that might at least earn some more to protect the NII [net interest income] going forward."

"We're not going to do anything to

Bye-bye, banks



source: Federal Deposit Insurance Corp.

protect the NII," Dimon presciently replied. "We're not going to invest in stuff making 50 basis points, 60 basis points or 70 basis points so we get a teeny little bit more of NII. We're going to make long-term decisions for the company, and if your NII in the end gets squeezed a little bit, so be it. But we don't want to be in a position where we lose a lot of money because we made investments in 5- or 10-year securities, which you'll lose a lot in if rates go up."

Not all banks could resist the "moron trade," as Stilwell styles the yield-scrounging purchase of long-duration assets at the bottom of a 40-year interest rate cycle, including former pick-not-to-click Silicon Valley Bank (*Grant's*, Nov. 19, 2019). Buying long-dated bonds, and/or issuing long-term loans at record-low yields, did lead to a handful of failures, but the "moron trade" to date has damaged many more than it's destroyed.

"At some point, net interest margins will inflect higher," Mackovak says. "With inflation persisting and rate cuts being further down the road, I think that's been pushed out. . . . What we like to do is bet on the inevitable. We don't always know the timing of it. I would say with these banks that are having profitability issues right now, you're basically betting on the inevitable. Now, is it one year? Is it three years? That's the wild card."

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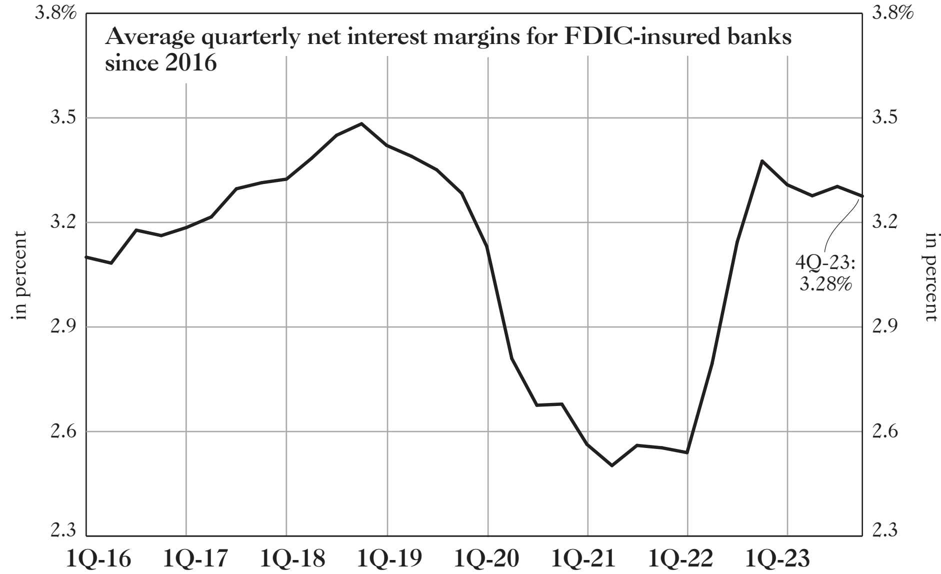
NIMs on the rebound



source: Federal Deposit Insurance Corp.

Headquartered in Denver, Colo., First Western Financial, Inc. (MYFW on the Nasdaq) is a wealth-manager-cum-private-bank that caters to households with a net worth of $1 million or more. The bank has established branches in Arizona, California, Colorado, Montana and Wyoming and in such tony locales as Jackson Hole and the Century City neighborhood of Los Angeles. Its assets, as of March 31, tipped the scales at $2.9 billion. It looks after $7.14 billion's worth of client assets.

Unlike Silicon Valley Bank, First Western did not gag on low-yielding bonds. The error to which it fell prey was rather overpaying its depositors and undercharging its borrowers. As a result, First Western's net interest margin declined to 2.34% in the first quarter of 2024 from 3.78% in the third quarter of 2022.

NIMs will expand for as long as the bank remains solvent; it's bound to happen, as Mackovak says, but when? If the Federal Reserve cuts rates, deposits will reprice quickly and net interest income will bulge. If today's high rates persist, the First Western loan book will slowly reprice. Newly issued loans pay interest in the 7%–8% range compared with the 5%-plus that the existing portfolio earns.

As of March 31, First Western's $2.3 billion loan book comprised residential mortgages (38.7% of the total), non-owner-occupied commercial real estate (23.4%), commercial and industrial loans (14.8%), construction and development loans (12.4%), owner-occupied CRE (9.7%) and other credits (1%). Some $2.5 billion of deposits reside on the other side of the balance sheet.

Nonperformers jumped in 2023—to 2.02% of total loans from 0.5% in 2020—but four-fifths of the problems stem from one customer, and the bank believes that it will incur little or no loss as it sells the associated collateral. Nonperformers dipped to 1.9% in the first quarter with the profitable sale of a construction and development note. As of March 31, Tier 1 common equity amounted to 9.8% of risk-weighted assets at the consolidated level (including the wealth-management unit) and 11% of risk-weighted assets at the banking unit.

The stock is valued at 18.2 times trailing earnings and 74% of tangible book value. Two of three analysts are bullish, and the third is noncommittal. Short interest runs to 1.3% of the float. Over the past 12 months, insiders have sold a net 44,393 shares for proceeds of $737,069.

CEO Scott Wylie, who owns 7.8% of the outstanding First Western shares, built and sold three banks prior to his 2002 founding of this one. Mackovak says that, in his opinion, First Western could easily fetch book value in an auction. "Well, they don't want to do that," our informant adds. "They want to stick around for a couple of years and get 1.5 to 2 times book."

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Going all-in on low rates isn't the only way to drive a bank to the wall. Ill-advised cryptocurrency lending is another approach, which Provident Bancorp, Inc. (PVBC on the Nasdaq) elected in 2021, more than two centuries after its 1818 founding. By the close of 2022, the bank had charged off $46.4 million out of a $121.3 million crypto portfolio and had said goodbye to the director of specialty lending, Paul Mansfield, and to his father, Dave, the chief executive officer.

"Never trust a bank where the CEO's son is in an executive role," advises Stilwell, who owns 10.4% of the outstanding Provident shares. On Jan. 26, the bank named Dennis Pollack to the board in exchange for a two-year standstill agreement with Stilwell.

Headquartered in Amesbury, Mass., Provident operates seven bank branches in the Bay State and New Hampshire. "It is in the best geographic sector—one of the best in the country—sort of New Hampshire right down to the high-tech corridor into Boston," Stilwell asserts.

Provident is a business-focused lender. At year-end, 35% of its $1.3 billion loan portfolio was invested in broadly diversified commercial real estate (office buildings collateralized 13.7% of those credits), and private equity–sponsored companies absorbed 32%. Commercial and industrial loans (13%), a mortgage-warehouse financing business (12%), construction lending (6%) and crypto (1%) filled out the portfolio.

The p.e. share is less dangerous than it seems as the bank lends on a first-lien basis and only up to three turns of Ebitda. The new management team says it wants no more growth in the p.e. book and that it's exiting crypto credits entirely. Deposits sum to $1.3 billion.

At year-end 2023, 1.2% of the loan portfolio was nonperforming (mostly the crypto residue) and loss reserves covered 131% of that exposure. Tier 1 common equity amounted to 12.8% of risk-weighted assets.

The cost of its self-inflicted problems is that the bank trades at 65% of tangible book value and at 12.1 times trailing earnings. The one analyst who follows the stock says hold, and short interest amounts to 1.2% of the float. Excluding Stilwell, insiders have purchased 18,110 shares over the past 12 months at a net cost of $177,805.

How does the current opportunity in small banks stack up, I asked Stilwell, whose firm celebrated its 30th anniversary last year. "It's as good as it's ever been," he replied. "It may be better than in my investing lifetime and probably better than it's ever been, except for maybe a day or two at the bottom of one of the financial crises."

Stilwell and his director of research, Corissa B. Porcelli, concluded their fourth-quarter letter with a look back at three decades of fund operations: "During those years we've grown from managing capital of under $1 million to just over $240 million. Our approach is not designed to make anyone rich quickly; it's designed to grow and protect our limited partners' wealth with relatively low risks."

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