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Bank of the Cycle

Before there was fintech, there was SVB Financial Group (SIVB on the Nasdaq), parent of the 36-year-old Silicon Valley Bank, lender and/or deposit-taker to the venture-capital business and banker par excellence to the start-ups behind the majority of American high-tech IPOs. On Silicon Valley, to anticipate, this publication trains its skeptical eye.

That's one eye. The other is openly admiring of a superlative record of business-building. While, in the decade ended June 30, U.S. banking assets grew by a cumulative 38%, SVB's assets jumped—leapt—by 425%. Among the 100 fastest-growing companies in America in 2019, *Fortune* counts SVB as No. 61.

The National Shoe and Leather Bank of the City of New York addressed itself to a single industry, but that was an old industry in distant times. In the 21st century, Silicon Valley stands athwart the with-it world of high-tech venture capital.

"When venture funds make new investments and sponsor new companies, they will often direct them to SVB to be their partner bank," Aaron Deer, who rates SVB a buy for Sandler O'Neill + Partners, L.P., tells colleague Evan Lorenz. "There are also a lot of situations where there are serial entrepreneurs who start one business, move on and start another. They continue to use SVB as their bank."

To knowledgeable students of banking, high rates of growth connote worry more than confidence, but Silicon Valley—which showed a 17% rise in third-quarter assets, to $68.2 billion—seems none the worse for exuberance, so far.

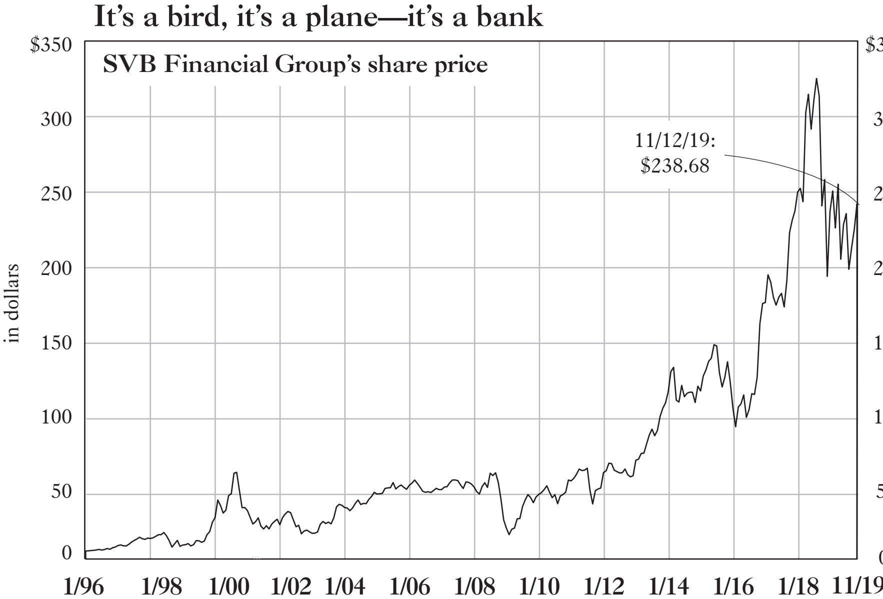
Thus, as of Sept. 30, common-equity tier-1 capital represented 12.7% of assets, while loan-loss provisions enveloped nonperforming loans, which amounted to 0.34% of gross loans, by a factor of nearly 3:1.

At last report, dated Sept. 30, 45% of the balance sheet was devoted to loans, 42% to securities (mostly Treasurys and U.S. government-agency paper). Capital-call lines constituted 52% of the loan book, followed by credits to software and internet companies (19%) and loans secured by real estate (12%).

Capital-call loans, Silicon Valley's specialty, are the hamburger helpers of the venture and private-equity promoters. Say you're a high-tech venture-fund manager, and half of the Ivy League's endowments have pledged to stump up money whenever you drop the flag. You spy an opportunity, but rather than immediately call on your limited partners to make good on their capital commitments, you draw on a Silicon Valley credit line. You get the money fast and—best of all—you do not start the IRR clock ticking. Calculations of the internal rate of return begin only when the limiteds' checks clear. You can generate a higher rate of return by delaying the call. To be sure, you also delay your receipt of management fees, but IRR is the coin of the realm in the private-investments business.

Off-balance sheet, SVB keeps watch over $96.5 billion of client funds, which it places in money-market funds, repurchase agreements and client-driven assets. The bank earned

It's a bird, it's a plane—it's a bank



source: The Bloomberg

SVB Financial Group—in brief
in $ millions

	2014	2015	2016	2017	2018	TTM*
net interest income	$856.6	$1,006.4	$1,150.5	$1,420.4	$1,894.0	$2,077.4
provision for credit losses	66.0	95.7	106.7	92.3	87.9	102.7
non-interest income	572.2	472.8	456.6	557.2	745.0	1,094.9
non-interest expense	700.7	780.0	859.8	1,010.7	1,188.2	1,448.1
profit before tax	662.2	603.6	640.6	874.6	1,362.9	1,621.5
net income	263.9	343.9	382.7	490.5	973.8	1,140.3
total assets	39,337.9	44,686.7	44,683.7	51,214.5	56,928.0	68,231.2
total equity	2,813.1	3,198.1	3,642.6	4,179.8	5,116.2	6,048.5

* For the period ended Sept. 30, 2019.
source: company reports

asset-management fees of $46.7 million, or 12% of overall pretax profit, in the September quarter.

Silicon Valley does more than take the deposits of, and extend credit to, high-tech fledglings. It also invests in those businesses through a company-managed venture-capital fund of funds. On this score, June 30 figures will have to do (the third-quarter 10-Q is pending as we go to press); on that date, such investments tallied to $169.2 million. Then, too, when lending to early-stage companies, SVB typically takes warrants as well as interest. Gains from v.c. investments and warrants amounted to $96 million and $67.4 million in the second and third quarters, or 21% and 17% of profit before tax, respectively.

The bull case for SVB boils down to the bull case for private companies in general. "In private equity, there are 150,000 companies that you can choose from," said Lawrence Calcano, CEO of iCapital Network, looking into the RealVision cameras on Nov. 5. "There are 4,000 public companies. There's a massive number of growth companies not available in the public market that are available in the private markets. You really, if you want to buy growth for example, you need to think about the private market."

By parity of reasoning, then, SVB must be the bank "to think about," indeed, to invest in. Well-publicized problems with certain fallen unicorns notwithstanding, SVB is guiding for growth in loans in the low teens and in deposits in the low double digits next year. "Do I think that we're going to end up seeing some pullback in valuations with some companies?" CEO Gregory Becker asked, and then answered, on the Oct. 24 earnings call. "Yeah, I believe that will be the case. Do I think there are going to be more discussions around board tables about corporate governance? Yeah, I think that's probably going to be happening as well. But I think all those things are healthy, and the investors that we're talking to . . . still look at the number of companies and the quality of companies and the upside these companies present. And there is talking with a very optimistic tone."

With 14 buys, eight holds and no sells, the Street, too, trains at least one admiring eye on SVB. A short interest equal only to 2.7% of the float indicates that the bears, too, have tipped their hats. As to valuation, SVB is either cheap (it trades at 11 times earnings vs. 12 times for the KBW Bank Index) or expensive (2.1 times book value vs. 1.3 times) depending on your perspective of the caliber of the balance sheet and the continuity of earnings, not to mention the lifespan of the v.c. cycle.

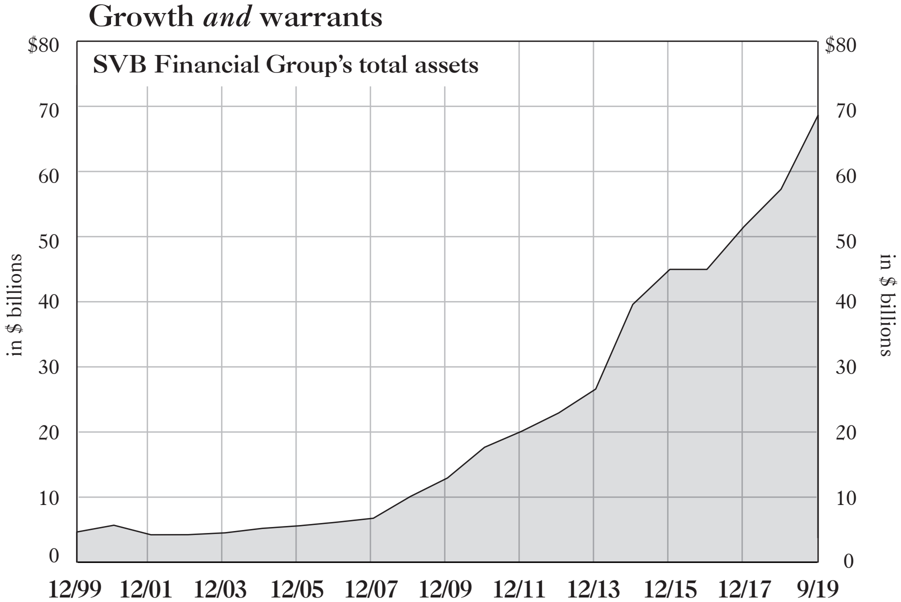
"[W]hat we've learned through many years of covering SVB is that when a valuation opportunity presents itself—even though none of us likes the reason providing the opportunity—that this is the ideal time to accumulate shares," Steven Alexopoulos, who rates SVB a buy for J.P.Morgan Securities LLC, wrote toward the end of October. "This was demonstrated in the global financial crisis in 2009 as well as the market meltdown in 1Q16. The eventual reward: As the global economy slows and investors assess which companies have the greatest prospects for outsized growth and returns in a slower macroeconomic backdrop, which may last for years, we see value as well as growth managers jumping into Silicon Valley Bank stock."

. . .

The bear case on SVB comes in three parts. First, the bank is exposed to a drop in interest rates. Second, competitors are working to break SVB's lock on v.c.-funded companies. And third, SVB would shoulder the worst of any future mass cull, let alone extinction, of today's unicorns.

Silicon Valley's core strength—the cheap deposit-gathering franchise—also makes the bank one of the most sensitive to falling interest rates. The

Growth *and* warrants



sources: The Bloomberg, company reports

loan book mostly comprises credits tied to Libor, prime and other floating rates. And because just 32% of the bank's $59.5 billion of deposits earns interest, falling deposit costs do little to offset falling loan yields. Thus, estimates Silicon Valley management, as of Sept. 30, a 100 basis-point decline in the rate of interest would cause a 10% drop in net interest income. (At year-end 2018, the same decline in interest rates would have nicked net interest income by 13.3%; management's purchase of interest-rate swaps to hedge exposures explains the reduction in 2019 rate sensitivity.) By contrast, in the third quarter, JPMorgan Chase & Co. estimates that its net interest income would contract by 4.5% if dollar-denominated interest rates ticked down by a single percentage point.

Sure enough, the Fed's three rates cuts this year have done SVB's net interest margin no good: They pared it down to 3.34% in the third quarter from 3.81% in the first. CFO Daniel Beck, speaking on the Oct. 24 earnings call, estimated that a fourth 25 basis-point reduction in the funds rate, coming in December, would cause next year's NIM to drop to between 3.1% and 3.2%. So if the economy softens, look out below—we're especially mindful in this context of New York Fed President John Williams serving notice at a *Wall Street Journal* event on Nov. 6 that the Federal Open Market Committee would use the occasion of even a garden-variety recession to slash money-market rates to zero.

SVB's rate sensitivity extends beyond declining NIMs to the aforementioned $96.5 billion in client funds amassed off-balance sheet. The investment fees earned on this lucrative segment in 2018 more than doubled from 2017, and more than tripled from 2016. Source of the step-function improvement was SVB's reinstatement of fees it had waived during, and immediately after, the Fed's zero interest-rate era.

That this revenue line is still rapidly growing (up to $46.7 million in the third quarter, from $36.3 million in the same quarter last year), and that it contributed 12% of third-quarter pre-tax profits, is all you need to know to understand how little SVB would welcome a return to ZIRP.

"Is competition increasing?" Beck again asked, and he again answered, on the Oct. 24 call: "Yeah, competition is increasing, and it's not surprising. . . . But, as we say, we believe our differentiation and our strength and we think about our market share, our market share has been consistent and we are continuing to expand our product set, so that we can even stay longer with clients and provide even more differentiated loan products and services."

JPMorgan Chase paid Silicon Valley the highest form of flattery last week by hiring away Pamela Aldsworth, SVB's head of venture-capital relationships, and four other executives. First Republic Bank, Western Alliance Bancorp and Signature Bank have also stepped up efforts to capture more capital-call lending and v.c.-sponsored clients. On SVB's second-quarter call, CFO Beck cited "strong competition" as the reason for eroding margins on capital-call loans.

WeWork and other unicorn flameouts may or may not herald the end of the v.c. cycle. If so, and if past is prologue, such a correction may play out fast and furiously for venture capital's favorite bank.

The new millennium started off with a bang for SVB, as *The Business Journal*, a Central Valley-focused paper, reported on Jan. 28, 2000: "Silicon Valley Bank shattered its single-year profit record during the fourth quarter 1999, raising earnings by more than 80% over the previous record year-end high in 1998." The Nasdaq reached its cyclical top on March 10, 2000. SVB's assets and deposits peaked on Dec. 31, 2000 at $5.6 billion and $4.9 billion, respectively, and, over the ensuing 18 months, they contracted by 32% and 38%.

"They have not distanced themselves from being tied to the v.c. and private-equity cycles," a publicity-shy SVB short-seller tells Lorenz. "If anything, they've tightened themselves to it by making money in more ways off of it. We are always careful to sing their praises because they deserve it. They've done an incredible job creating new ways to make money off of that industry, but they have hardly diversified. The only reason it would be different this time is that it is possible that interest rates could go negative and that would be that much worse for them."

For their part, insiders have sold a net 37,187 shares for proceeds of $8.9 million over the past year.

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