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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Banks Offer Attractive Risk/Reward at Current Valuations

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SECTOR — BANKING

TWST: Could you tell me about the firm?

Mr. Cummings: Elizabeth Park was started in 2008, and we have three strategies and we have a long/short strategy. We have a bank consolidation strategy, and we also manage a mission-driven bank strategy, and we have approximately $320 million of assets under management.

TWST: Did you want to talk about the long/short strategy?

Mr. Cummings: Yes. Our long/short strategy is where we are investing in micro-cap, small-cap, mid-cap, and even super-regional banks across the country.

The reason we think this is a ripe strategy to invest in now is that, first, the liquidity crisis that the industry experienced in spring of 2003 is behind us. Despite all of the concerns about deposits leaving the banking system, deposits for the banks that we monitor, which is close to 500 banks, have grown for five consecutive quarters. And that suggests that they've been able to maintain their relationships with both their business and consumer customers.

What's happened, however, has been a shift in the deposit mix, which is understandable given the fact that interest rates are high and consumers and corporations want to maximize the yield on their monies. And we've seen both of those groups move money from non-interest-bearing checking accounts into the money markets and CDs, which has caused some pressure on bank net interest margins. But they've been able to retain their customers.

And so, that's one reason why we think banks are attractive now, is that they've shown that they could get through this liquidity crisis. The stocks bottomed in May of last year, and they have steadily recovered.

And the second phase of the recovery will be the banks getting through this credit cycle. The industry currently has net charge-offs of 3 basis points, and nonperforming assets of 42 basis points. And of course, credit costs have to normalize. A normalized level of net charge-offs would be 15 to 20 basis points. A normalized level of non-performing assets is around 80 basis points.

So, over the next several quarters, we do expect both net charge-offs and nonperforming assets to trend up, but the market is pricing in something much worse than normal credit costs. Importantly, banks are already reserved for 30 to 35 basis points of net charge-offs. The banks have proactively built their reserves and they're already reserved for charge-offs greater than the normalized levels.

And I think based on what we're seeing and hearing is that normalized charge-offs might not be reached until 2025. I think 2024 charge-offs for the industry probably will not reach that 15 to 20 basis point level, clearly not on a full-year basis. Maybe one quarter they could reach it, but not on a full-year basis.

When we think about what's going on with commercial real estate, there's clearly some weakness in office. We're seeing higher levels of non-performing loans. We're seeing some negative migration in terms of criticized assets. However, we're not seeing big losses just yet. And most banks are telling us that as these commercial real estate loans mature, most of their customers are able to absorb higher repricing at the contractual rates, and they're able to service that debt at a higher level.

But some banks will have some issues in their commercial real estate portfolio, specifically office, but it's very bank-specific, based on the markets that they serve. And then, frankly, you're seeing some huge differences in central business district loans that some of the big banks make versus office loans to developers and owners who own buildings in the suburban markets.

So, credit quality is performing well, but the market's going to need to see several more quarters of manageable credit costs before being confident that the banks have gotten through this down cycle. But that's going to take some time. That's really the second catalyst for the group — is getting through the credit cycle.

And the third thing we think needs to happen is a return to a more normal profitability level. And that will be driven by interest rates declining, and hopefully net interest margins expanding for banks.

When you think about the profitability level of the industry, it's at a respectable level today. When we look at the median return on assets for the banks in the S&P regional bank index, it's at 95 basis points. Pre-pandemic, the return on assets was 127 basis points. So, while it's down, it's still at a respectable level.

And most of that decline has been driven by lower margins. The margin in 2019 pre-pandemic was 368, the median, and the margin in the first quarter, was 320, which reflects the cumulative impact of higher interest rates. That's why banks need to see the Federal Reserve begin lowering rates so they can lower their deposit costs. And then, hopefully that'll lead to the margin expanding and recapturing some of the lost profitability.

In addition, banks can optimize their profitability with a steeper yield curve. That would be a positive as well if the yield curve shifted from being negatively sloped to a positive slope.

And within that portfolio, our weighted average market cap on the loan side is approximately 4.6 billion. The weighted average market cap on the short side is approximately 1.9 billion.

TWST: What about the bank consolidation strategy? What are some of the things that investors should know about that one?

Mr. Cummings: That strategy will own approximately 35 banks. And there we like owning microcap banks, and maybe 65% will be in microcap banks, which are banks with market caps less than $250 million. Another 30% will typically be in banks with market cap between $250 million and $1 billion.

And here we want to identify banks who operate in good markets. They have very attractive deposit franchises and they have low risk balance sheets, and that combination should help them attract a strategic buyer if they decide to sell.

So, it's a buy and hold strategy we employ in that strategy. And we typically have a two-to-three-year investment time horizon for the positions that we invest in. And there, again, we will own roughly 35 positions in the bank consolidation strategy and it's spread out across the country.

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And with the improvement in profitability, the final catalyst — and we're starting to see it now — is more M&A activity. We know that there are a lot of discussions between buyers and sellers in the marketplace today, and you are starting to see deals get done and we think you're going to see more of that. The higher-for-longer rate environment will probably force more liability-sensitive banks to sell. And there are a sufficient number of strong banks who are looking to buy in the right markets.

And we've seen a pickup in M&A activity. During the second quarter, three good-sized deals were done and two of them were done at very attractive premiums to market. And so, we expect M&A activity to pick up over the next several quarters.

All of this is with the backdrop of banks trading near 30-year lows. When you look at their price to earnings ratio, as well as their price to tangible book ratio, valuations are near 30-year lows. And so, for that reason, we like the risk/reward and we think this is a good time to consider building positions in bank stocks.

TWST: When we talk about the long/short strategy, what is important for investors to know and consider?

Mr. Cummings: Four considerations are: One, it's a diversified portfolio, whereby on the long side we typically have 30 to 35 positions. On the short side, we typically have between 12 to 15 positions. We're focused on higher-quality banks in the portfolio.

Our top 10 holdings typically represent 40% to 50% of the AUM and our net exposure today is about 67%, which reflects our favorable view of the industry. Our gross exposure is around 140%. And those would be some of the key attributes of the portfolio today.

And that portfolio is also exceptionally attractive from a valuation perspective as it's trading near tangible book value today. And historically, banks have bottomed around tangible book value.

And some of these banks do have commercial real estate. Today, all of them have commercial real estate exposure, because that's what community banks do and they do have some office exposure. But today those assets are performing very well.

And of course, we know that every bank has different underwriting standards and a different risk profile, based on the markets they serve. And we hope that we're identifying banks who are going to have very good credit quality over the cycle. So that portfolio should do very well, particularly as interest rates decline and we see a more active merger and acquisition environment.

TWST: Do you want to provide examples of different banks that you're watching or that you own in the strategies?

Mr. Cummings: So, in our long/short strategy, some of our top holdings would include **QCR Holdings** (NASDAQ:QCRH), a bank in Illinois; **Fifth Third Bank** (NASDAQ:FITB), a bank out of Cincinnati, Ohio; and **East West Bancorp** (NASDAQ:EWBC) in California. These would be three of our larger holdings in our long/short strategy.

And when you look at our bank consolidation strategy, we own **Coastal Carolina Bancshares** (OTCMKTS:CCNB) in Myrtle Beach, South Carolina; **Virginia National Bank** (NASDAQ:VABK) in Charlottesville, Virginia; and **SmartFinancial Corporation** (NYSE:SMBK) in Knoxville, Tennessee.

TWST: And are there some common characteristics among the holdings?

Mr. Cummings: What's common about the holdings in the bank consolidation strategy is that they each have, we believe, an attractive deposit franchise, relatively low loan to deposit ratios, they have a very competitive cost of deposits, and they have solid profitability. And we think those are the characteristics that will allow them to attract a strategic buyer if they decide to sell the bank.

I think they're all trading at very attractive multiples to tangible book below 115% of book, each of those banks traded below 115% of book.

TWST: You mentioned merger and acquisition activity. Do you think it's going to be a merger of banks of equal size, or might it be more of a larger bank taking over smaller banks?

Mr. Cummings: It'll primarily be larger banks taking over smaller banks. But there will be some mergers of equals as well. Predominantly, we expect larger banks to be buying smaller banks. But a lot of larger banks are trading at higher multiples, so they have the ability to buy a smaller bank. And so, we would expect that to be the predominant type of M&A activity.

TWST: And with a lot of these banks, both the small and the larger ones, is there a certain direction that they're going in? Are they going to be doing more online offerings, more use of artificial intelligence?

Mr. Cummings: Well, the larger banks will probably be using artificial intelligence more so than the smaller ones because they have the ability to invest in things like that. The smaller ones need their third-party providers to help them with that. But all banks are focused on improving productivity and using technology to do so.

And that's one reason why smaller banks might decide to sell, the need to invest in technology; it's costly, and that can be better done with a larger bank, a partner, and compliance costs.

The biggest concern that most banks have is cybersecurity risk. That's something that all banks will focus on. And then you look at Bank Secrecy Act and Anti-Money Laundering compliance. That's something all banks are focused on as well.

TWST: I would assume that during the pandemic, because fewer people were going into branches, that people were using more online offerings, and that encouraged the spread of online services to bank customers?

Mr. Cummings: Yes, you are correct. And that's the nice thing. All banks have the ability to do mobile banking. And so, the smaller banks are really not at a disadvantage vis-a-vis the larger ones, given the technology that exists through their service providers. And that will always be a need.

And productivity improvement is important given the challenges with net interest margins, every bank in the country is focused on productivity improvement. And even the challenging revenue environment makes productivity improvement even more important in today's environment.

TWST: Even with the use of improved productivity and technological offerings, can customers still get personalized service from a manager at a local bank?

Mr. Cummings: That's the key. That's why these banks were able to maintain their customers during that liquidity scare in the spring of last year. These customers trust the banks. They have personal relationships with some of the bankers, and particularly the corporate customers, and even a lot of the retail customers as well.

That allows them, that personal relationship, to gain a sense of comfort with the bank, and that's what led them to keep the decision to keep their money with the bank who they had a longstanding relationship with.

So even though you want to use technology, you also want to be able to provide personalized service to customers, because that's what really allows you to build long-term profitable relationships.

TWST: Do you think the sector learned a few lessons from the experience of places like Silicon Valley Bank?

Mr. Cummings: Yes. I think the biggest may have been deposit concentration risk, and that's probably what hurt **Silicon Valley** (OTCMKTS:SIVBQ) the most. They had huge deposit concentrations. But most banks have a more diversified deposit base, and that was a function of their business model.

And so, that probably just reinforced that issue for most banks, because most banks always focused on having a pretty well-diversified deposit base and not having too much concentration in any one sector or industry and/or customer. And that's probably the lesson that was learned.

The other thing is, of course, regulators have encouraged every bank to focus more on liquidity management and having the right, appropriately structured bond portfolio that's not too long in duration, because if you needed to sell bonds, you have the ability to do so, and then even more importantly, probably holding more cash on the balance sheet.

So there are a number of lessons learned from the **Silicon Valley** and **Signature Bank** (OTCMKTS:SBNY) failures from last spring.

TWST: Any basic advice you could give to those investors who might want to invest in the banking sector?

Mr. Cummings: Well, you want to invest with conservative management teams who focus on soundness, profitability, and growth, because typically when you grow too fast in banking, that can lead to problems.

The best banks to own over a long period of time are those that focus on soundness, making sure they have the right capital, making sure they have good credit quality, making sure they have good liquidity, and then they focus on profitability, maximizing their return on assets, return on equity, having a good attractive net interest margin.

Then they focus on growth in terms of how fast they can grow loans and deposits. So growth is probably the least important metric you have when you invest in banks. Soundness and profitability are more important than how fast you grow when you're investing in bank stocks.

TWST: Thank you. (ES)

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