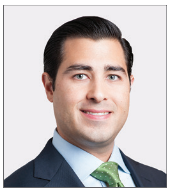
BostonPartners

May 2024

Insights Series | Banking Revisited

Podcast Transcript



Chris Villalba
Investor Relations

Kevin Duggan, CFA
Equity Analyst

Tim Collard
Assistant Portfolio Manager

C.V. | Welcome to Boston Partners Insights — going beyond the headlines to provide a deeper perspective on the capital markets. I'm Chris Villalba from Boston Partners investor relations team. On this episode, we delve into the profound shifts that have reshaped the landscape of the banking industry in the United States.

Gone are the days of traditional brick and mortar branches. Today's banks are embracing a new era of digital convenience. Transactions that once required physical visits can now be completed in seconds on mobile devices, reflecting a paradigm shift towards instant on the go banking. Behind this modern facade lies a complex web of operations moving at breakneck speed, fueled by advanced digital infrastructure. However, this rapid pace also exposes vulnerabilities within the system, as evidenced by the events of last year.

In early 2023, the banking sector faces significant crisis with the collapse of Silicon Valley Bank, a major player serving the tech industry and one of the nation's largest banks. This collapse sent shockwaves through the financial system, quickly followed by insolvency of two regional banks, Signature Bank and First Republic Bank. These events, coupled with additional bank failures, resulted in staggering losses exceeding half $1 trillion, raising serious concerns about the industry's stability. In response, a flurry of policy interventions, government support, industry consolidations and mergers ensued to prevent a wider systemic breakdown. Yet challenges persist, as evidenced by the recent collapse of New York Community Bank earlier this year. As we reflect on these events, we'll assess whether the banking system has successfully navigated these turbulent waters or remains susceptible to future shocks.

To gain perspective on this issue we welcome back Kevin Dugan. Kevin is an equity analyst at Boston Partners, specializing in the sectors of banks, financial services, and life insurance. With nearly 30 years of experience, Kevin has dedicated the last 18 years of his career to analyzing these sectors at Boston Partners, making him one of the most seasoned experts in the field. We also welcome back Tim Collard. Tim has spent nearly 20 years in the business, and he now serves as a portfolio manager in Boston Partners Mid Cap Value strategy. Joining us from our headquarters in Boston, Kevin and Tim bring unparalleled insights into our conversation as we revisit the U.S. banking industry through the unique Boston Partners three circle investment approach. Kevin and Tim, welcome back.

K.D. | Good to be back Chris.

T.C. | Thank you Chris.

C.V. | As we sit down to record this conversation in early April, let's start with the state of the industry. Kevin, where is the U.S. banking sector one year after Silicon Valley Bank.

K.D. | I would say they're in a better position, but they're not fully out of the woods. The regulators have gotten tougher with the banks. It's debatable whether they're tough enough. They're focusing on not only capital but more on liquidity, which was a core driver of what happened with Silicon Valley and First Republic. As we all know, in a digital world, you can pull your deposits out from your mobile phone. You don't need to go on a branch. And I think that was misunderstood by the regulators, that the velocity of deposit outflow can be a lot faster than they think.

C.V. | Tim, from a portfolio management perspective, can you please revisit what the mid cap team did in response to Silicon Valley Bank's collapse?

T.C. | So if I rewind even further back, so for a year or even longer prior to SVB, we had been cutting our bank exposure. And that's not because we anticipated what was going to occur, but more a consequence of having some concerns about credit being exceedingly benign likely could only go in one direction, as well as some concern about where industry net interest margins were, could be prospectively peaking at the time. In any event, we entered, the "crisis" with a slight overweight. And as things transpired, we moved decisively and pretty much overnight, we went to an underweight. And to be clear, that's not a top down declaration. That's a bottom up, three circle view of our regional bank holdings. And at the time, we thought these bank holdings had become one circle stocks, so valuation stocks. And internally we'll say one circle valuation stocks are the kiss of death because cheap can get cheaper, and certainly with banks which require a lot of leverage, the range of outcomes is exceedingly wide.

C.V. | So being able to be nimble was something that was helpful for the team.

T.C. | Nimble, and then, like I said, we cut exposure, but then we quickly redeployed capital into some names that we thought were upgrades across all three circles actually. Those would include LPL Financial, so leading consolidator in wealth management industry, 40 plus percent Return on Equity (ROE) business growing high single digits at a mid-teen multiple, as well as Ares, so number one private credit player 20 plus percent ROE had grown for 20 plus percent for over a decade, and we knew they would be a beneficiary of tightening lending post SVB.

C.V. | Kevin, looking at the U.S. banking system overall, has there been anything done on a regulatory front?

K.D. | So as I mentioned before, liquidity is more of an issue. You're going to see banks issue more debt, and they're going to put the proceeds from that debt issuance in short term securities. If you look back to Silicon Valley and First Republic, there was a big duration mismatch from the asset side of the balance sheet and the liability side of the balance sheet. For Silicon Valley, the duration mismatch was on the securities book; they had a long duration securities book. And for First Republic, they had a long duration mortgage book. So I think you're going to see the duration on the asset side, and the duration on the liability side are going to need to come in. I think in general, the securities books are going to have to be a lot shorter than they were a year ago.

C.V. | That's a good segue to the next question that I have for you. What have the surviving banks learned and what changes have they made? More specifically.

K.D. | You've seen more debt issuance. You've seen cash and securities as a percent of total assets go up. Banks are now looking at the type of deposits they have. They're well aware that you could have a very concentrated deposit base where those deposits can leave within a week. Silicon Valley was a perfect example of that, where you had deposits tied to the innovation economy, and those deposits went out pretty fast. First Republic, you had a very affluent base that's well aware of what was going on. And you saw those deposits leave just as fast. And then, you know, some of the names that we focus on, we focus on names that have a more diverse deposit base – so think consumer, commercial, small business. You could be a small business running your working capital through a bank and the more diverse your deposit base is, the safer you are. And in many cases, the higher returns of the business as well.

C.V. | Where are there still risk in the system? Is commercial real estate still a looming issue for bank earnings, or has that already been priced in?

K.D. | I don't think it's been priced in. I still think it's an issue. There was some maturities last year. You've seen a lot of those get extended for a year. So most of the 2023 maturities, I think I read somewhere that 40% of them just got extended. And what's happening there is a lot of the borrowers and a lot of the lenders are just looking for lower rates to make the economics work. You have a pretty large maturity wall coming up in 2024 and given rates really haven't budged, I would expect to see some further stress within that. You had some loss in '23, but I think this is a multi-year process. That's going to take time to work out.

C.V. | Tim, in terms of the profiles of the banks that you guys look for, are you trying to avoid banks that have over exposure to commercial real estate and even maybe multifamily?

T.C. | That's a good question. So I just say generally at Boston Partners, we want to be risk averse and protect capital and draw down events like that. And that's certainly true in regional banks, right. The business model requires a fair amount of leverage to earn adequate returns, somewhat commoditized, low returns. So higher sensitivity to that sector, probably more so than any other sector. Specifically to CRE, that's certainly front and center. So we own three banks, the two largest banks, Fifth Third and Huntington. If you look at their CRE exposure, it ranges from high single digit to low double digit percent of loans. And then specific to office, it's 1 – 1.5%. And a name like Fifth Third, they have best in class non-performing loans within CRE. Huntington has the highest reserve to non-performing loan and all in regional banks. So we're certainly credit sensitive, especially as it relates to CRE. And then the last holding that we have is the East West Bank Corp., which we would say is actually somewhat of a differentiated name, best fundamental name within banks, mid- to high-teen ROE, best in class capital levels — so low teens. But they do have higher CRE exposure, I think just under a third of loans and then office somewhere in the mid-single digits. So despite being what we'd characterize as a superior fundamental business within banks, the lower weighting is a consequence of higher CRE exposure.

C.V. | Kevin, do you see further consolidation in the U.S. banking industry as a result?

K.D. | I think it needs to happen. 2023 was probably the lowest year of non forced M&A in the last couple decades. Given that all banks have huge unrealized losses in their securities book, the economics of bank M&A really don't make sense because upon deal closed, you have to mark to market the balance sheet. Under the Biden administration, the approval rate on bank mergers is very low. Deal timelines are getting extended. So until that changes in the economics, I think it's going to take time. For those one, the securities losses to burn off, so to speak. So in general, I think 40% of the losses for your average bank would burn off in 2 or 3 years. Under the Trump administration, maybe you have a more favorable, M&A environment where the hurdle for a deal to close goes down a little bit. I think at the end of the day, we certainly don't need 4,000 banks. I think you're going to have the mega banks, the JPMorgan, Wells Fargo, Bank of America's of the world, and you're gonna have more super regional banks, and then you're going to have a lot of very small community banks. But that's going to take a long time for that to happen.

C.V. | Where do you feel the most opportunities lie within the bank stocks? When thinking about the Boston Partners three circle framework, do you want to just stick with the mega cap money center banks? Do you want to be a little bit invested in the regionals? I know Tim mentioned some names that are very attractive, within our framework. So where do you see the best opportunities?

K.D. | I think longer term, the best opportunities are in the larger banks. Scale matters in banking, investment and digital matters in banking. More diverse loan books matter in banking. Not having a high concentration in any specific loan category. Typically larger banks have a lower percentage of commercial real estate relative to their total balance sheet. Again, given that the customer base is more diverse, they have more consumer business, they have a higher credit card mix. Most core checking accounts are done at large, mega banks. But not to say that there's not opportunities in regional banks as well. As Tim mentioned, I continue to like Huntington bank shares, good returns, relative to a regional bank. Good diverse deposit base, low commercial real estate exposure, high loan loss reserves. So they've been building the kitty, so to speak, for future losses. So they're ahead of the game. Some banks have been quite slow to build up those reserves, notably in office. A lot of banks have even the good banks that push the reserve up to close to 8% for some of the office books. So you would need an 8% loss or greater to put up additional reserves. I think that can still happen, but they're well along the way, in my opinion.

C.V. | And what about the community banks? I mean, we have New York Community Bank. I don't even know if that's really considered a community bank or more because of their assets is just really in their name. But maybe you could touch on community banks. Do you see further consolidation there? How can they differentiate? Is there still a place for them within the industry? And then maybe just touch on NYCB and just let us know what happened there.

K.D. | I think the community banks are kind of in a tough spot. I think returns of the business need to come down. If you have to run your bank with more liquidity, there's less spread income, available. And typically they don't have a lot of fee income, they're more of a big interest rate driven franchise. So there's going to be times where they're doing mid-single digit ROEs and other times where maybe they're doing high single digit ROEs. In our framework, I wouldn't call that a good fundamental business. I think it's really tough to get the fundamental circle on there. And then as Tim mentioned earlier, you know, we stay away from one circle stocks, and I think that's where a lot of the one circle stocks live. Will there need to be consolidation? Yes, but again I think it's going to take some time.

C.V. | And then any comments on your community bank that you want to make. I know obviously that's been in the news this year. And we thought we were kind of out of the woods a little bit with the regional banks, and then this pops up. So where are we on that front?

K.D. | Back to your earlier question on the regulator. When you grow into a bank with greater than $100 billion in assets, there's a few items that you need to check off. One is you have to have adequate capital levels. They did not. The regulator wants banks of that size to get up to 10% capital. Number two, you need more liquidity. Their liquid assets, so to speak, were thin relative to larger regional banks. They have concentration in commercial real estate, notably multifamily. They had a couple of large credits charge off. In fact, I think in Q4, the charge offs they took were greater than the cumulative effect of the last ten years. So there was some pretty large charge offs there. And their reserve for their future loan delinquencies was quite low relative to the space, so the regulator made them bring all that up. Market didn't like it. There started to be a deposit run there. And then some strategic investors stepped in to stem the bleed. In my opinion, that's probably a zombie bank for the next, as far as the eye can see. So TBD on that one. But could there be another one? There could be, but it's not presenting itself at this point.

C.V. | Tim, I'm going to shift gears to you for a little bit from a portfolio management perspective, what does the team look for from a characteristics perspective within the banks to make it a candidate for the portfolio?

T.C. | So I touched a little bit on it, Chris. But, a history of good underwriting. Right. So very much, credit risk averse, as well as some of the things that Kevin mentioned earlier. Again, this is a commodity business for the most part. But we are looking for some competitive differentiation, whether it's low cost funding, lower levels of loan to deposit ratios, things that just give us some comfort. Again, given the leverage that's required to earn an average return for a bank. You need to be very mindful of risk.

C.V. | Kevin, you've been doing this for almost 20 years at Boston Partners. You meet with a lot of company management teams, particularly the banks coming through Boston, they come to our office. What's the most important question you ask banks C-suite executives right now when you meet with them?

K.D. | For me, in general, it's all about credit and more so even now. Obviously office commercial real estate. What's your exposure? Where is it? What are you reserved for? What is your outlook? But even beyond that, the next level down is multifamily. I think that's something that should be watched. So any early reads on that. And then obviously the consumer, consumer's done well coming out of Covid. They had stimulus checks. They spent, they were saving a lot of money when they couldn't go out for a while. You are seeing some early stage delinquencies for the low end consumers, so certainly something that we're watching, and it could ultimately bubble up to some of the higher tier customers. And we're certainly sitting here at pretty low unemployment levels. So again, for me, it's credit. Net interest margins, obviously, matter for banks. Capital markets, banks that have capital markets. We've been in a bit of a trough cycle for a couple of years now, so any green shoots they may be seeing there to re-accelerate the momentum in the business.

C.V. | And how important is it to your process that you meet with these banking executives now at this point?

K.D. | I mean, it's pretty important you listen to the earnings calls. You see what they release in their quarterly earnings. You can see it in the regulatory filings that they need to do quarterly with the regulators. So you can get a little bit more granularity on the credit book. But you really need to be front and center on this. And what Tim mentioned earlier. You want conservative underwriters. So you need to meet with them and get that sense that they are conservative underwriters, that nothing has changed. Sometimes banks will reach for growth. So whenever you see a bank that's growing more than the economy, you need to get comfortable with that credit because ultimately it could end up in a pretty bad stock.

C.V. | Before we go, let's pull back slightly back to the macro context of this year and some key current events on the horizon. Kevin, interest rates cutting cycle ahead should be good for the banks. Yes. No. What are your thoughts there?

K.D. | Generally speaking, yes, for a couple of reasons. One, it takes the rollover risk on credit down a little bit. So if you have an office loan you would have to refinance today at 8%, but you can refinance tomorrow at 6%. Some of the economics of that may be more feasible. You've seen funding cost pressures spike over the last year or so should the Fed cut, that would likely abate to some degree, and you would still have some fixed rate assets that would need to reprice up. The flip side to rate cuts is why is the Fed cutting rates? If the Fed is cutting rates due to a weakening macro, then certainly there would be some higher risk for credit as well. So it really depends on why the Fed is cutting. 2024 election.

C.V. | 2024 election - have to bring it up. Trump versus Biden. We can't end this conversation without mentioning it. You touch a little bit on it earlier Kevin. Trump versus Biden, which president will likely offer a favorable environment for the banks?

K.D. | I think under a Trump administration, I think the regulatory environment would be more favorable to bank M&A, which ultimately needs to happen. I think the existing regulators are very rigid in allowing that to happen right now. Under the administration, it's still going to be driven by the macro — What's the economy look like? What the interest rates look like? All of those things will affect banks. But as Tim mentioned earlier, we're bottom up investors and we'll be looking for the best opportunities in any of the stocks, no matter who was who wins the election in November.

C.V. | Tim, in terms of your outlook, what do you foresee this year? And perhaps more important, are there any red flags you're seeing out there that you're trying to avoid?

T.C. | The main ones we touched on CRE in office, as it relates to rates, key distinction, no top down, prognostications at Boston Partners. Right. It's all bottom up. But need to be mindful of the macro and rates things of that nature. So I'd say over the last year we've had success, buying some businesses that have been hurt by higher interest rates. So First American Financial, this is a title insurer; Rocket Mortgage number one mortgage originator; as well as, Kevin talked to before, capital markets Evercore, number one independent M&A boutique. So most of these business saw volumes drop anywhere from 40 to 70%. And we needed to be anticipatory. We don't know when the momentum is going to inflect upwards. But these were solid two circle stocks as it relates to fundamentals and valuation on what we deemed normalized margins. But we were going to take our time and be deliberate and look for some signs of stability on momentum and that's what's transpired over the past couple quarters, because for these cyclical stocks, by the time it's evident that momentum is inflecting upwards, the stocks are already gone. So that's again no big macro calls, interest rate bets in the portfolio, but mindful of where we are and trying to be anticipatory.

C.V. | So these high quality businesses that are trading at attractive valuations, getting a little bit ahead of the potential catalyst or business momentum that's going to project that stock upward to where we've seen fair value.

T.C. | Second derivatives important. But again these are two plus circle stocks where we're seeing signs that momentum is stabilizing. We don't know the trajectory, but when we look out to normalized earnings whether it's two, three, or four years these are very attractive businesses.

C.V. | Kevin let's end with your outlook.

K.D. | I mean, I think it's still a very uncertain environment. Bank stocks in general have moved up over the last 3 to 6 months. I think valuation is generally fair. We try to be nimble and drawdowns to what Tim was talking about earlier, and try to upgrade the quality of the book if everything sells off, and then we just really lean quality. We don't try to take any home runs. We don't when it comes to credit. We just don't go there, quite frankly. And at the end of the day, it's three circle stocks for us. We don't deviate from that at all.

C.V. | Discipline to the process. Love to hear it. Yes, sir. Kevin and Tim, thank you again for coming back on the show. We really appreciate your insights. That was Kevin Dugan, Boston Partners equity analyst, along with portfolio manager Tim Collard. Stay tuned for more and also look for deeper investment related content from Boston Partners, including our Entry Points video series on our website. You can find it at boston-partners.com. Also, give us a follow on our LinkedIn page to stay on top of the latest information and analysis from our team. I'm Chris Villalba. We'll see you next time with more Boston Partners insights.

Christopher Villalba
Investor Relations
Mr. Villalba is a member of the Investor Relations team at Boston Partners and joined the firm in July 2010. In this capacity, his responsibilities include sales and relationship management of Boston Partners products within financial intermediary channels. Prior to joining the firm, Mr. Villalba was a regional private banker with Wells Fargo Bank, N.A. Before that, Mr. Villalba held the role of investment associate at Morgan Stanley in the firm's Global Wealth Management division. He holds a B.B.A. degree in finance from Pace University and FINRA licenses series 7, 66, and 3. Mr. Villalba began his career in the industry in 2007.

Tim Collard
Assistant Portfolio Manager
Mr. Collard is an Assistant Portfolio Manager of the Boston Partners Mid Cap Value strategy. Prior to this, he was an equity analyst with Boston Partners, specializing in the aerospace & defense, transportation, housing, and automobile sectors of the equity market. Mr. Collard joined the firm in April 2018 from Shellback Capital where he was a founding partner and equity analyst. Prior to that, he worked as a research analyst at Vinik Asset Management and Diamondback Capital Management. He began his career as an associate at the investment bank America's Growth Capital. Mr. Collard holds a B.A. in American Studies from Middlebury College. He began his career in the investment industry in 2005.

Kevin Duggan, CFA
Equity Analyst
Mr. Duggan is an Equity Analyst for Boston Partners, specializing in banks, financial services, and life insurance sectors of the equity market. He joined the firm in April 2006 from Fidelity Investments where he held several positions, most recently as a complex securities analyst. Prior to that, he was with State Street where he was an accounting manager. Mr. Duggan holds a B.S. in Business Administration from Boston University and the Chartered Financial Analyst® designation. Mr. Duggan began his career in the investment industry in 1995.

Boston Partners | One Beacon Street, Boston, MA 02108 tel: 617-832-8200

www.boston-partners.com