MONARCH PARTNERS
ASSET MANAGEMENT, LLC

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Thinking Through a Major 2022 Theme: Normalization

As we enter 2022, a major theme the investment team at Monarch Partners has been discussing is "normalization" and the resulting impact on the fundamentals of the companies in our sectors, sub-sectors and portfolios. The "normalization" theme is another way of thinking through what sector and company fundamentals might look like as (1) Covid-19 transitions from pandemic to endemic, (2) the economy takes form in a post-Covid world and (3) the impact of fiscal and monetary stimulus begins to wane. More importantly, we have also been discussing whether the potential changes in company fundamentals are accurately reflected in sector and stock-specific valuations.

Within the financials sector, which is predominantly comprised of community and regional banks, the "normalization" theme has many well-known benefits. It was these benefits that caused the Nasdaq Bank Index to increase 40% in 2021 with continued outperformance in the early days of 2022.

The tailwinds for banks from our normalization theme include:

- A steepening of the yield curve brought on by a rapid rebound in nominal GDP and elevated inflation rates. A steepening yield curve has been positive for the outlook on bank net interest margins (i.e. the spread earned by banks based on the interest rate they charge on loans and the interest rate they pay on deposits and debt). In fact, the spread between the 1 year and 5 year treasury rates is currently ~100 basis points, higher than the ~85 basis point average over the last 20 years.
- The expectation by both the Federal Reserve and the interest rate futures market for 2-3 increases in the Federal Funds short-term interest rate in 2022. This represents another positive tailwind to many bank net interest margins.
- The economic consensus calls for the 10-year treasury rate to be 2% at year-end 2022 and ~2.35% and year-end 2023. If consensus is correct, both the short-end and long-end of the yield curve would rise ~50-75 basis points. This would be a tremendous positive for banking revenues, earnings and profitability ratios.
- Liquidity on bank balance sheets is at a record level today. The loan-to-deposit ratio of the U.S. banking sector today is 59%, which is the lowest (i.e. most liquid) since at least the early 1970's. To put this in perspective, the median loan-to-deposit ratio of the banking sector since 1972 is 81%. To get back to the median ratio, U.S. banks would need to lend out **<u>$3.9 trillion.</u>** For further perspective, $3.9 trillion is 17% of 3Q21 annualized GDP of $23 trillion. Banks have significant levels of liquidity which can be lent out into an environment where interest rates are rising.
- In addition to the positive outlook for NIM and liquidity, loan growth has begun to show signs of life. SMID-cap banks grew loans at a ~6% annualized pace in 3Q21, which was up from ~4% in

the prior quarter. Federal Reserve weekly data also indicates an acceleration of loan growth in 4Q21 is likely.

- As a result of the fiscal and monetary stimulus, the rebound in the GDP and regulatory lenience towards banks on providing forbearance to borrowers, the delinquency rate for the U.S. banking sector ended 3Q21 at an all-time low of 1.3%. The median since 1985 is 2.6%. Balance sheets are very healthy today.
- The pandemic has ushered in a new willingness by many consumers to embrace digital banking. This has allowed banks to close expensive branches and reduce costs. In 2020, total U.S. bank branches declined by nearly 2,100 branches, or 2.7% of all branches, per the FDIC. This marked the highest percentage of consolidation on record (the FDIC data dates back to 1934). In all likelihood, 2021 and the years beyond will show an acceleration of this trend.
- A rebound in bank stock valuations, and a strong economic outlook, has led to increased M&A activity. In 2021, there were 210 transactions totaling $77.6B in aggregate deal volume. This represents a 33% increase compared to 2019 pre-Covid activity levels.

However, a portion of this good news is reflected in consensus estimates and valuations today, in our view, and is why we are roughly equal-weight the sector compared to our relative benchmarks. We also recognize our own inherent limitations in predicting the direction of interest rates, which makes us hesitant to significantly overweight or underweight the sector barring extreme risk-reward dynamics, which are not present today. Consensus estimates are largely calling for net interest margin expansion, high-single digit annual loan and EPS growth, with efficiency and profitability improvements through 2023. Valuations and profitability metrics are largely back to pre-Covid levels.

So how could our normalization theme become a headwind for banks in 2022?

- As noted above, bank delinquency rates on loans and provision expenses related to potential losses in 2021 were abnormally low and beneficial to earnings. While the immediate term outlook remains positive, we have started to observe cracks in the credit quality armor outside the banking sector. Most notably, during 3Q21 earnings season and in various intra-quarter updates during 4Q21, several consumer finance companies that provide lending to near-prime and sub-prime borrowers noted an increase in credit related expenses sooner than anticipated. The higher credit related costs caused share price underperformance in several of those names.
- A recent sell-side broker survey of investors noted that 47% of respondents expect organic loan growth trends will be the #1 driver of outperformance in 2022. With investors expecting high rates of loan growth, record levels of liquidity on bank balance sheets and a benign credit quality environment, we have observed banks beginning to originate higher risk loans. While not an immediate risk, we are increasingly cognizant that the old banking maxim “the worst loans are made in the best of times” could be occurring today.
- The regulatory dynamic is set to become far more stringent under the current administration in Washington D.C. Recent and expected appointments to regulatory bodies like the Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation and the Federal Reserve all indicate that M&A and capital rules will become more stringent and climate change risks will be incorporated into regulatory reviews.

With more tailwinds than headwinds heading into 2022, we are positive on improving fundamentals in the banking sector, while cognizant that valuations have substantially recovered from the Covid-19 pandemic driven recession. At Monarch, we are sticking to evaluating banks on the following themes when looking at our current positions and new potential ideas:

- **Strength and track record of the management team** – we target banks with high performance on metrics such as insider ownership and ability to compound tangible book value per share growth over multi-year periods which include all points of the economic cycle.
- **Liquid balance sheets that benefit from rising rates** – we target banks with high performance on metrics like NIM expansion during the last rising rate cycle, the ratio of interest rate sensitive assets to interest rate sensitive liabilities and cash/liquidity on the balance sheet.
- **Credit discipline** – we target banks with better historical loan loss ratios, lower levels of problem loans, and those who still have substantial loan loss reserve ratios compared to pre-Covid levels. We also target banks who we expect to grow their loan portfolios without adding excess risk to their balance sheets.
- **Efficiency** – we target banks who are not solely dependent on the shape of the yield curve to drive fundamental performance. For instance, banks with higher levels of non-mortgage related fee income (i.e. wealth, payments, and technology), non-commoditized lending verticals, high levels of deposits per branch and improvements in efficiency ratios over time.
- **M&A –** we target banks who possess attributes that could make them not just candidates to own for fundamental reasons, but also because larger competitors could covet their products, services, talent or geography and acquire them for material premiums.