RMB Mendon Financial Funds

Commentary: April 2019

With the calendar page turning to April, the team spent most of the month reviewing Q1’19 financial earnings reports. While we have experienced between 50 and 100 earnings seasons since inception, this one had increased emphasis as market participants try to analyze the stability of the industry’s earnings power and the accuracy of current estimates. Or, more simply put, with price-earnings (P/E) ratios at multi-year relative and absolute lows, is the “E” real and durable?

We argue that the banking industry is a stable and mature business. There are certainly challenges in the industry, but the group is the healthiest, most profitable, and as sound as it’s been in decades. First-quarter results continued to bear this out. Post-earnings, KBW reported that of its 219 bank research universe, 54% beat estimates, 17% met estimates, and only 29% missed estimates. Further, 71% of the beats saw 2019 earnings estimates grow 3% on average. For calendar year 2019/ 2020 estimates, 48%/37% saw higher estimates, 19%/29% were unchanged, and 33%/34% saw lower estimates. With all of the gyrations in interest-rate expectations, global growth uncertainty, recessionary fears/headwinds, etc. that have kept generalists on the sidelines for the group, overall 2019 estimates were reduced by around 1% in aggregate and currently imply 7% growth for the year. For a group trading close to the largest discount to the market multiple in decades, we think the stability of earnings and potential growth outlook is meaningfully undervalued.

More recently, the SMID-cap segment has begun aggressively taking advantage of this disconnect by managing capital much more proactively. This is especially true of our portfolio as we have had active discussions with our management teams around the merits of share buybacks at current valuations versus the last dollar of loan growth in a flatter curve environment. It’s a great opportunity to test how our managers think about capital allocation broadly speaking and within the various channels they have to grow their balance sheets. And it’s fair to say we have shifted portfolio weightings in several names based on the quality of management’s response. As bank return on equities (ROEs) have returned close to historical levels, capital generation is once again exceeding levels needed to fund loan growth. This excess capital can be distributed to shareholders via both dividends and share repurchases. Depending on the level of rates and the valuation of a company’s shares, capital utilized to buy back stock can provide superior returns (that are risk-free) than if that same capital were used for balance-sheet growth (especially if that growth brings higher incremental risk). Lacking the ability to generate significant balance-sheet growth, large banks have been active in capital management for many years following the introduction of the Comprehensive Capital Analysis and Review (CCAR) process, and KBW estimates that almost all of the group’s forward earnings-per-share (EPS) growth is due to share repurchases. SMID-cap banks have become much more active repurchasers in the last two quarters, taking advantage of high overall capital levels, sturdier capital generation on said higher levels of capital, accompanied by valuations that have actually gone lower, not higher, than the pre-election levels of lower returns. Additionally, KBW estimates that share repurchases for the SMID-cap group account for only ~41% of its expected 2020 earnings growth, as there continues to be multiple drivers of growth. We argue that repurchases can be used for both offensive and defensive purposes, protecting stocks against indiscriminate sell-offs as well as reducing excess capital, which, in turn, increases return on average tangible common shareholders’ equity (ROTCE)—leading to stronger currencies for companies to be acquisitive.

To close, despite a constructive outlook, quality earnings, and stout capital return, the group remains extremely under-owned (as of May 10, the S&P Financials sector accounted for 18.7% of the index’s 2019 profits, but it only represents 12.8% of the index’s market cap). The Fund’s positions each have multiple positive catalysts available to them to create meaningful return, whether it be specific to demographics, M&A, disruption from M&A, capital return, or some combination thereof. Throughout its history, Mendon has generated alpha by benefiting from our expertise in accurately determining true franchise value in financials and opportunistically taking advantage when these values deviate from current market values—however, this rarely happens during measured intervals or discrete return periods, both to the upside and downside.

As always, we welcome your feedback, comments, and questions.