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MONEY MANAGER INTERVIEW

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Mendon Capital Advisors

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Investing in Small, Nimble Banks in Fast-Growing Regions

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ANTON V. SCHUTZ is President and Chief Investment Officer at Mendon Capital Advisors. He is the Portfolio Manager of RMB Mendon Financial Services Fund. He founded Mendon Capital in 1996 with a long/short and event-driven investment strategy focused exclusively on the financial services sector. Previously, he worked at RBC Dain Rauscher with an institutional sales trading role in the financial institutions group. He also spent 10 years at Chase Manhattan Bank, where he structured investment products utilizing hedge funds and also developed and applied financial risk strategies. He has been interviewed by CNBC, Bloomberg, *The Wall Street Journal*, *Barron's*, *The New York Times*, *Financial Times*, *Business Week*, *Investors' Business Daily*, *Smart Money* and others. He graduated from Franklin and Marshall College and received an MBA from Fordham University.

SECTOR — GENERAL INVESTING

(AHU567) TWST: Could you talk about the firm?

Mr. Schutz: Mendon Capital Advisors, which is the subadvisor of that fund, was established in 1996 to capitalize on the wave of consolidation in the banking industry. The mutual fund was begun in 1999.

TWST: Could you discuss the investment philosophy at the firm?

Mr. Schutz: The investment philosophy at Mendon Capital Advisors is to take advantage of price discrepancies in the market, which means both short- and long-term objectives of undervalued financial services companies, primarily with a focus on depositories, meaning typically, banks. We really like banks that do a great job. It might be in a really great, growing geography and have a management team with lots of skin in the game and have a desirable franchise that other banks would like to possess.

TWST: And what is it about banks that makes them attractive for investors?

Mr. Schutz: There are a few different factors that make banks attractive. First of all, many of them pay dividends. Second, they're actually regulated, which, in today's world, I think is a pretty good thing, given what we just saw in the world of crypto.

I think one of the other factors that's really important about the banking industry is there's too many of them and there has been for a long, long time. It really goes back to historical laws that prevented banks from being nationwide, from even being across states or counties. So there are literally states in this country that still have over 300 banks in them.

TWST: And could you talk about the fund that you work on?

Mr. Schutz: The fund has been around since 1999. It's shifted focus within financial services several times. Obviously, one of the shifts was when dot-com was happening. There was a real obvious undervaluation in the space. Book values, dividends mattered to me, didn't matter to the market. That was a really interesting time to own a lot of financial services stocks, particularly banks.

And then the next phase was sort of pre the great financial recession. I would call it a depression. And it was avoiding companies that took too much risk, that had managements that didn't get it, managements engaged in lending practices and products that really made no sense. And so, an avoidance of those was really, really important to maintaining the stability and success of the fund, really preventing loss.

And then if you go back to 2008 and 2009, a lot of the big banks got recapitalized and lots of new capital came in. So, we actually focused a little bit upstream on some bigger banks for that short period of time. I would also say in 2008, a sector of the market called mortgage REITs was really important because what they owned were mortgage-backed securities backed by the government that were trading at spreads that made no sense and were going to be major beneficiaries of interest rates dropping when the Federal Reserve finally realized it was time to lower rates.

So those were very important parts of the fund at that point in time and those are some things that I'm looking at today.

TWST: Do you want to highlight a company that you find interesting?

Mr. Schutz: AGNC (NASDAQ:AGNC) is one that I owned back in 2008. It actually IPO-ed, I believe, that year. And I'm finally back being an owner again, because, again, they will benefit from spreads a little too wide on mortgage-backed versus Treasuries. They'll benefit from the value of those mortgage-backs potentially increasing if the Fed has potentially gone too far and they start lowering rates, or at least stop raising them. And eventually if the Fed lowers rates, which could be some time, their margins will also improve.

“People are worried about credit quality. And I think that one of the most important things about the banking sector, those that survived 2007 and 2008, is management has seen it. They’ve seen good practices and bad practices. A lot of the lending now takes place outside the regulated banking industry. I would say I’m hard pressed to find banks that are doing dumb stuff.”

They have a double-digit dividend. So, obviously, that helps mitigate risk. And then eventually, book value grows as rates drop. And that may be over some time. I’ve just started to dip my toe in the water on that investment.

TWST: And what’s ahead for the company?

Mr. Schutz: Well, really, it’s a company that uses leverage and invests in mortgage-backed securities. They could certainly hedge their portfolio, but their funding is typically shorter term in nature. And so short-term rates going down would help.

And securities they own are longer term in nature and spreads kind of got very wide in mortgage-backed securities, even though they carry the same risk as Treasuries backed by the U.S. government. So those spreads have been coming in. That will help. They have lots more to come in, I believe, versus historical perspective. And the stock is down substantially because book value has been hurt as rates rose dramatically driven by what the Fed’s activities have been.

I’m, like I said, dipping my toe in the water here and starting to build a position.

TWST: Did you want to mention another company?

Mr. Schutz: Sure. When we talk about optionality, there’s a bank called **The First** (NASDAQ:FBMS). They’re headquartered in Mississippi. They’ve been a very acquisitive company through the years. The latest acquisition, which is pending, actually puts the pro forma company 30% in Florida and 30% in Georgia.

It’s a management team that has created a lot of value and owns a fair bit of stock. They actually have the ability to benefit should they ever decide to sell that company. Now that company is very attractive to others, particularly the Georgia and Florida piece, the deposits in Mississippi, and has a loan-deposit ratio in the 60s.

And what matters there — those deposits are what’s really valuable. The cost of funds is very, very important to banks. And when you have lots of deposits, excess deposits, you get to match those off against long growth. And as they grow in places like Georgia and Florida that are faster growing, you actually get to improve your earnings because typically the yield on loans is better than that on securities.

So the company has got upside. They’ve got management that cares. They’ve got a great geography. And they have that optionality they talk about, which is they’ve done a great job, they’ve built value, they can continue to build value, or someone else can go, “You know what? This is an $8 billion bank in great markets. I would really love to own that bank.” It’s certainly one of the fund’s bigger positions.

TWST: And for a regional bank like this one, or others, are there concerns with what might happen with interest rates and inflation?

Mr. Schutz: Sure. I think that’s what has made the group cheap. People are worried about credit quality. And I think that one of the most important things about the banking sector, those that survived 2007 and 2008, is management has seen it. They’ve seen good practices and bad practices. A lot of the lending now takes place outside the regulated banking industry. I would say I’m hard pressed to find banks that are doing dumb stuff. I would say the banking industry is probably one of the places that’s not going to get pounded if credit starts to turn the wrong way.

And most of my banks are not heavily involved in consumer financing, particularly at the lower end, where companies like credit card companies and buy-now, pay-later companies have some real risk at the lower end of the consumer as the Federal Reserve keeps pushing financing costs higher and eventually may be leading to unemployment, which again would hurt that sector harder.

TWST: And did you want to mention another company?

Mr. Schutz: Happy to. A big fan of self-help stories and I think I mentioned before, you get paid to wait sometimes when you have a high dividend. So **Provident Financial Services** (NYSE:PFS) is in the middle of closing a merger also. Funny there’s a theme there. They’re buying a company called **Lakeland Financial** (NASDAQ:LBAI).

1-Year Daily Chart of AGNC Investment Corp.

Chart provided by www.BigCharts.com

Management knows each other well at the two banks. In fact, they worked together at a bank many years ago. They’ve got some good overlapping geography. This is a management team I’ve known very, very well from the chairman on down for several decades.

And they are a conservative bunch. Their cost savings projections, I think, are conservative. You got close to a 5% dividend while you’re waiting for them to show and get the deal approved and start getting the cost cuts in place. When I look at where this company trades, it's probably about seven times 2024 earnings. And I think they'll eventually — beyond the dividend — I think eventually they'll also turn to buying back stock. Both companies have had some of that in their history.

"Banks need to invest in technology one way or another. If you're a really, really large bank, you're investing tens of billions of dollars and a lot of that goes to maintaining your old systems. And if you're a smaller bank, you have a chance to actually be a little bit more nimble and take advantage of some of the best providers that are out there."

So, again, banking on a management team that I've got a lot of history with, has a lot of skin in the game and the word "self-help" matters, because you can go out and buy an index of regional bank stocks, and there's good companies and bad companies and undervalued and overvalued, but a company that actually can differentiate itself in the middle of that index, I think, is really important.

Let me also go back to the word "index," or ETF. There'll be a lot of buying interest in this company. Assuming this deal closes, the ETFs are going to have to increase their weighting because their target **Lakeland** is not in all the same ETFs that **PFS** is in. So, lots of buying interest should happen. Actually, some of the estimates I've seen are over 20 days of buy interest of **PFS** when this deal closes.

TWST: And with deals like these, either with this bank or others, are a lot of them acquisitions of smaller banks or financial services operations — or is it more a merger of like-size companies?

Mr. Schutz: For the most part, it's typically bigger buying smaller. That word merger of equals is a real tough one, because it never ever equals. It has to be clear who the company is, what's the name, where they are headquartered, who is running it, because if you don't get that clearly defined, it gets very difficult to actually execute. So typically, it's bigger buying smaller.

TWST: Did you want to mention another company?

Mr. Schutz: Sure. Happy to talk about **Nicolet Bank** (NYSE:NIC) up in Wisconsin. They've been a proven acquirer. Very conservative management basically founded the bank. And every deal they've done has been nicely accretive and very good at executing on closing transactions. They're digesting what they have today. But this is over a $1 billion market cap — a bank that a lot of people never heard of, that is really doing a nice job.

They don't pay a dividend yet. We'll see if they do down the road. They've historically also bought back stock at times. But I think that this company has built a tremendous amount of value coming out of nowhere. And I think they're going to have a lot of small banks over the next few years to buy again to help create value.

Their footprint stretches from Michigan all the way over into Minnesota. And there may be lots of small banks that will raise their hands. And the reason some small banks may raise their hands to try to sell themselves are multiple factors.

One that's always been out there is age. Another one has been cost of deposits. Rates have been rising. They may not have loans offsetting that and may be tough to earn money. And then lastly, I think a more and more important factor that we wrote about in our last interview is technology.

Banks need to invest in technology one way or another. If you're a really, really large bank, you're investing tens of billions of dollars and a lot of that goes to maintaining your old systems. And if you're a smaller bank, you have a chance to actually be a little bit more nimble and take advantage of some of the best providers that are out there. But if you're really small, you may not have the expertise or talent or the money to invest in improving your technology.

And what's happened since the whole COVID crisis is people have changed their banking habits. They've gone much more online, much more digital, and having that right type of product is really critical to their success. A lot of smaller companies just can't afford to either have the time, knowledge or money to invest in improving their technology stack.

1-Year Daily Chart of The First Bancshares, Inc.

Chart provided by www.BigCharts.com

TWST: And did you want to mention a final company?

Mr. Schutz: I'll mention **Equity Bank** (NASDAQ:EQBK), headquartered in Wichita, Kansas. And that bank has also been very successful at doing acquisitions using its currency, buying back stock, investing in technology and they also have a very good deposit structure. I think **Nicolet** also has a good deposit structure where they're core funded.

Some of those more rural communities are great places to get funding. There may not be a lot going on in those communities, but from a deposit perspective, a really great place. And then obviously, you can lend in some larger, more actively growing markets.

I believe that that company has a nice footprint. I think others, again, would have interest in it. I think they have control of their own destiny by executing. And again, this company grew tremendously through acquisition. And there's a lot more from the debt.

TWST: And with the banks that we've been talking about, what kind of risks do they see if there's a recession coming up?

Mr. Schutz: The interesting thing is that everybody reads about it, everybody hears about it. We've just not seen it when you talk to management teams. They're not seeing any of their core customers having issues.

"But the most important thing is when you underwrite any loan, you should be underwriting that loan for all sorts of risks. You've got to have the proper debt coverage, you've got to have proper loan to value, the right profile of the individuals that are behind those loans. And if you do it right — even in a recession."

What can transpire and what will transpire are two different things. But the most important thing is when you underwrite any loan, you should be underwriting that loan for all sorts of risks. You've got to have the proper debt coverage, you've got to have proper loan to value, the right profile of the individuals that are behind those loans. And if you do it right — even in a recession. And by the way, banks have done well in recessions.

I mean, everybody wants to extrapolate and go back to 2007 and 2008. And part of that was some terrible products, some terrible managements. And by the way, those managements have not gotten the money to go start other banks. I mean, they're kind of gone. You've got a lot of managements that have experience from that perspective. The products aren't silly. The underwriting has been good. A lot of people obviously tightened up underwriting in the spring of 2020 and very few of them loosened it.

The loan to value is very, very important for managing your risk if you're lending to something tangible. If you're lending something intangible, it's the people behind it, the business behind it and projecting where their exposures are.

The banking industry is pretty well capitalized. They've got good loan loss reserves. Eighty percent of lending is taking place outside the banking industry, not regulated, not as conservative, and they're different products, buy now, pay later products, which could cause some pain for some of those lenders.

TWST: And among a lot of the regional banks that you follow and invest in, anything they'd like to see the federal government do in terms of financial policy or economic policy that would be helpful to them?

Mr. Schutz: I would say the majority of managements feel like they do a good job. And I think that the relationship with the regulatory agencies is something that shouldn't be political, and I mean that with any administration, the pendulum swings. In a Democratic administration, the regulators get tougher, in a Republican administration, the regulators get looser. It'd be nice if regulatory policy was regulatory policy and consistent and I wish that they would be consistent over time.

I think that there are agencies that are much more political than others. And I think from an evidence perspective, I'll give you the good versus the bad. But the OCC, the Office of the Comptroller of the Currency, I think, the temporary head, Michael Hsu, I've heard management say great things about him, being fair and evenhanded. You want to hear that type of commentary versus agencies that are trying to destroy companies.

TWST: And in other sectors, like restaurants or retail, we've heard stories of companies unable to find adequate staff, especially after the pandemic. Has that been a problem for banking, especially with entry-level positions, maybe tellers and some other types of positions?

Mr. Schutz: Yes, you're absolutely right. I think every business has had a hard time hiring people. I think what's gone on in banking — and obviously the teller level has been one of the entry-level places in banks — it's been harder to fill those positions. But you've also had an environment where there's less and less branches, there's less and less requirement for tellers. There are intelligent ATMs out there that provide all sorts of services to customers. I think the reliance on tellers is less, but you're absolutely right. The entry-level employees anywhere are hard to find.

I think it's holding back the economy in this country. I think manufacturing onshoring, which would be great for the banking industry because of great lending activity, is hard to do because manufacturers can't find all the employees to staff new factories or new lines. It's really unfortunate. I do think that there may be some policies out there that could be enacted, as you ask about it, to encourage people to come back to work.

1-Year Daily Chart of Provident Financial Services, Inc.

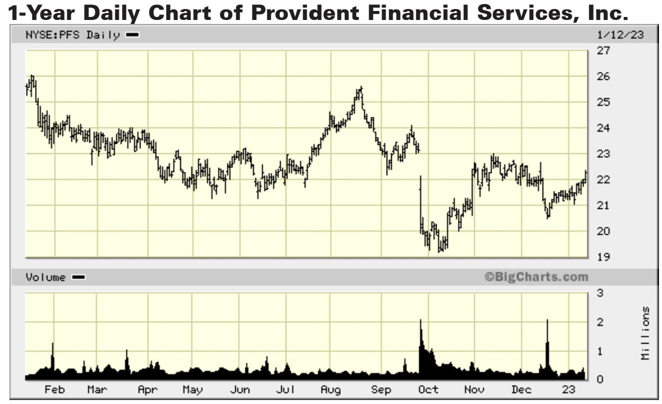

Chart provided by www.BigCharts.com

TWST: And any advice overall for investors who might want to have financial services as part of their portfolio? Should they stay clear of the big, mega banks and focus more on the regional or even maybe sometimes the community-type banks? Anything you could suggest for them?

Mr. Schutz: There are a couple of really great points in the big versus the small. First of all, the regulators at this point really have it in for the big. And they want to hold more capital, they don't want to do mergers and they're really camped out at the big. So it's hard for those big companies to operate as entrepreneurs where smaller banks can do that and be more nimble.

I also think that one of the things that's important to me is geography. I love faster-growing geographies. I only gave you one bank today in places like Georgia and Florida. But there are places in this country that are growing much, much faster. States in this country are growing much, much faster than the rest of the country. I think that's also important to be able to be nimble.

I can pick a bank in Tennessee, or a bank in Texas. Those markets grow faster. And even in a recession, those states may not be in recession. I think that that's a really important thing to do from a stock-picking perspective.

So you've got the regulatory, you've got the geographic, you've got the entrepreneurial and then lastly, you really have M&A. So the large banks really can't engage in it. They can't sell. And if you kind of take an actuarial look at the banking space, you'll find that between 3% and 5% of all banks sell every year.

Now, obviously, we've had a slowdown in this last year because the regulators have been slower in approving deals and a little bit more uncertainty out there when you're buying your neighbor and going, who do they lend to and how do they lend and what's in their securities book?

But I do believe the resumption of mergers and acquisitions will drive a lot of value down the road because companies that have deposits will be valuable to those who don't, and those who don't may actually have to sell if they can't buy. So I expect there will be a resumption of merger and acquisition activity. The question is always when, but valuations are incredibly intriguing. And I do like the dividend aspect of banks in terms of belonging in a portfolio.

TWST: Anything we haven't talked about you care to bring up?

Mr. Schutz: I think if you look at valuation of the banking index, particularly the regional banking index versus the S&P 500, it's near historical lows from a price-to-earnings ratio perspective. You could have a scenario where you could have the S&P down a fair bit and banks not down at all or even banks up. And I could point to the year 2000 where you had the tech wreck and banks performed pretty well, particularly smaller banks, in the last three quarters of the year in 2000.

TWST: Thank you. (ES)

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Fund holdings are allocations and are subject to change at any time. As of 12/31/22, the Fund held: 0.95% of AGNC Investment Corp. (AGNC), 5.75% of First Bancshares Inc. MS (FBMS), 1.22% of Provident Financial Services Inc. (PFS), 6.77% of Equity Banchares Inc. (EQBK), and 1.84% of Nicolet Bankshares Inc. (NIC) of the Funds's total net assets.

Investment Definitions:

Book Value: The net asset value of a company, calculated as total assets minus intangible assets (patents, goodwill) and liabilities.

Price-to-Earnings Ratio: The price-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

S&P 500: The S&P 500 is widely regarded as the best single gauge of the United States equity market. It includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 focuses on the large-cap segment of the market and covers approximately 75% of U.S. equities.

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