RMB FUNDS

# RMB MENDON FINANCIAL FUNDS

## Commentary: November 2017

At the one-year anniversary of President Trump's election, the main drivers for financials' valuations are well known. The initial market euphoria in financials predictably has ebbed and flowed when encountering political realities during the year, while the overall, broader market has had a remarkably unwavering run. These drivers, namely consolidation, correlation with higher rates, regulatory relief, tax reform, and valuation, continue directionally, but at varying paces. During the month, we saw an increase in consolidation and regulatory relief, which we think warrants additional commentary.

November overall saw a resumption in mergers and acquisitions (M&A) activity after a seemingly sluggish September and October. Updating our year-over-year comparables yields the following: Through November 2017, 227 deals have been announced for an aggregate value of $24.53 billion and median price/tangible book value of 163.6%. In the same period in 2016, 228 deals were announced for an aggregate value of $25.34 billion and median price/tangible book value of 130.2%. Since 2012, there have been only six new FDIC-insured institutions created. To put this number into perspective, 178 FDIC-insured institutions were chartered in 2006 alone. Also of interest regarding today's M&A environment is the many ways that deals are "getting to the tape." We think it is illustrative to examine several transactions during the month to get a sense of the different structures and attributes of the current M&A environment.

The first transaction was an in-market deal in North Florida/South Georgia. It is notable because the cost savings are expected to be 55% of the target's stand-alone expense base. Interestingly, 67% of its branches are within two miles of the buyer's branches. This significant overlap allows for considerable operating efficiencies while improving the product offering for the target's customers.

The second notable transaction was a bank in Chicago that acquired a well-run, privately held bank headquartered in the desirable Evanston suburb of Chicago. The combination creates the Chicago area's largest community bank under $10 billion in assets. The buyer itself was recapped by an investor group, led by its current chairman, in 2013 and was privately held until it went public earlier this year. One of the compelling reasons why it decided to list was to provide itself a currency that would be appealing to potential sellers seeking liquidity. Upon announcement of the transaction, the shares traded up, once again reinforcing the notion of banks creating value by enhancing their franchises via thoughtful M&A.

Lastly, towards the end of the month, there was a merger transaction in Texas where the acquirer funded the cash consideration of the transaction in an overnight capital raise. We like the efficiency of this type of transaction because the proceeds are immediately put to use and easily analyzable. We have seen more of these transactions over time as certain management teams with proven track records are able to raise "just in time" capital, reducing the drag created by lugging an M&A "war chest." In the many meetings we conduct each year, not only do we get to learn about the companies with which we meet, but the companies also get to learn about us and our suitability as shareholders.

On the regulatory front, tangible evidence of reform emerged from both Congress and regulatory agencies (and the intersection of the two with the confirmation hearings of Jerome Powell for Fed chair). On November 13, a bipartisan group from the Senate Banking Committee released a proposal that would exempt banks between $50 billion and $250 billion in assets from heightened Federal Reserve (Fed) oversight, including Comprehensive Capital Analysis Review (CCAR) and Systematically Important Financial Institutions (SIFI) designations. This year, only about one-third of the 34 CCAR banks had assets greater than $250 billion, so this change would be meaningful. Piper Jaffrey analysts noted, "We estimate banks near/over $50-250 billion in assets ***could*** see a 20%+ tailwind to EPS over the ***long term*** if the threshold were moved" (emphasis theirs). If passed, it would result in a material reduction in regulation and provide management teams with a greater ability to intelligently manage capital return. In addition, M&A should benefit from removing the artificial regulatory asset levels, resulting in larger companies potentially returning to the market as buyers and creating some compelling transactions with powerful synergies and cost savings.

Meanwhile, the arbitrary asset level triggers (among other items) created by the Dodd-Frank Act is resulting in the unintended consequence of many banks examining whether the benefits of bank holding companies (BHCs) outweigh the costs. As background, the Bank Holding Company Act of 1956 established the conditions under which a corporation may own a U.S. commercial bank and granted regulatory/supervisory responsibilities to the Fed. Broadly, the intent of the Act was to restrict banks' activities in nonbanking endeavors, which could increase risks to the safety and soundness of the underlying institution. Amendments to the Act were made over time (in 1970 – allowing multibank holding companies through subsidiaries to engage in activities "closely related to banking," and in 1999 – Gramm-Leach-Bliley Act allowing banks to engage in insurance, investment banking, and merchant banking), arguably swinging the regulatory pendulum further away from the Act's original intent.

Post-crisis, the Dodd-Frank Act reversed this trend in a "one size fits all" manner meant to curtail the financial engineering activities of universal banks. In doing so, it promulgated onerous regulations for all banks, regardless of size or complexity. Dodd-Frank implemented the restrictions at the BHC level, enforced by the Fed. Year to date, several banks approaching the $50 billion asset size that results in enhanced regulatory scrutiny have decided to collapse their holding companies. These banks include Bank of the Ozarks (OZRK), BancorpSouth (BXS), and, most recently in November, Zions Bancorporation, Inc. (ZION). While all of these banks are important, one could not make a case that any of them are systematically important to the global banking industry. As such, we think this strategy has a lot of merit for "plain vanilla" banks engaged in taking deposits and making loans. By collapsing the holding companies, banks will no longer have duplicate safety and soundness regulators – banks will either be FDIC- or OCC-regulated and will no longer be under the jurisdiction of the Fed. Additionally, there should be cost (and/or time) savings realized and quicker regulatory approval for acquisitions. We are early in this process, but are monitoring it closely.

Before we close this update, we would be remiss if we did not discuss our thoughts regarding fund flows and overall positioning within the market. As we noted, expectations of the catalysts influencing financials have ebbed and flowed over the course of the year along with valuations. Our expertise within the sector allows us to opportunistically focus on what the market is mispricing relative to franchise value. There are many reasons why the market may misprice a security or sector, rational or otherwise. It was interesting to see the forceful rotation towards the end of the month out of growth/winners into value/laggards. Financials benefited as many of the familiar factors seemingly coalesced all at once, resulting in extremely strong inflow days for financial ETFs. Funds flowing into or out of the group in this manner results in unique opportunities for all parts of our strategy.

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

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