RMB Mendon Financial Funds

Commentary: October 2019

During the month, the team spent a majority of its time analyzing third-quarter earnings releases. As our partners know, we have been more positive on the fundamentals for the group than consensus, and third-quarter results bore this out. Of the 217 banks that the KBW Bank Index ("KBW") covers, 164 banks (76%) beat, 18 (8%) met, and 35 (16%) missed their estimates. This compares to 2Q19 when 58% of banks beat estimates and 3Q18 when 57% of banks beat estimates. Admittedly, sell-side expectations were somewhat lower than the prior periods listed. Operating EPS increased 3.6% sequentially in the third quarter, better than KBW's flat growth estimate, and 6.4% annually, also stronger than their 2.6% growth estimate. Loan growth was mostly as expected, and margins were slightly worse than expected. Fee income benefited from the increase in mortgage volumes due to lower rates, and credit remains extremely solid. Small- and mid-cap banks (SMIDs) posted the highest percentage of earnings beats and had the most robust loan growth. Despite this, the larger the market cap or the greater the asset sensitivity, the better the return in October. A lot of this can be attributed to passive fund flows out of defensive/growth factors and into cyclical/value sectors. The widening of the 2- to 10-year spread, stability of bank earnings, the increasing market belief (which we've maintained all year) that a U.S. recession is not imminent, and the relative valuations of the group have caused the beginning of flows back into the group ($1 billion in the month/$6 billion out for the year) and has the market refocused on the potential benefits of owning the group.

One of the seemingly missing ingredients to the success of community bank returns has been the lack of M&A announcements for banks over $1 billion in assets. Of the 231 transactions year to date, all but 21 deals were sub-$1 billion in assets. Early November saw what could be a reversal of this trend when Iberiabank Corp. ($31.5 billion in assets) and First Horizon Corp. ($43.7 billion in assets) announced a merger of equals, creating a $75 billion regional bank with a pro forma market cap of $9 billion. This newly minted regional bank will operate in 11 southeast/southwest states and will have greater profitability than that of either institution on a standalone basis. Importantly, the transaction was viewed favorably by the market with both stocks strongly up since the announcement. We think this transaction will engender further conversations among the more sophisticated community banks in the portfolio with additional transactions to follow.

Finally, we always like to share some of our recent travels, this time aimed at keeping a pulse on the disruption potential for technology in our space. During the month, we hosted a trip to Jacksonville with five bank CEOs and CIOs to meet with a fintech firm developing a banking core processor in the cloud off a modern technology stack. At the end of October, we traveled to Las Vegas to attend Money 20/20, which we have attended multiple times in the last several years. It is the premier trade show for all things fintech. We do these things to stay on the leading edge of the constant drumbeat of change within our focal industry. We emerged from these trips with a reinforced viewpoint of the convergence between traditional financial services and technology. We strongly believe that many banks will remain the relevant gatekeeper of the customer relationship while partnering with technology providers on a host of offerings, ranging from niche lending strategies to payments and digital banking offerings. This is especially true for commercially oriented banks where relationship penetration spans far beyond a single product line. In other instances, banks will serve as the infrastructure partners of technology companies who do not wish to wade into regulatory and compliance matters.

After attending Money 20/20, we worry more that some segments of the banking marketplace will be more susceptible to technological change. As firms like Uber and Apple partner with Goldman Sachs and Greendot to enable partial solutions, we feel that homogenous consumer products will be a very competitive area going forward with many very powerful brands in the space. This is why we view the mid-size regional banks as being net losers, as they are too small to be cost leaders and too big to be able to nimbly work with fast-moving technology companies. Community banks, however, offer a very different value proposition that is targeted toward small- and medium-sized businesses, and they don't try to compete with mass market consumer products. We continue to focus on where we think the business is going and to find the businesses and management teams that are most capable of getting there quickly and taking advantage of the dislocations along the way. What was different this year in Las Vegas and in the depth of our field trip conversations is the adoption of digital, customer-facing technology amongst the banks and a more fulsome discussion around how to use open technology to partner with niche providers on things such as payment solutions. *At the end of the day, the key is to find ways to de-commoditize the* *banking business, which is likely going to be done through partnerships and open architecture initiatives. Over time, this is going to drive more pronounced winners and losers in the banking space.*

We know that many investors have a lot of questions around fintech development and what that means in terms of investment opportunities. As always, we welcome your feedback, comments, and questions.