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Opportunity Abounds in Financial Services

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Opportunity Abounds in Financial Services

On the longest day of the year a small bank owner in Greenwich, Connecticut stared out the window of his office. On this evening – June 21, 2024 –the sun still shone brightly, though it was nearly 9 p.m. The rain had stopped, giving way to a radiant rainbow. The banker looked closely: he was almost certain that at the end of the rainbow he could see a pot of gold.

Mirage or not, a pot of gold is a fitting metaphor for a small bank with assets of $3.5 billion, a booming wealth management business, and a leading commercial and industrial portfolio of loans to small businesses. In today's economy small banks are attracting large investment accounts and competing for sizeable loans. For those that can act decisively and capitalize on a good market, 2024 holds a lot of promise.

Our story of a small bank owner in Greenwich, Connecticut is not an isolated one. All across the United States – from Palo Alto, California (Silicon Valley headquarters) to Houston (where oil & gas money spills on top of business services and shipping), and from Buckhead, GA (corporate and citizen America are migrating to Atlanta) to Palm Beach (the Monte Carlo of Florida) – small sub-regional banks are flourishing. Wealthy family offices need consulting services; small businesses need funding; private equity funds need help managing cash flow. These economic tailwinds, combined with low valuations and normalizing interest rates have made small banks attractive investment opportunities. Investment brings capital and strategic planning that allows small banks to grow, improve operations, and maximize shareholder value, ultimately facilitating growth to a larger platform. In 2024 investment is the rainbow leading small bank owners to the proverbial pot of gold.

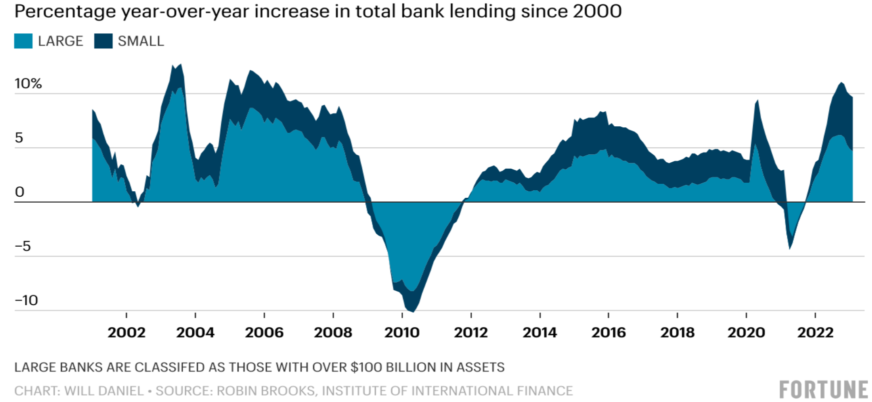
Low Valuations for Financial Services Companies

President Calvin Coolidge famously said in 1925: "The chief business of the American people is business". These words ring just as true almost a century later: today the American economy is still driven by invention, entrepreneurship, and venture capital. The United States is home to dozens of regional growth markets, each with its own opportunities that arise from social and economic factors, regional geographies and changing demographics. Shrewd investors anticipate which markets will attract a disproportionate number of growth elements, such as a new industrial plant drawing a group of suppliers, historic wealth concentrating with each generation, a growing immigrant population, or a favorable tax code.

Each sub-region in the United States has its own set of factors at play, with the potential to create a growth market. Boston, Silicon Valley, Chicago, Austin and Philadelphia all have large student populations interested in venture capital and entrepreneurship. In such fertile environments local businesses, colleges, universities and governments support this dynamic in myriad ways. Chicago is poised to become one of the country's quantum computing and artificial intelligence hubs as a result of the concentration of top universities, national labs and industry partners. Small banks are starting to tailor their products to meet the needs of fast-growing submarkets, and grow their businesses alongside the US economy.

Small banks, with a big role in U.S. lending growth

Percentage year-over-year increase in total bank lending since 2000



Low Valuations for Financial Services Companies

Despite clear evidence of healthy and growing submarkets, the financial services companies that serve them remain undervalued. This is the result of several factors, including the disruption of the Global Financial Crisis in 2008, the Federal Reserve's zero interest rate policy that followed, interest rate spikes in 2018 and 2022, and of course, the fallout from Covid. This confluence of events has caused investors to shy away from financial service companies over the last decade-and-a-half. As a result, price-to-earnings multiples dropped from 14X to 8X earnings, book value multiples fell below 1X, M&A multiples went from 2X to 1.5X and the market capitalization of the financial services industry shrank overall.

A "Pot of Gold"?

Where does all this leave our small bank owner from Greenwich, Connecticut? His bank is located in an attractive growing submarket, and is favored by local businesses who prefer to bank with a small independent bank. In the current environment free from large economic shocks, banking is an attractive business with consistent earnings, high profitability and opportunities for growth. At the same time, the historically low valuations of financial services companies provide a rare opportunity to invest at a discount. Our small bank owner does what anyone in his position would do: he amasses shares in his bank.

At the moment small banks are valued at 8X earnings and 95% of book value. Nonperforming loans are at the lowest level in almost four decades, deregulation could come as early as next year, interest rates have risen above zero, and the yield curve should normalize within a year. M&A activity is just starting to improve and investors will soon begin circling.

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