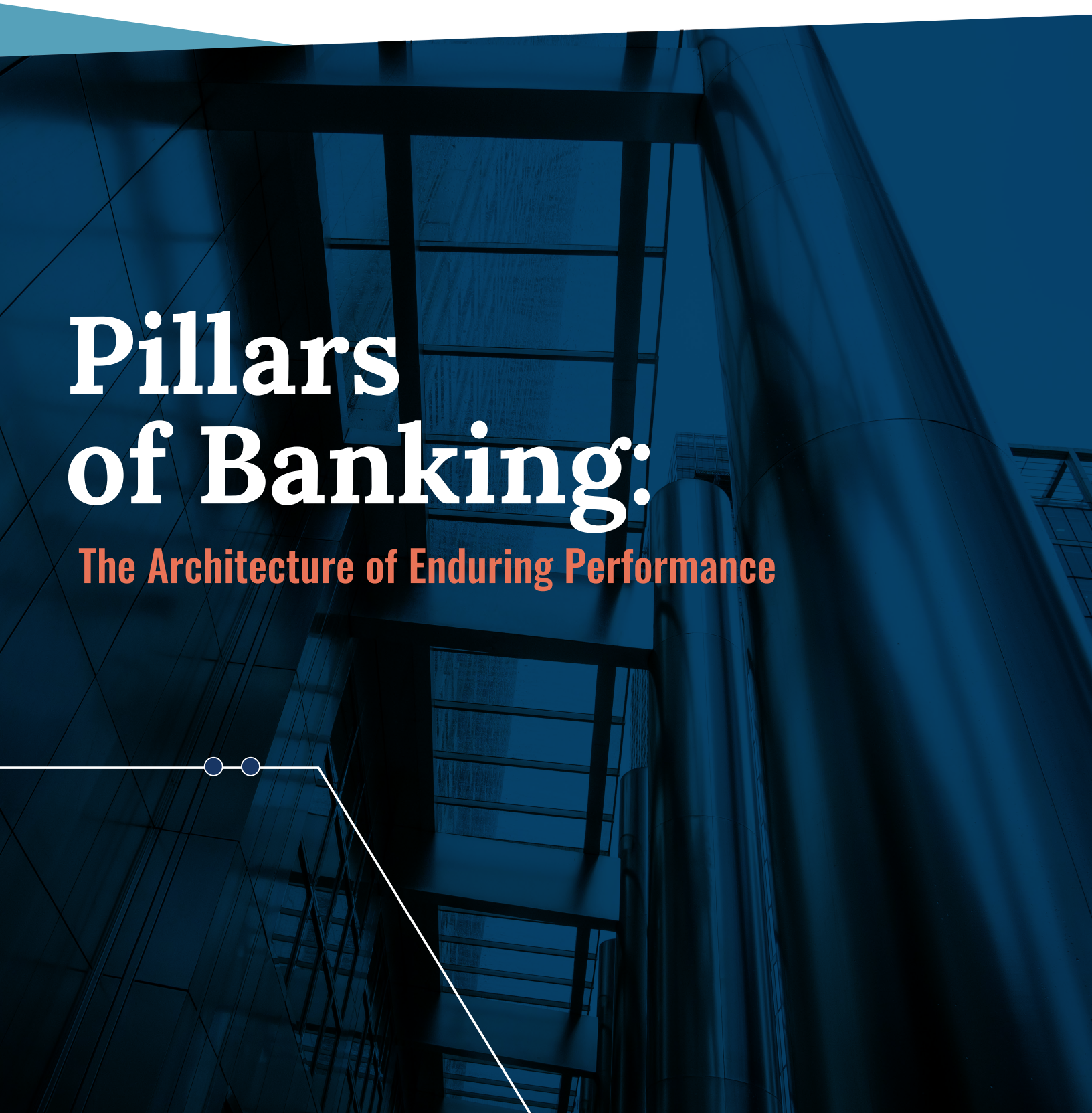
Kennedy Capital Management®



Pillars of Banking:

The Architecture of Enduring Performance

Introduction

The words "buy low, sell high" can be read on more than one wall at the office of Kennedy Capital Management ("KCM"). It is not uncommon to hear veteran value investors talk about their passion to buy low and the challenge to sell high. To that end, it is every investor's dream to find a stock that may never need to be sold—that is the stock of a business that can generate and reinvest profits to perpetuate their competitive advantage. Investors commonly identify this as a "compounder." These businesses don't all look the same but may share commonalities such as high Returns on Invested Capital (ROIC), fast Earnings Per Share (EPS) growth, or strong Free Cash Flow (FCF) generation[1]. Specific to banking, compounders are typically institutions that grow their Equity or Tangible Book Value (TBV) per Share[1] at a rapid pace because of their apparent ability to consistently monetize one or several of their differentiating factors. Investors, aware of the power of compounding, may award an extraordinarily high valuation to such businesses. Buying bank stocks that have compounded over an extended period may appear to be a successful investment strategy—but is it?

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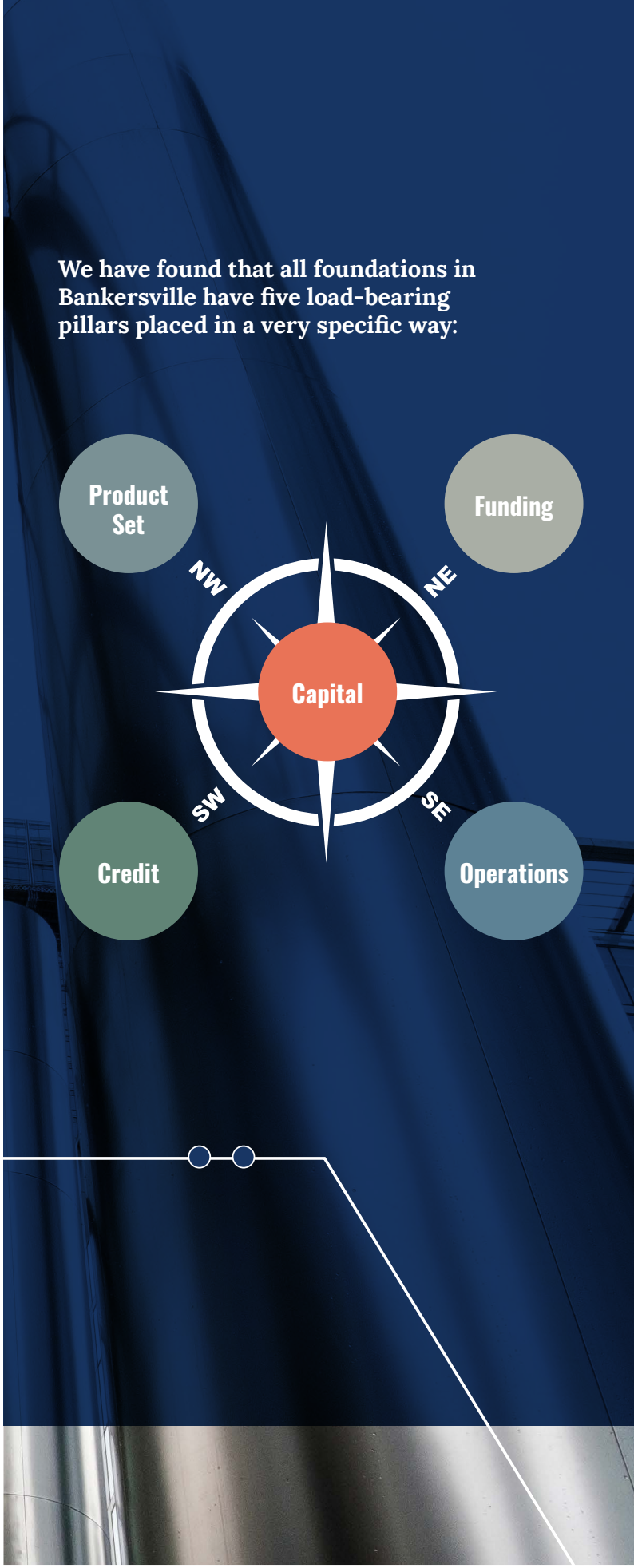
From the 2008 Great Financial Crisis through the end of 2022, Silicon Valley Bank (SIVB), First Republic Bank (FRB), and Signature Bank (SBNY) were in the top decile for performance among all US bank stocks[2]. These institutions rapidly compounded their equity, held a perceived competitive advantage, were led by well-respected management teams, and enjoyed relatively elevated valuations. The three stocks checked many of the boxes of a compounder, and yet they all collapsed in the spring of 2023. The word "collapse" has been chosen carefully. There was not slow bleeding. These businesses failed rapidly—some of them seemingly overnight.

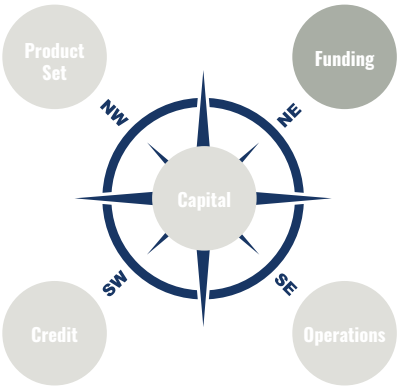
Please see footnotes on page 13 of this document.

Skyscrapers in the Town of Bankersville

At KCM, we use a skyscraper analogy to explain our framework for analyzing banks. Specific to compounders, think of a bank that compounds as a building that grows taller over time, progressively pressuring the structure the higher it goes. Other than the obvious added weight, winds at 1,500 feet high are more severe than at 100 feet, and city inspectors scrutinize the taller buildings with increased rigor because the collapse of one could have systemic consequences for everyone living in this town, which we call "Bankersville." It goes without saying, we think of the bank's management team as the crew in charge of the expansion project. Their decisions and level of execution are critical.

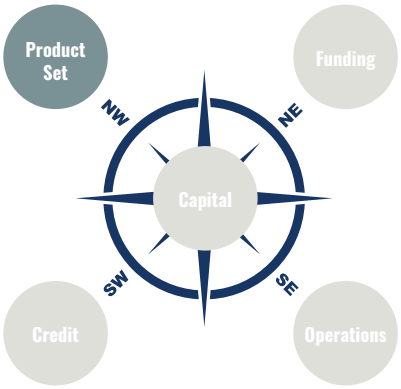
Walking around the streets of Bankersville, there are numerous investors looking up, admiring the intimidatingly tall structures around them. But occasionally you will cross paths with someone looking down, trying to understand what is underneath, supporting those buildings. That is how KCM walks around Bankersville: head down, studying foundations, and trying to find those buildings with the appropriate team to execute viable projects that increase the value of the building. In the case of compounders, we look for resilient foundations that a talented crew can leverage to build a tall and beautiful skyscraper over time.





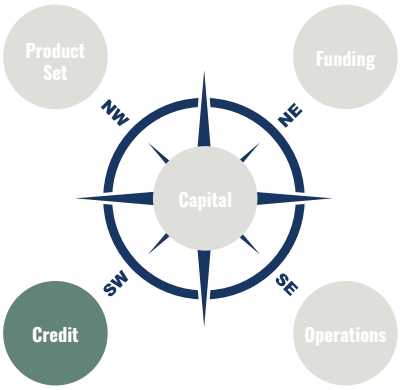
Funding (NE)

The "Funding" pillar sits at the northeast corner. Think about this one as a pillar made of ceramic—hard but brittle. It is believed that the defining characteristics of this pillar are the cost and stickiness of the funding. Evaluating the quality of the pillar based on cost is short-sighted, as the stickiness of the funding defines the resiliency of the structure. A bank with high cost of funding may struggle to grow profitably, but one susceptible to major, unplanned deposit outflows may quickly collapse. To an extent, cost can be a result of stickiness because a loyal, satisfied depositor will usually be less cost-sensitive. Given the fragility of this pillar, it is useful to utilize appropriate materials in the construction of the building. In banking, duration can be viewed as the measure of weight. Management teams that overestimate the quality of their funding can make the fatal mistake of growing through long-duration assets, which can be compared to building a skyscraper with heavy stone. More on this later, but if winds change aggressively and the weight of the structure shifts toward this corner of the building, funding could snap, forcing adjacent pillars to work much harder to avoid an imminent collapse of the building.



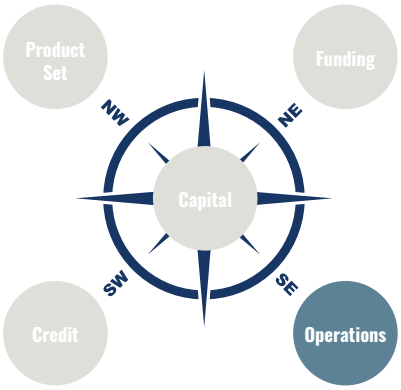
Product Set (NW)

In the northwest corner and adjacent to "Funding," we find the "Product Set" pillar. This pillar, fabricated from steel, is marginally flexible and can be customized with relative ease. Finding truly different Product Set pillars in the foundations of Bankersville is rare but can be powerful. It is not uncommon to see small banks mostly focused on commercial real estate, while bigger ones can have multiple lines of specialty lending. Similarly, while the typical smaller bank makes most of its profits from its lending activity (gathering deposits to originate loans), others have found ways to make money through fee-based businesses such as wealth management, interchange fees, and capital markets. A versatile and robust product set allows for growth under different environments, offers different duration profiles, and can directly alleviate pressure in funding and credit via diversification. Buildings with a narrow Product Set pillar may find themselves more exposed to negative exogenous events, which in this analogy could be represented by winds, earthquakes, or city regulations.



Credit (SW)

In the southwest corner, adjacent to the "Product" pillar, is the "Credit" pillar. We've found most Bankersville debacles to be rooted in credit. Due to its multi-layered construction and differing sets of materials from building to building, this pillar is particularly difficult to analyze. When learning about credit, an investor needs to understand all aspects, from the underwriting process to the maintenance routine, to the ability to resolve issues in an effective and timely manner. This pillar deteriorates from the inside out, so a deep understanding of its core should allow the investor to foresee potential cracks before they become visible to other passersby. The weight carried by Credit is difficult to redistribute if this pillar starts failing. The first step a bank experiencing credit weakness can take to help protect the building is to remove weight—or at least stop growing. Credit is essential for the integrity of the building and is certainly a pillar unique to each building in Bankersville.



Operations (SE)

"Operations" is at the southeast corner of the foundation. This is rarely an investor priority, but we believe that operational excellence offers both downside protection and upside opportunity. This is one of the pillars that regulators analyze in greater detail when the building climbs to certain heights. Banks with less than $10 billion in assets have fewer regulatory requirements than those with over $100 billion[3]. Regulators also pay more attention to this pillar if the bank is growing through unconventional or novel practices such as Banking as a Service or crypto-related offerings. On the upside, having a lean cost structure allows the bank to maximize profits, which can ultimately be reinvested for growth, while also being able to defend profitability against more drastic downside economic scenarios. To this end, we believe efficiency to be an important determinant of success for a compounder.

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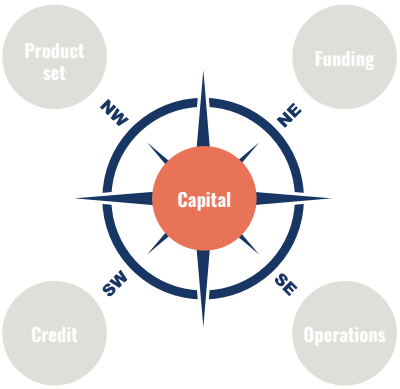

Capital (Center)

Commanding the center of the foundation, we find the "Capital" pillar. It sits in the center of the foundation because we consider it the core of the building. Jamie Dimon, CEO of JP Morgan Chase, highlights its value when he talks about his bank's "fortress balance sheet."[4] Should any of the four surrounding pillars start to suffer damage or experience challenges, it is the durable Capital pillar that bears extra weight to resolve those issues. For instance, if there has been an issue in the Credit column and cracks are showing up, the Capital pillar supports that weight until the repairs are complete. If winds (e.g., interest rates) change and the weight of the building shifts to the northeast corner ("Funding"), a robust Capital pillar gives the bank a chance to work on the foundation or simply wait for the wind to calm down. While Mr. Dimon highlights the essential value of the Capital pillar in defensive actions, we see it as valuable in offensive events. Management teams may use excess capital to increase dividends, accelerate buybacks, aggressively enter new markets, complete strategic transactions, or expedite balance sheet changes. At times, the Capital pillar bears a heavier burden than the building crew and investors realize, leaving it unavailable to assist during moments of crisis. The importance of the Capital pillar is well-reflected in modern regulatory guidelines, with the largest institutions facing strict requirements to ensure this pillar can support the building during extreme events[3]. Bankersville resides in an area prone to strong winds and occasional earthquakes. As one Wall-Streeter once said, "A well-capitalized bank doesn't just survive a storm; it becomes the port (replace with 'building') where everyone runs for safety."

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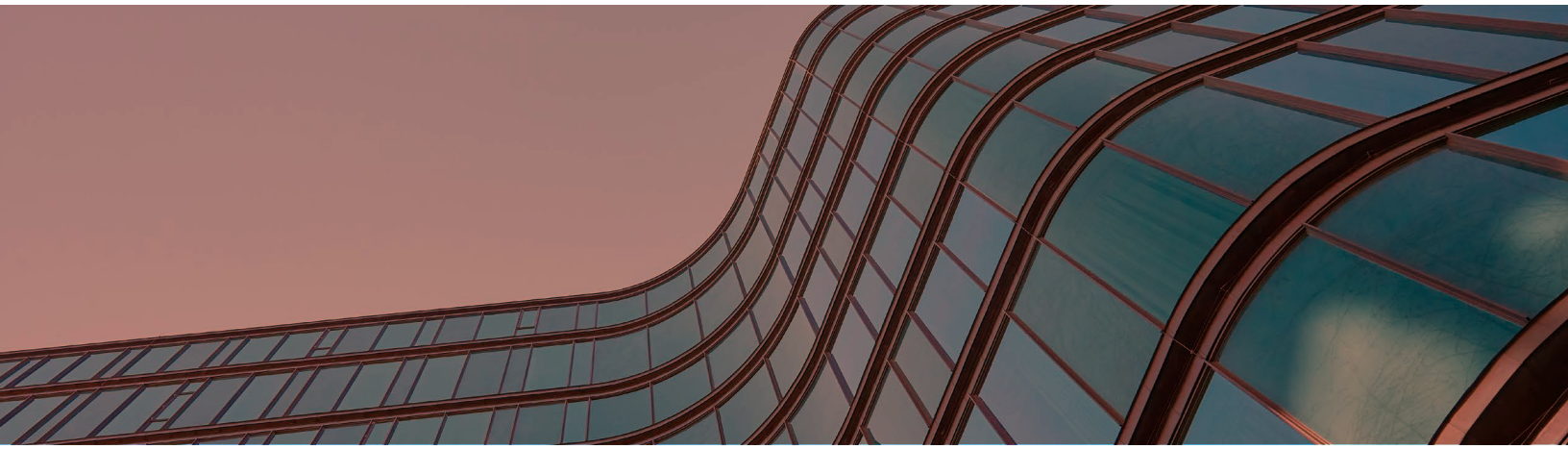

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"Through the skyscraper analogy, we can track the evolution of the building that grew very fast and collapsed even faster. These builders identified an area of Bankersville that was relatively underdeveloped but where the economic activity was increasing rapidly."

The Anatomy of a Weak Skyscraper – Silicon Valley Bank (SIVB)

A New Building in Bankersville

Silicon Valley Bank was founded in 1983 in Santa Clara, CA, with the vision to provide banking services to startups in the Silicon Valley area. This focus on the emerging innovation economy allowed the bank to dominate one of the fastest growing areas of business in the United States[5]. Taking advantage of that leadership, Silicon Valley Bank was consistently delivering above-average shareholder returns, Earnings Per Share growth, and Tangible Equity Per Share growth. These attributes made its stock, trading under the ticker SIVB, one of the leading compounders in the banking sector and one of the most valuable bank stocks in the United States.

Through the skyscraper analogy, we can track the evolution of the building that grew very fast and collapsed even faster. These builders identified an area of Bankersville that was relatively underdeveloped but where the economic activity was increasing rapidly. With this vision, SIVB broke ground in 1988 through an IPO and, leveraging its unique "Product Set" pillar, it quickly became one of the fastest-growing buildings in Bankersville. For the sake of brevity, it suffices to say that the dot-com bubble exposed the narrow scope of the "Product Set" pillar and other structural concentrations, but the building prevailed and growth continued at a rapid clip. Less than a decade later, the 2008 Great Financial Crisis was the equivalent of a massive earthquake with the epicenter in Subprime Mortgage Avenue, causing multiple collapses and a domino effect that marked a before and after on how city engineers evaluated the health of skyscrapers in town. Silicon Valley Bank fared better than most simply because it was far from that location. As a result, the building exited the most severe banking crisis since 1929 in a position of strength, and with a reinforced brand, which allowed it to expand even faster. By the time COVID-19 arrived, SIVB was one of the tallest buildings in Bankersville[6], and remained one of the fastest growing.

Please see footnotes on page 13 of this document.

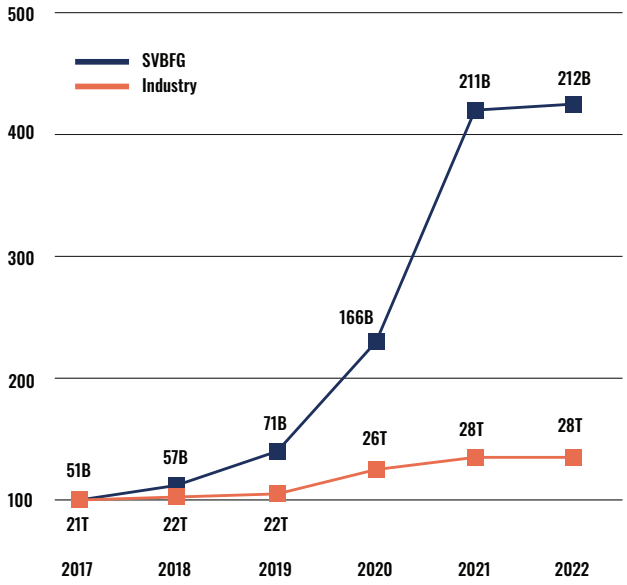
Hurricane Powell Blows Through Bankersville

This is when cracks began to appear. The U.S. government and the Federal Reserve decided to implement a series of stimulative fiscal and monetary measures with the goal of preventing a systemic economic downfall. These expansionary policies bridged the economic gaps created by the pandemic but also created sizable anomalies in specific areas. Related to banks, interest rates plummeted to near-zero levels and deposits increased dramatically. Between 2019 and 2021, bank deposits grew more than 20%, but SIVB nearly tripled its deposit base to nearly $211 billion[5].

Following the simplest laws of monetary abundance, inflation and interest rates started moving higher in 2022. This rapidly chilled venture capital ("VC") activity[5], resulting in sharply lower loan demand from SIVB's clients. Given the massive amounts of deposits gathered and the lack of loan demand, the SIVB team redirected large portions of its deposits from loans to long-dated securities with relatively safe credit profiles[5].

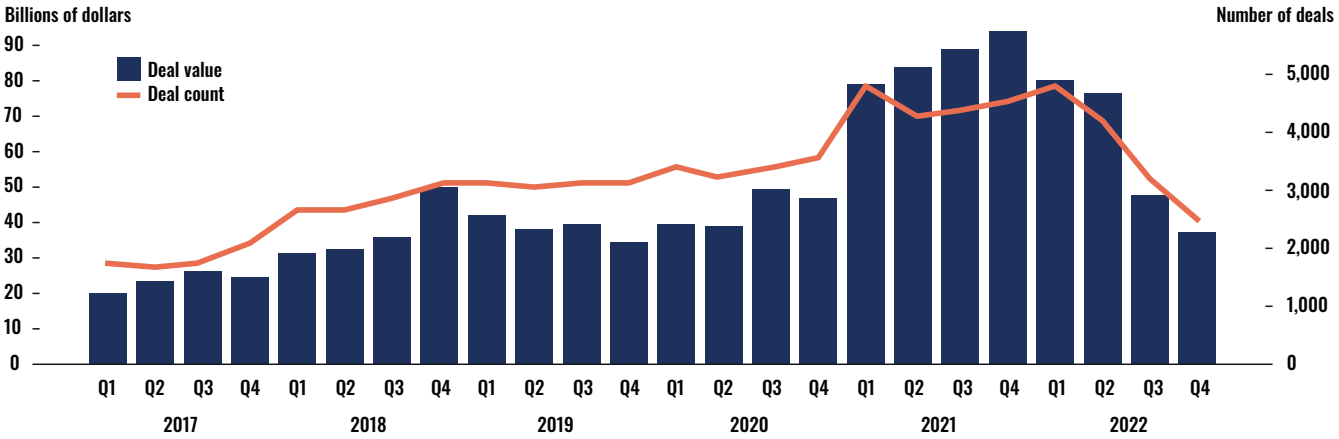
Silicon Valley Bank vs. Bank Peers – Total Assets

Index (2017: Q4 - 100)



Note: The key identifies lines in order from top to bottom. All values indexed to 100 at year-end 2017. Values are as of year-end. Values are in billions of dollars for SVBFG and in trillions of dollars for the industry. Industry aggregate includes all top-holder firms. Source: FR Y-9C and Call Report.

U.S. VC Deal Activity by Quarter



Note: Deal activity is defined as equity investments into startup companies from an outside source. Source: 2022 Pitchbook NVCA Venture Monitor.

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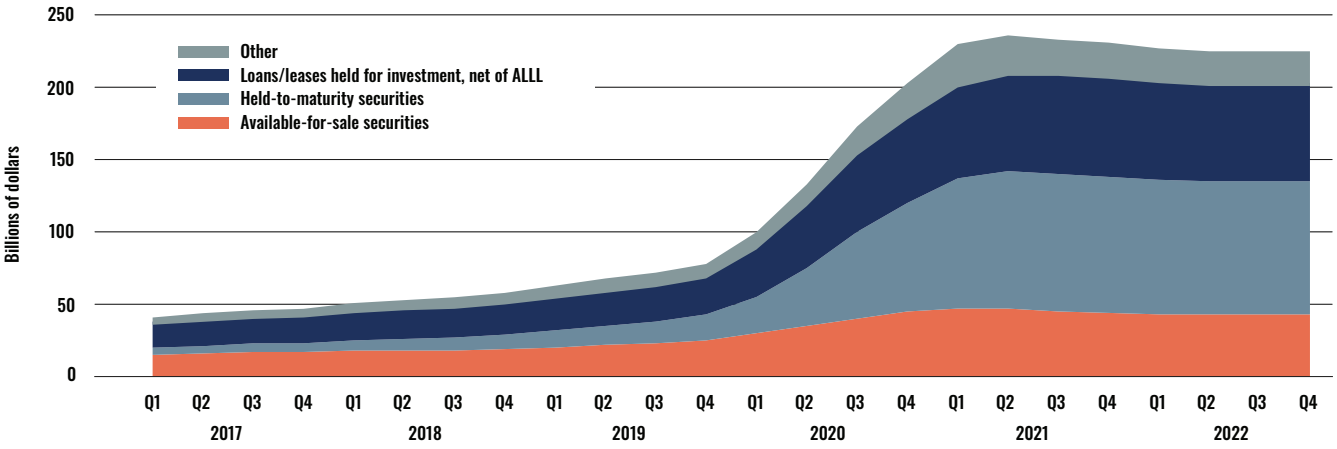
Assets Shifting from Loans to Securities

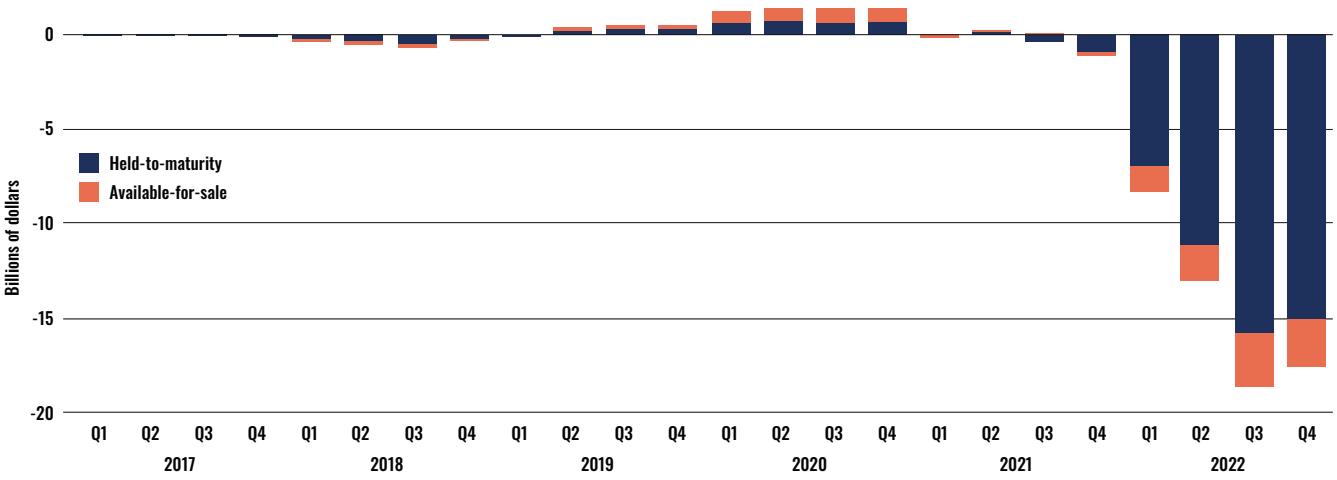


Note: The key identifies areas in order from top to bottom. ALLL is allowance for loan and lease losses. Source: FR Y-9C.

With an anemic fundraising environment for VCs, clients started using their excess deposits rather than borrowing money to fund their needs. SIVB's deposit base dwindled, while its large asset base was parked in long maturities. SIVB's clear solution was to convert its asset base into cash to honor the deposit withdrawals. The forced sale of long-dated securities after a rapidly rising rate environment came at a high cost[5].

While SIVB's capital buffer looked healthy at first glance, the burgeoning unrealized losses and rapid deposit outflows laid bare the fragility of their capital[7].

SIVB's Unrealized Losses Transform to Realized When Forced to Sell



Note: Estimated unrealized losses on securities calculated as: (held-to-maturity fair value less held-to-maturity amortized cost) + (available-for-sale fair value less available-for-sale amortized cost). Estimates do not reflect losses related to available-for-sale securities that were transferred to held-to-maturity and do not reflect hedging impacts or tax consequences. Source: FR Y-9C.

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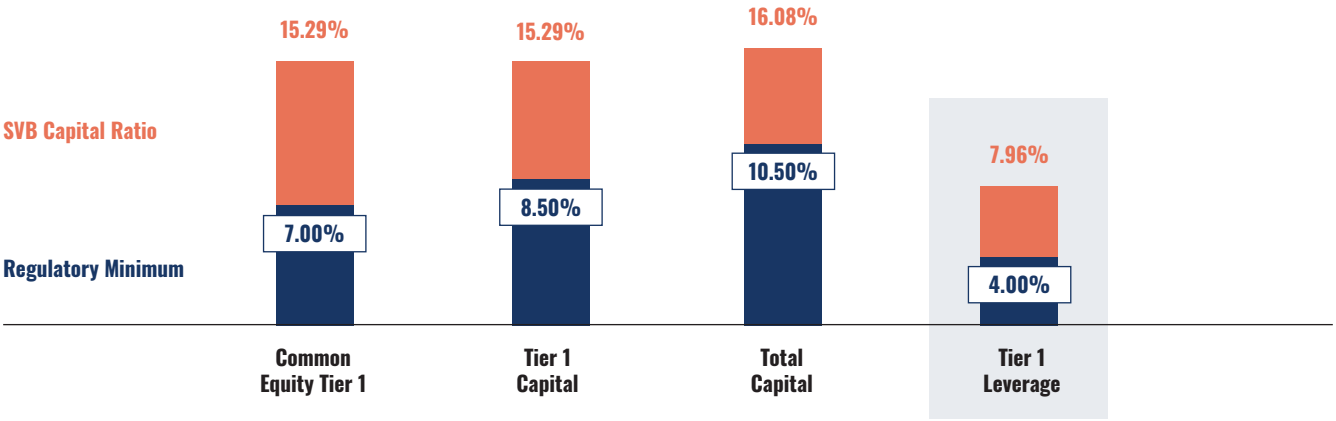
Silicon Valley Bank Capital Ratios

As of 12/31/22



Source: Silicon Valley Bank. "Q4 2022 Financial Highlights, January 19, 2023," **https://s201.q4cdn.com/589201576/files/doc_financials/2022/q4/Q4_2022_IR_Presentation_vFINAL.pdf**.

On March 8, 2023, the company announced its intention to sell a portion of its assets, along with a $2.25 billion new equity raise from investors, to absorb the aforementioned losses. One day later, as clients worried about the financial health of the bank, SIVB experienced more than $40 billion of deposit outflows—nearly 25% of its total deposits. On the evening of March 9 and into the morning of March 10, the bank communicated to regulators that depositors were requesting more than $100 billion, or over 80% of the remaining deposits. Unable to honor these redemption requests, and with insufficient capital to create the needed liquidity, SIVB was promptly closed by the California Department of Financial Protection and Innovation (CDFPI).

The Bankersville analogy helps to highlight SIVB's source of weakness. Healthy growth can veer off course without a robust and well-balanced foundation. Vertical expansion not only adds weight but also increases the exposure to external factors like winds and city regulation. What happened during COVID was that this building crew saw how the "Funding" pillar tripled in size and thought it was time to make a push upwards, leveraging its newly acquired strength. Given the lack of demand for loans due to economic uncertainty, Silicon Valley Bank decided to use heavy, prefabricated materials (long-dated, investment securities) to grow the building. The structure tripled in size, becoming one of the 20 tallest buildings in town[8]. Shortly after, Hurricane Powell blew through with higher rates. The heavy winds started to stress the "Funding" pillar in the form of deposit outflows, exposing its elevated fragility. Worried about the integrity of the structure, the builders checked on the "Capital" pillar to help with the stability of the building, but they found even this pillar was unstable and could not bear any more weight. The crew decided to reinforce the Capital pillar before shrinking the building (removing assets at the top). By the time the builders were asking for quotes to reinforce the Capital pillar, funding snapped in an unprecedented way. In less than 48 hours, the building imploded. Bankersville was shaken by a failure that tested every other building in town. Only two days after the collapse of Silicon Valley Bank (SIVB), Signature Bank (SBNY) was seized by the New York State Department of Financial Services (NYSDFS), and less than two months after that, First Republic Bank (FRC) was also closed to the public.

Please see footnotes on page 13 of this document.

The Lessons from Silicon Valley Bank's Collapse

The rise and fall of SIVB provided valuable lessons for all observers:

1

The pillars are connected:

Concentrations in Product Set can lead to concentrations in Funding and Credit

2

Funding quality:

Cheap is rarely synonymous with best, especially when cheap is the current market value established by a zero-interest rate policy (ZIRP) environment that the bank can't control. Cost of funding is ultimately subordinated to certainty of funding.

3

Duration is a bet, not a strategy:

In uncertain times, there is more economic value in a nimble balance sheet producing small profits than in one producing high returns but without flexibility.

4

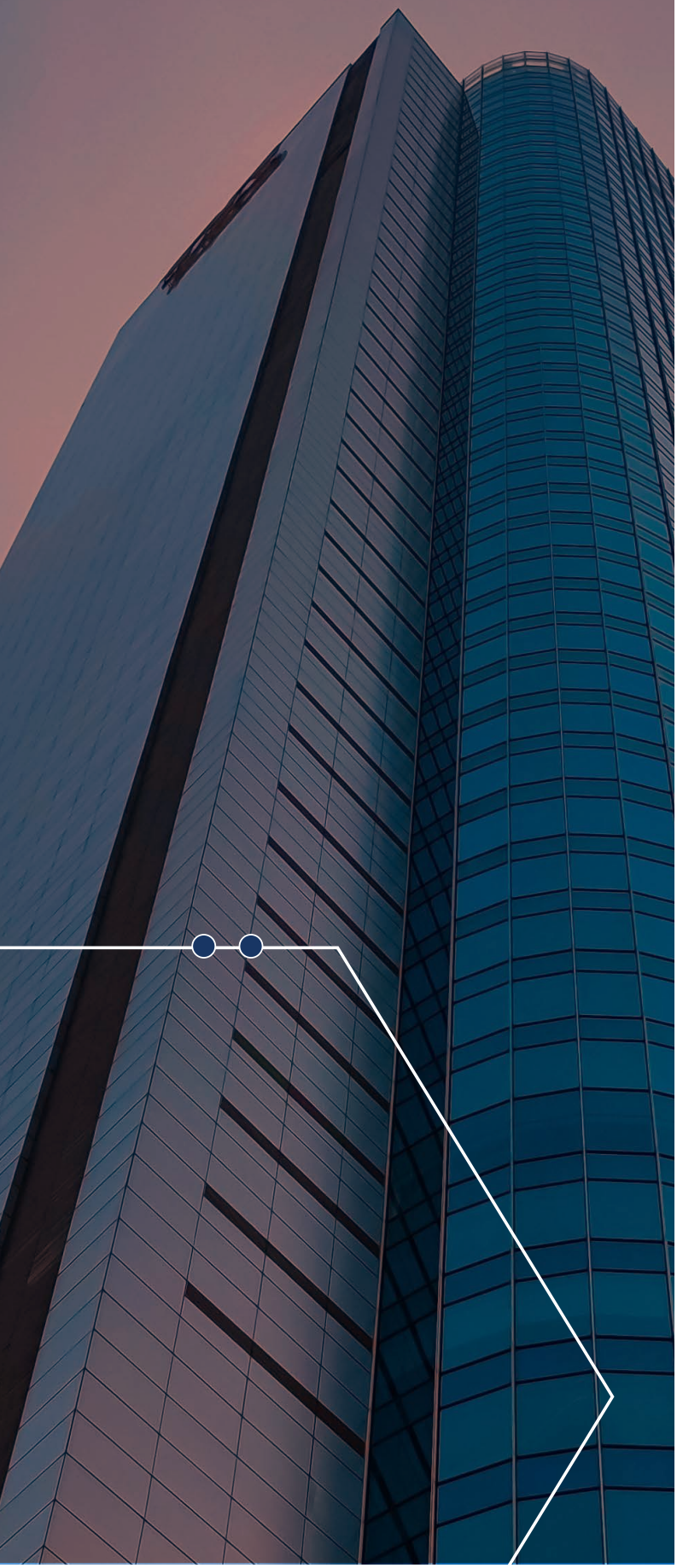
The accounting mirage:

Knowing the numbers is very different than understanding the numbers. Financial statements may provide a map to economic values, but investors must assiduously navigate toward their own version of the value of a business.

5

The abundance curse:

In banking, as in most endeavors, too much of a good thing may lead to disastrous consequences.



The Conclusion

The events that unfolded in the spring of 2023 were a painful reminder that betting on the prosperity of the status quo (compounders will compound) requires investors to have a deep understanding of "how" the compounding is happening and "why" it would be sustainable and defensible in the future. At Kennedy Capital, we understand that a favorable investment opportunity may take different forms, but we strive to employ a consistent analytical framework. Over the years, we have invested in many different types of banks. There are times where a damaged pillar can lead to a valuation opportunity, particularly when we believe the crew has the willingness and ability to transform the building successfully. Other times, the building is simply in a highly desirable area of Bankersville or has attributes other builders would like to incorporate into their own project, which could drive the value of the building to rapidly appreciate. Sometimes, a better building crew takes over a building where we see strong potential, or most investors ignore a building that is too small to stand out. In other situations, we identify emerging areas of potential opportunity in town, where new buildings are developing successfully.

When it comes to compounders, we believe that mediocre or even bad businesses can show "compounder" attributes during specific periods of time, but only truly exceptional businesses can do so through multiple cycles. True compounders don't collapse when winds change, when regulation becomes more stringent, or when an earthquake hits. Finding true compounders is a research-intensive process. In banking, opacity and complexity happen to be an advantage for those willing and able to put in the hard work.

Important Disclosures:

1) **Returns on Investment Capital (ROIC)** is a ratio used as a measure of the profitability and value-creating potential of companies relative to the amount of capital invested by shareholders and other debtholders. It indicates how effective a company is at turning capital into profits. **Earnings Per Share (EPS)** is the monetary value of earnings per outstanding share of common stock for a company during a defined period of time, often a year. It is a key measure of corporate profitability, focusing on the interests of the company's owners (shareholders), and is commonly used to price stocks. **Free Cash Flow (FCF)** is the amount by which a business's operating cash flow exceeds its working capital needs and expenditures on fixed assets (known as capital expenditures). It is that portion of cash flow that can be extracted from a company and distributed to creditors and securities holders without causing issues in its operations. As such, it is an indicator of a company's financial flexibility and is of interest to holders of the company's equity, debt, preferred stock and convertible securities, as well as potential lenders and investors. **Tangible Book Value (TBV) per Share** is a method by which a company's value is determined on a per-share basis by measuring its equity without the inclusion of any intangible assets. Intangible assets are those that lack physical substance, thus making their valuation a more difficult undertaking than the valuation of tangible assets.
2) FactSet Research Systems, Inc.
3) Source: Congress.Gov, "Over the Line: Asset Thresholds in Bank Regulation, May 2021": **https://www.congress.gov/crs-product/R46779**
4) Source: JPMorgan Chase & Co., "Chairman and CEO Letter to Shareholders – Annual 2024 Report": **https://www.jpmorganchase.com/ir/annual-report/2024/ar-ceo-letters**
5) Source: Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, April 28, 2023": **https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf**
6) Source: Federal Reserve Statistical Release, "Large Commercial Bank as of December 31, 2019": **https://www.federalreserve.gov/releases/lbr/20191231/default.htm#:~:text=BIRMINGHAM%2C%20AL,0.00**
7) Source: Silicon Valley Bank "Q4 2022 Financial Highlights, January 19, 2023": **https://s201.q4cdn.com/589201576/files/doc_financials/2022/q4/Q4_2022_IR_Presentation_vFINAL.pdf**
8) Source: Federal Reserve Statistical Release, "Large Commercial Bank as of December 31, 2021": **https://www.federalreserve.gov/releases/lbr/20211231/default.htm#:~:text=BIRMINGHAM%2C%20AL,0.00**

ABOUT KENNEDY CAPITAL MANAGEMENT LLC

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