Bank Director

# Breakout III: Community Bank Debt Issuance: The Credit Markets' Updated View


**Van Hesser**
*KBRA*


#AOBA23

# Community Bank Debt Issuance: The Credit Markets' Updated View

Acquired or Be Acquired Conference 2023

Van Hesser
Senior Managing Director and Chief Strategist
January 2023

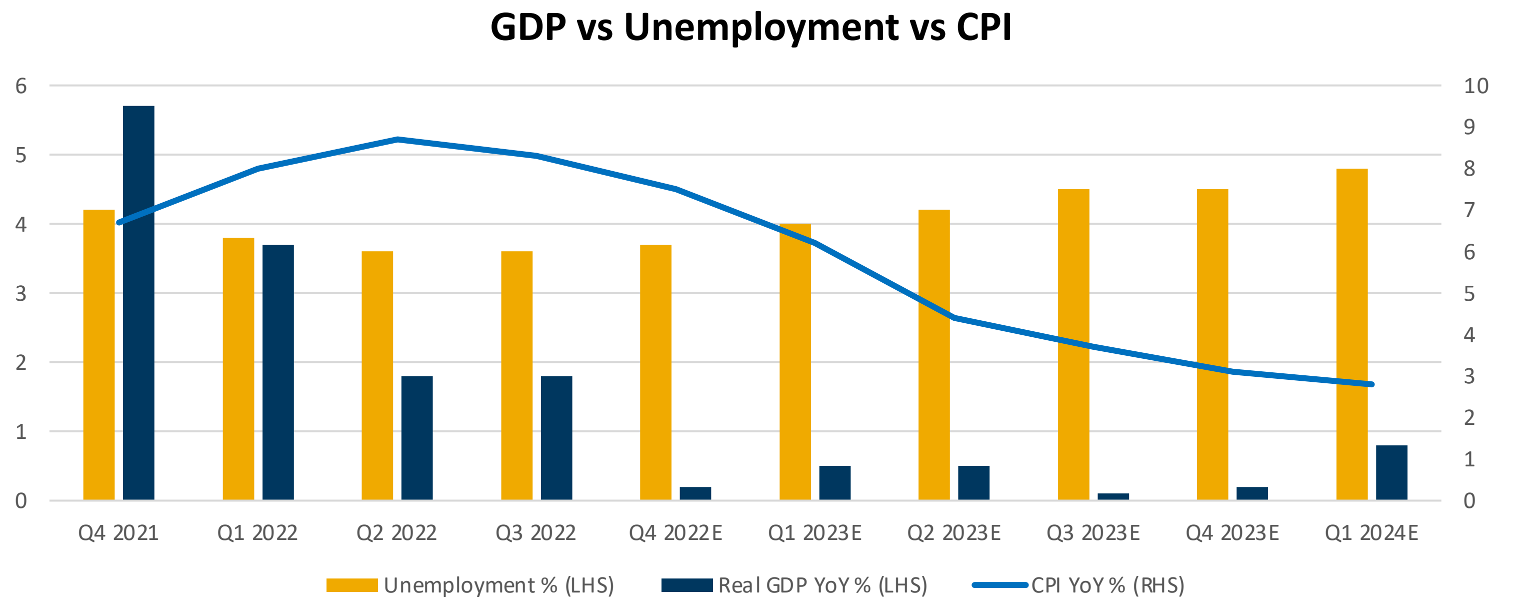
# This Time is Different…

"The four most dangerous words in investing are 'this time is different.'"

*- Sir John Templeton*

| **Epic Distortions** | **Three Shocks and a Correction** |
|---|---|
| **Everything rally—<br>Stocks, bonds, real estate** | **Risk is repriced,<br>Volatility surges** |
| ▪ Historically low interest rates<br>▪ Surge in consumer income, savings, net worth; rapid recovery in jobs<br>▪ Surge in corp. earnings, margins<br>▪ Super low default rates | ▪ Inflation—40-year high<br>▪ Russia's war—Supply shock<br>▪ China's repositioning, lockdowns—Demand shock, supply shock<br>▪ Central bank policy errors heighten recession risk |

# The Cost of Bringing Inflation Under Control

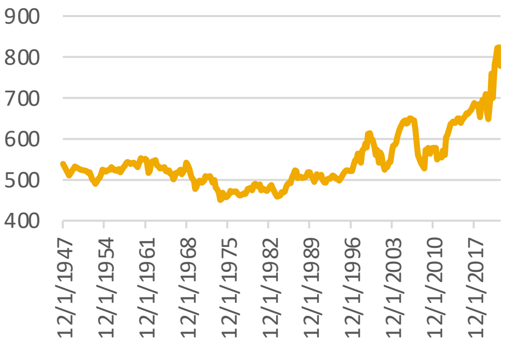



*Source: Bloomberg, using consensus data*

# Strong Starting Point

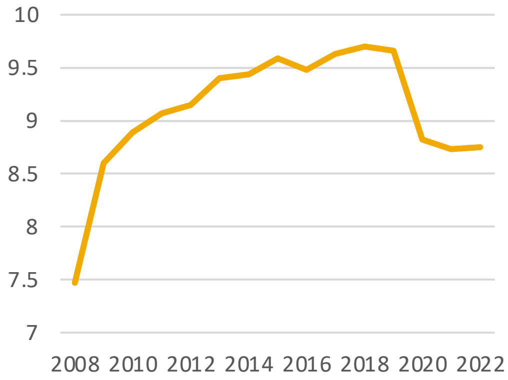
## Consumers: A Lot of Cushion

**Household NW % Disp Inc**




## Businesses: Margins Best Since 1950


## U.S. Bank Core Capital: Materially Better




*Source: US Consensus Bureau, BEA, KBRA Financial Intelligence*

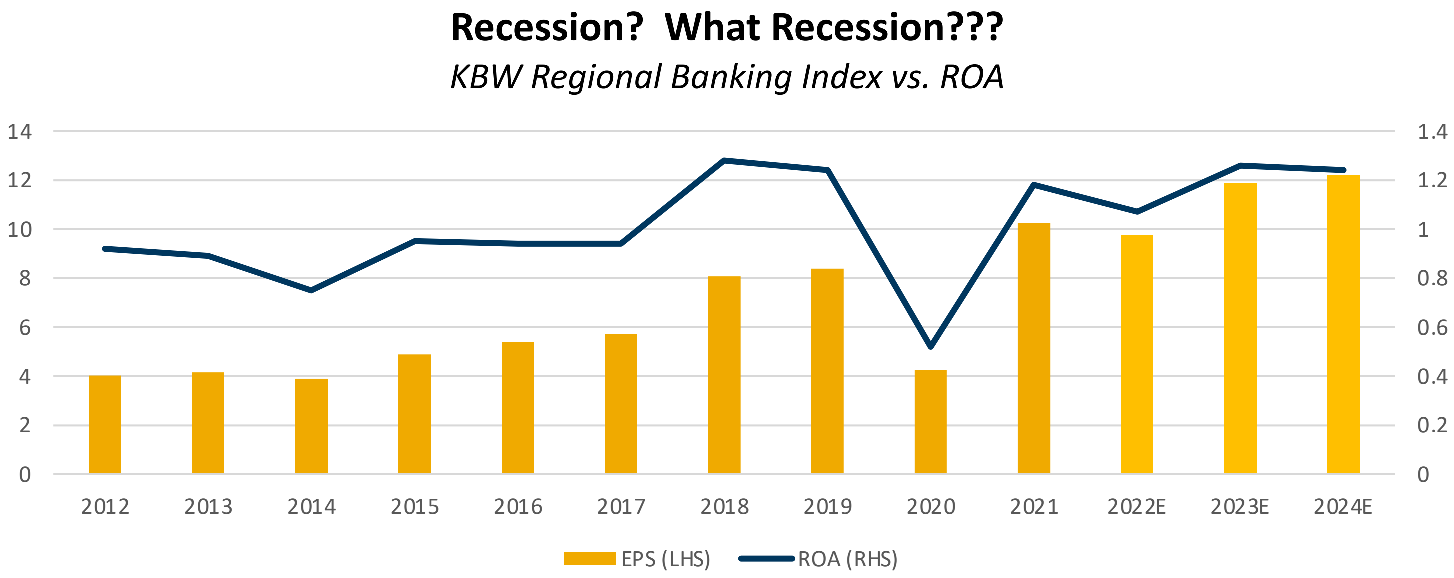
# Recession Contours

- Unique: Well-Telegraphed
- Problem is well defined, Solution is well defined
- Financial system is sound
- Consumers, businesses well positioned to withstand downturn

US:

- Terminal rate ~ 5%
- Unemployment 5% not 10%
- Earnings decline 10-20% not > 40%
- HY default rate peak 6% not 12%
- Duration: 10 months not 20

# Banking Sector View: Modest Impact from Rising Loan Losses

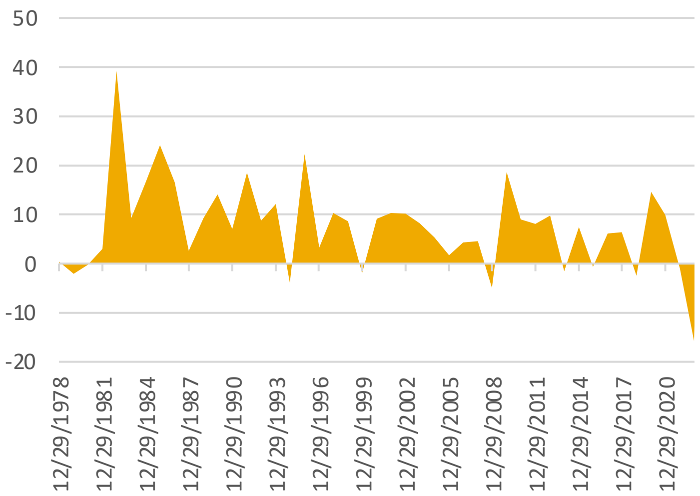



*Source: N.B. EPS 2012-2022E Earnings before extra items; 2023#-24E Earnings as forecast*

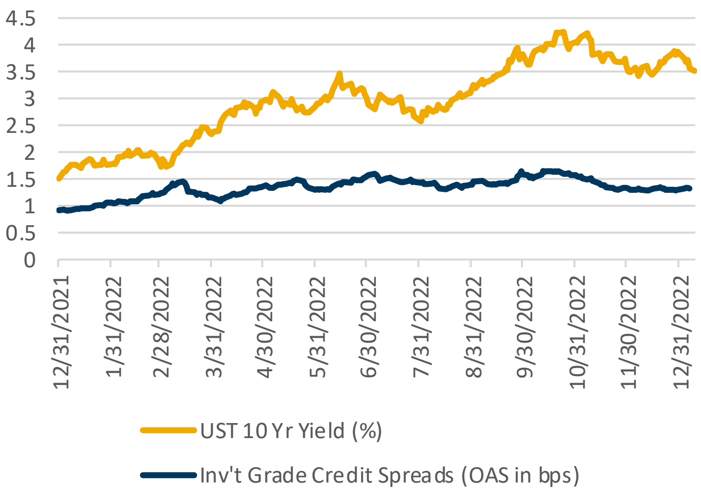
# Bond Market: "The Worst in History," But Not So Bad

2022's Losses Mostly Related to Move in Rates, Credit Spreads Less Worrisome

## IG Total Return (%)...




## ...Driven Largely by Increase in Rates



# Bond Market: Entering a New Paradigm

Credit Story (Durability of Cash Flows) Matters Again

- Cost of capital normalizing
  - Poorly positioned business models don't work
  - Inappropriate capital structures don't work
- Harder to raise capital, harder to generate an acceptable return
  - Higher interest rates
  - Slower growth
  - Technological disruption
  - ESG sensitivities, costs
  - Heightened geopolitical uncertainty, costs
- Return of capitalism's creative destruction
- Expose/flush out zombies

# Community Banks' Story Positions Well Against the New Paradigm

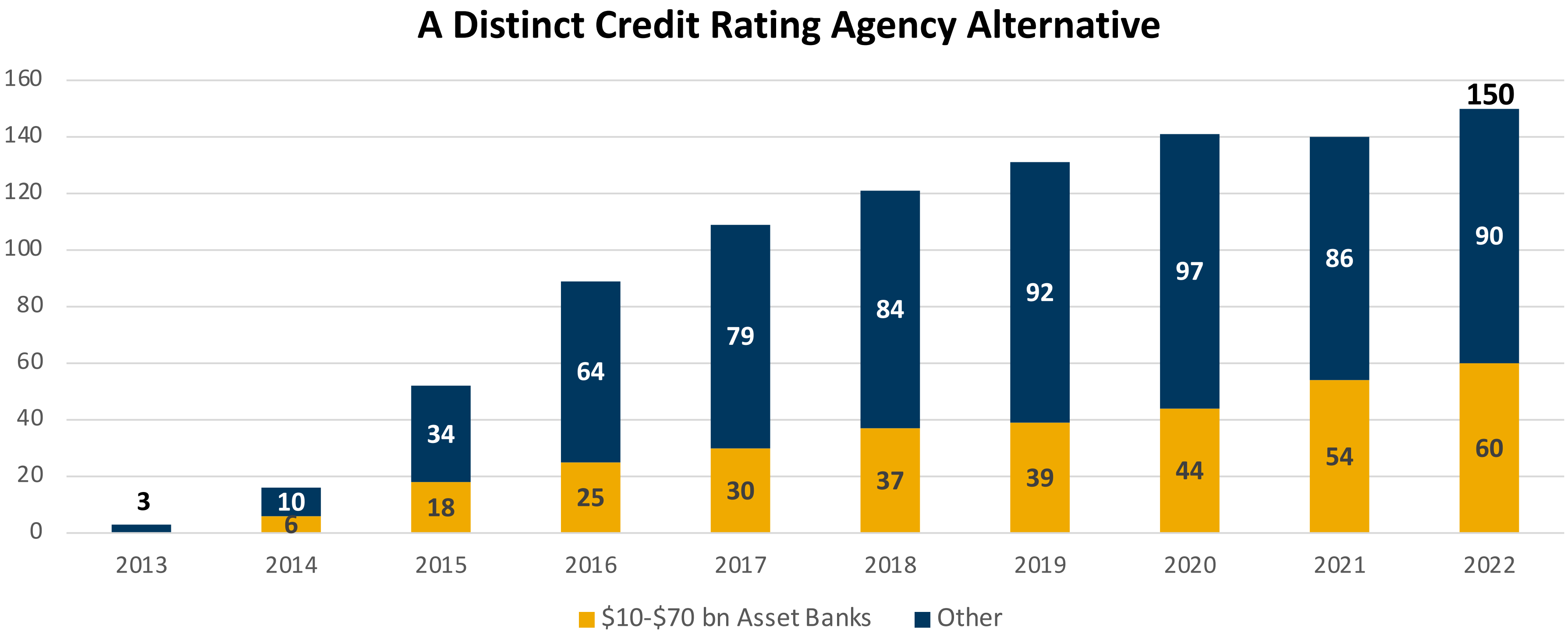
Risk/Reward Relationship of Well-Run Institutions Stands Up to Scrutiny

- Core deposit funding
- Focused business model
- Well diversified risks
- Attractive returns through the cycle without reaching
- ESG-Friendly

# KBRA's Differentiated Approach to Rating Financial Institutions

- **Experienced analysts**
  - Senior team members average 25 years industry experience including buy side, sell side and rating agency experience
- **Holistic Viewpoints to Ratings**
  - A review of financial metrics and trends is merely the starting point for our rating assessments; qualitative factors, market strategy, risk management, liquidity management, and operating environment are essential elements in our rating determinations
- **Forward Looking**
  - We are informed by the past, but are not held hostage to it; in other words, we believe that institutions, and institutional oversight (management, boards, investors) evolve and learn from the past rather than the assumption that they are condemned to repeat it
- **Specialists in complex, esoteric transactions**
  - We have built expertise in rating complex transactions that do not fit neatly into traditional rating agency boxes

# KBRA Bank Ratings: Resonating With The Market



# Select KBRA Rated Community and Regional Bank Debt Issuance

| Issuer | Assets ($ Bn) | Level | Issue Date | Deal Size ($ Mn) | Type | Fixed Cpn (%) | Floating 3M SOFR + | KBRA Rating |
|---|---|---|---|---|---|---|---|---|
| **Univest Financial Corp.** | 6.9 | HC Sub | 11/7/2022 | 50 | 10NC5 | 7.250 | 3.098 | BBB |
| **Pathward Financial** | 6.7 | HC Sub | 9/23/2022 | 20 | 10NC5 | 6.625 | 3.140 | BBB |
| **Valley National** | 54.4 | HC Sub | 9/20/2022 | 150 | 10NC5 | 6.250 | 2.780 | BBB |
| **Flushing Financial** | 8.3 | HC Sub | 8/19/2022 | 65 | 10NC5 | 6.000 | 3.130 | BBB- |
| **QCR Holdings** | 7.4 | HC Sub | 8/18/2022 | 45 | 10NC5 | 5.500 | 2.790 | BBB- |
| **Bankwell** | 2.4 | HC Sub | 8/12/2022 | 34 | 10NC5 | 6.000 | 3.260 | BBB- |
| **Berkshire Hills** | 12.1 | HC Sub | 6/28/2022 | 100 | 10NC5 | 5.500 | 2.490 | BBB- |

*Source: Company reports, KBRA*

# KBRA Team

**Van Hesser**
Chief Strategist

Van Hesser is Chief Strategist at Kroll Bond Rating Agency (KBRA) and previously served as a Senior Managing Director in the Financial Institutions and Corporates groups, where he leveraged over 30 years of experience as an investor, sell-side research analyst, investment banker, and regulator. During his professional career, Van was named to Institutional Investor Magazine's All-America Fixed Income Research Team rankings 10 times across three categories, and has served as an expert witness in important industry litigation. Prior to joining KBRA, Van was a managing director in the Financial Institutions Group at Wells Fargo Principal Investments. Previously, he worked at HSBC Securities for 10 years, most recently serving as global head of Credit Research and before that as a senior corporate bond research analyst covering U.S. banks, brokers, and specialty finance companies. He also served on HSBC's six-person Global Research Management Committee. Van also held senior sell-side corporate bond research roles covering financial institutions at Credit Suisse First Boston and Goldman Sachs, as well as a corporate finance position in Salomon Brothers' Financial Institutions Group. Van started his career as a bank examiner at the Federal Reserve Bank of New York. Van earned a B.S. from Fordham University an and MBA from Yale University.

# KBRA Team

**Joe Scott**
Senior Managing Director, Financial Institutions

Joe Scott is a Senior Managing Director and leads the Financial Institutions Group at Kroll Bond Rating Agency (KBRA). Joe joined KBRA in 2015 and has over 30 years of financial industry experience, including ratings and research coverage of domestic and international banks, broker-dealers, alternative asset managers, and other financial services firms. Prior to joining KBRA, Joe worked at Fitch Ratings, Thomson Financial BankWatch, CoreStates Financial Corporation (now Wells Fargo), and Bank of Lancaster County. Within the banking sector, Joe has covered a full range of banking institutions, from community banks to major U.S. and international banks. In addition, Joe's career experience includes speaking at industry conferences and interacting with bank executives, institutional investors, risk managers, and the financial press. Joe earned a B.S. degree from Penn State University.

**Ian Jaffe**
Managing Director, Financial Institutions

Ian Jaffe is a Managing Director in the Financial Institutions Group at Kroll Bond Rating Agency. Ian brings 30 years of experience analyzing financial institutions, including four years at Fitch Ratings, followed by 16 years as a sell-side fixed income credit analyst at Bear Stearns & Co., J.P. Morgan Chase, and most recently, RBC Capital Markets.  During his tenure on the sell-side, Ian was selected by Institutional Investor magazine six times—on two occasions under two different categories—to its All-America Fixed Income Research Team list. Ian received his B.A. from Franklin & Marshall College and an MBA from Fordham University.

# KBRA Team

**Shannon Servaes**
Managing Director, Financial Institutions

Shannon Servaes is a Managing Director in the Financial Institutions Group at Kroll Bond Rating Agency (KBRA). Prior to joining KBRA, Shannon held a variety of investment management roles over the past 20 years, focusing on portfolio management, credit trading, and served as head of research at both a large institutional money manager and a life insurance company. Shannon began his career at the FDIC, where he examined financial institutions across the U.S. and served as an instructor for a joint FDIC/Federal Reserve Board bank analysis school in Washington D.C. Shannon earned an MBA from the Kellogg Graduate School of Management Northwestern University and holds the CPA designation and is a CFA charterholder.

**Brian Ropp**
Managing Director, Financial Institutions

Brian Ropp is a Managing Director in KBRA's Financial Institutions Group. Brian joined the company in 2020 and has over 20 years of financial institutions experience, including as the CFO of a community bank in Maryland, a buy-side fixed income credit analyst at T. Rowe Price, and an international treasury analyst at York International. As CFO, he led the bank's conversion to a bank holding company, inaugural subordinated debt issuance, and transition to trading on the OTC Pink market. At T. Rowe Price, Brian analyzed U.S. regional and trust banks, Canadian banks, and credit card companies during the global financial crisis. Brian holds an MBA from the University of Chicago and a B.S. from Mount St. Mary's University. He also holds a CPA designation in the state of Maryland. In addition, he is president of the Rotary Club of Frederick, and he has served on the boards of the Maryland School for the Blind and the Weinberg Center for the Arts.

## Register for Access at KBRA.com