Opportunity in Community Bank Subordinated Debt

Emerging Community Bank Subordinated Debt

- Community bank subordinated debt ("sub-debt") issuance is on the rise due to renewed interest from investors after a long drought.
- Community banks are issuing more sub-debt to meet stricter capital requirements, implement growth acquisition plans, and redeem legacy Trust Preferred Securities ("TruPS"), TARP and SBLF.
- Smaller banks have fewer options when it comes to capital raising and limited capital markets expertise.
- We believe Angel Oak is well-equipped to explore the inefficiencies and relative value in community bank debt issued by smaller banks.

WHAT IS COMMUNITY BANK SUBORDINATED DEBT?

Sub-debt ranks below senior debt but above equity in the event of a bankruptcy.

Sub-debt typically provides a higher yield than senior debt given its lower position in the capital structure and thus a lower rating (if rated).

Banks may consider issuing sub-debt for the following reasons:

1. The proceeds are classified as Tier 2 Capital.
2. Sub-debt doesn't dilute existing shareholders.
3. The interest payments, unlike dividends, are tax deductible.

EVOLUTION OF FUNDING SOURCES FOR COMMUNITY BANKS

While large banks have easier access to the capital markets, it has been a challenge for smaller banks to raise or replace capital, whether in the public or private markets, as potential investors are scarce.

Prior to the 2008 financial crisis, banks utilized TruPS to fulfill their capital requirements because U.S. regulators permitted bank holding companies to fulfill 25% of their Tier 1 capital requirements with TruPS. However, the Dodd-Frank Act forced banks to change their capital structure, and the $60 billion TruPS market came to an abrupt halt.

Given the dilutive effect of issuing common equity and the repeal of the favorable capital treatment TruPS previously enjoyed, community banks have turned to issuing long-term debt, typically sub-debt at the holding-company level. Issuing sub-debt is one of the few attractive capital options available to community banks in the current environment.

1 Sub-debt usually has a minimum maturity of 10 years. To ensure that the amount of outstanding capital doesn't fall sharply once a lower Tier 2 issuance matures, regulators require that the amount qualifiable as Tier 2 capital amortizes on a straight line basis from maturity minus 5 years (e.g., a $10 million issue would be worth only $8 million in capital 4 years before maturity). The remainder qualifies as senior issuance and is therefore excluded from the capital requirement. For this reason many Tier 2 instruments have been issued as 10 year non-call 5 issues.

2 The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173; commonly referred to as Dodd–Frank) was signed into federal law on July 21, 2010. Passed as a response to the Great Recession, it brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the Great Depression. It made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the nation’s financial services industry.

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Why Is There an Opportunity in Sub-debt?

Sub-debt was not an option for community banks in most of the post-crisis period, as investors worried about survivability through the severe economic downturn. However, the market is slowly thawing as confidence in banks recover. According to SNL Financial, U.S. banks and thrifts with less than $30 billion in assets issued approximately $3.1 billion in sub-debt in 2017. While this number is down slightly from the approximately $4.0 billion in issuance in both 2015 and 2016, this is largely due to the relative attractiveness of issuing equity capital during the market rally since the November 2016 election. Although sub-debt issuance remains strong, smaller banks still struggle, as they generally lack the capital market expertise to raise capital. In addition, fewer investors understand the operations of small banks and how they are funded. Also, recently issued bank sub-debt is perceived as less liquid due to its infancy in the post-crisis period and smaller deal sizes.

The current market inefficiency leads to a unique opportunity for sophisticated investors who are able to identify relative value in the space. In our view, in the wake of the financial crisis, banks are significantly more stable. This is due to higher capital requirements, increased regulatory oversight and enhanced loan underwriting standards. We believe bank sub-debt credit spreads are attractive compared with other fixed income products, and any expected spread tightening could likely add to total return.

Banks, insurance companies and money managers are predominant investors in community bank sub-debt. These investors are attracted to the relative value, high-quality credit and liquidity premium available in this asset class.

The Angel Oak Edge in Analyzing Banks

The founders and senior management of Angel Oak Capital Advisors (“Angel Oak”) have an extensive background in banking. Additionally, Angel Oak Consulting, LLC, an affiliated company, provides a wide range of specialized consulting services to banks. As a whole, we believe that the Angel Oak family of companies’ understanding of the evolving regulatory environment and of bank balance sheets enables us to capitalize on the aforementioned opportunity in bank sub-debt. Angel Oak will target banks that exhibit the following characteristics:

- Well-capitalized
- Consistently profitable
- Able to grow or restructure their balance sheet
- Strong management team

IN CONCLUSION

Recovering from the 2008 financial crisis, the banking industry is now heavily regulated and well-capitalized. Angel Oak believes community bank sub-debt should provide stable performance in light of the U.S. economy’s strong fundamentals. In addition, we believe the rising issuance of bank sub-debt, particularly by smaller banks, presents a compelling opportunity to find relative value. We believe Angel Oak is well-positioned to fill the void of bank sub-debt investors and well-equipped to canvas the market in search of attractively priced issuances.

TARP: Troubled Asset Relief Program.

SBLF: Small Business Lending Fund.

Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities.

Past performance does not guarantee future results. Index performance is not indicative of a fund’s performance. Current performance of the fund(s) can be obtained by calling 1-855-751-4324.

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