Angel Oak
CAPITAL ADVISORS

# Bank Equities versus Community Bank Debt

Q1 2019

We have seen a lot of volatility in the equity markets lately, and banks, particularly smaller banks, have been no exception. We closely monitor earnings and equity market trends for the read-across impact on bank debt, though we note that equity markets are typically more influenced by the rate of change of future earnings growth, while bank debt is more correlated with asset quality trends.

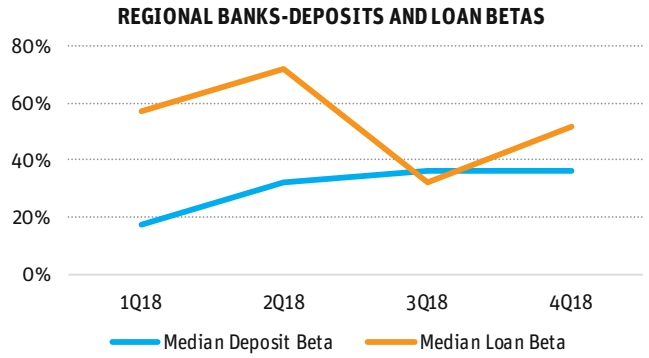
We focus on three key areas of potential concern:

- Slowing earnings growth
- Deteriorating credit quality
- Economic downturn

## Slowing Earnings Growth

Equity markets behave in a manner fundamentally different from debt markets. Equity valuations are based on investors' perceptions of future earnings growth and the multiple they are willing to pay for that growth. The banks that benefit the most from higher interest rates—the regional and community banks, or what we call asset-sensitive banks—have been trading at higher multiples relative to their large bank counterparts as the markets price the full benefit of future rate hikes into earnings expectations.

Loan growth for the industry remains below analyst expectations (5.9% quarter-over-quarter annualized for the industry, 6.3% quarter-over-quarter annualized for the community banking cohort) and deposit betas have been normalizing to prior cycle levels after a long-tailed ramp over the past couple of years. We do note two positives to consider in the face of normalizing deposit betas: 1) fourth quarter earnings have seen a deceleration in the rate of increase in deposit betas (median deposit beta of 36% in 4Q, in-line with 36% in 3Q) and 2) loan betas have rebounded, suggesting that pricing competition is becoming less heated.




Source: Morgan Stanley Research. Financial data as of 12/31/18.

As equity investors come to grips with the fact that the market is likely at peak earnings growth and the likely path for future earnings is increasing at a decelerating rate, forward price-to-earnings (P/E) multiples will begin to mean-revert. Bank equities have been one of the biggest beneficiaries since the 2016 election, and, in our view, opportunities going forward will likely be more stock-specific rather than sector-driven.

However, from the perspective of a debt investor, we are less concerned with the rate of earnings growth. Asset quality is our primary focus from a debt perspective. Earnings are still growing, banks are benefiting from the impact of recent tax cuts, balance sheets are less leveraged and debt coverage levels remain strong.

## Credit Quality Concerns

Credit quality across the sector remains pristine, with adjusted non-performing assets/total assets (adjusted NPA ratio which excludes performing troubled debt restructurings to analyze on a consistent basis) have improved from a peak of 2.95% to 55 basis points. We expect credit costs will eventually begin to normalize upwards; however, equity analysts have been increasing their loss estimates for years now and banks continue to beat on credit. With the U.S. consumer showing no signs of stress, especially with continued home price appreciation (2.2% CAGR over the past 10 years); a 6%+ savings rate; and a 4.0% unemployment rate[1], we expect the next credit

[1]Bureau of Labor Statistics, January 2019.

downturn will be driven by the corporate sector. We are concerned about high/growing leverage in the corporate sector, as higher rates will drive higher defaults and restructurings at some point, and tariffs will likely squeeze corporate margins.

While the industry at large has continued to deliver excellent credit results, we have seen some episodic instances of earnings misses driven by higher credit costs; these banks have been severely penalized in the equity market, as investors fear any potential turn of the credit cycle. We are nine years into the current cycle, and investors are trying to quantify the bear case: how big will the next recession be, and when and where will it hit?

Bank OZK (OZK) is one such bank that missed on credit in the third quarter. While OZK has been one of the brightest performers over the past few years from an equities perspective, we have been more cautious on the debt side given the composition of the loan portfolio. It is important to note that not all CRE is created equal, and approximately 40% ($6.5 billion) of OZK's loans are construction and development loans. This is among the highest concentration in this category of any bank in the U.S. These loans are very profitable when things go well, but they were one of the largest contributors to the downfall of many banks during the crisis. The bank has also been very acquisitive over the past eight years and there is some noise in the data that may mask the true underlying fundamentals.

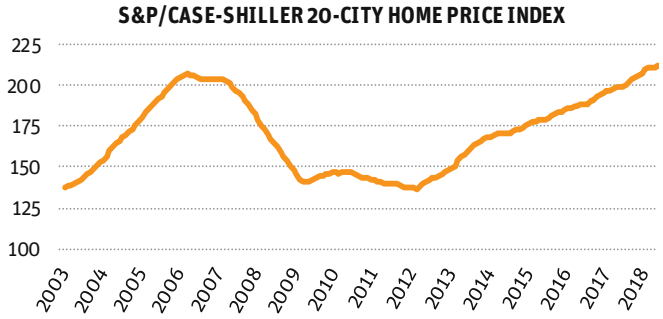
A key component of our diligence process, particularly in the smaller bank space, is detailed analysis of the loan portfolio, including concentrations, delinquencies, underwriting methodology, geographic footprint and loan limits.

## Economic Downturn

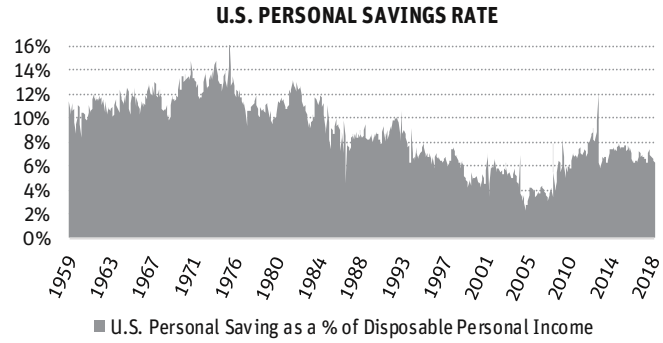
Several factors are likely driving the compression in bank equities: we are at or near the peak in terms of earnings growth, loan growth has remained more muted than expected, credit is likely as good as it gets and investors are jittery about the potential risk of a changing regulatory environment. In the equity space, perception can be worse than reality and investors often "shoot first and ask questions later." We saw a particularly asymmetrical reaction to earnings beats versus misses at the height of market volatility during third quarter earnings season, with revenue misses in particular getting heavily penalized initially.

Given the underlying dynamics of the equity and debt markets, we believe the debt market is currently more attractive. It is interesting to compare the KBW Regional Banking Index to the Angel Oak Financials Income Fund (ANFIX), which is essentially an index of community bank debt. This shows the stability of returns and minimal correlation of the bank debt market.

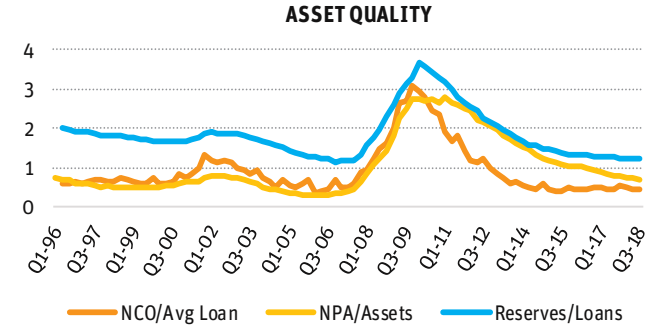
As mentioned, we are nine years into the current cycle, and investors are trying to quantify the bear case: how big will the next recession be, and when and where will it hit? The U.S. consumer, which accounts for approximately 75% of GDP, is in great shape, carrying lower levels of leverage than in prior cycles. The savings rate is up and unemployment is near all-time lows. Additionally, credit underwriting standards are tighter. The credit cycle, when it turns, is more likely to be driven by corporate credit, given high and increasing leverage.



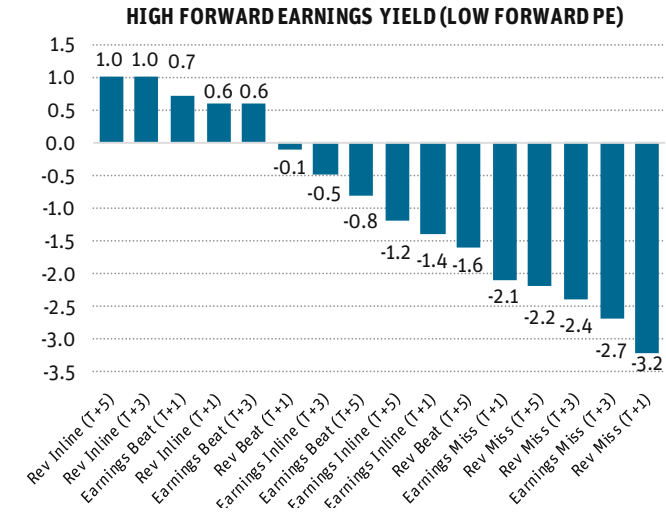

Source: S&P/Case-Shiller as of 11/30/18.




Source: Bloomberg as of 11/30/18.



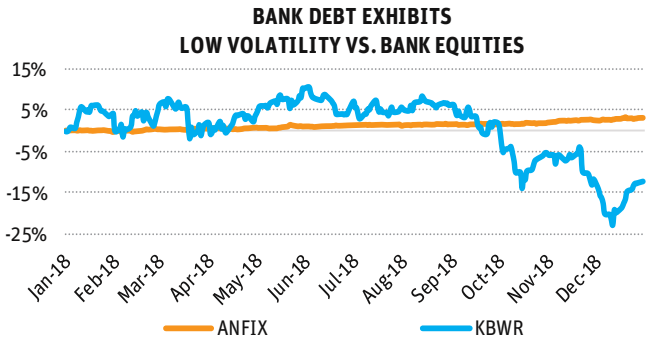

Source: S&P Global Market Intelligence as of 9/30/18.



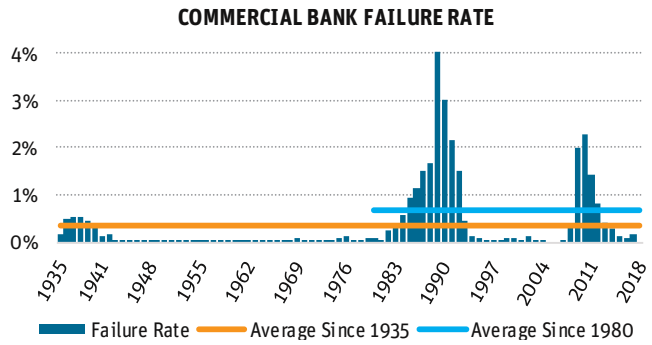

Source: Refinitiv and Morgan Stanley Research as of 10/29/18.

While a credit downturn would negatively impact equities as well as debt service coverage for debt investors, we note that bank failure rates are low. The average annual default rate for banks is less than 40 basis points, significantly below the average annual default rate for high yield bonds. Since the sub-debt market emerged for community banks in mid-2014, there has been just one instance of default on a subordinated debt issuance.

To summarize, we believe the fundamentals in the banking sector are incredibly strong from the perspective of capital, credit quality and regulatory oversight. The divergence in the equity and debt markets is a result of 1) slowing earnings growth, driving mean reversion of P/E multiples, and 2) concerns about timing and magnitude of a potential turn in the credit cycle, perhaps increasing the probability of weighting of investors' bear case in bank equities. With equities, it is all about the forward rate of change in earnings, which is likely at or near peak growth. By contrast, the capital cushion of banks is approximately 300 basis points higher than prior cycles, debt servicing ability is strong and credit costs would need to double from current levels to even get to cycle averages, all of which support our view that the community bank debt market has a long tailwind to its attractiveness.




Source: Bloomberg as of 12/31/18.
Past performance does not guarantee future results.




Source: FDIC as of 12/31/18.

# Authors

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Cheryl is a Senior Portfolio Analyst at Angel Oak Capital. Cheryl has more than 15 years' experience in financial services and primarily focuses on investment research, particularly in the non-bank financials and community banking sectors.

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Navid is a Senior Portfolio Manager at Angel Oak Capital and a Portfolio Manager of the Financials Income Fund. He has over 10 years of experience in fixed income markets, focusing on corporate credit trading, risk management, credit derivatives and structured products.

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Johannes is a Managing Director and Portfolio Manager at Angel Oak Capital. Johannes' primary focus is on investment research and management of community and regional bank debt across the firm's strategies.

# Disclosures

**Financials Income Fund Performance**

| Total Returns (as of 12/31/18) | 4Q18 | YTD | 1 Year | 3 Years | Since ANFIX Inception[1] |
|---|---|---|---|---|---|
| Class I | 1.33% | 3.11% | 3.11% | 2.85% | 3.05% |
| Class A at NAV | 1.37% | 2.87% | 2.87% | 2.63% | 2.83% |
| Class A at MOP[2] | -0.86% | 0.54% | 0.54% | 1.85% | 2.27% |
| Bloomberg Barclays U.S. Agg. Bond Index | 1.64% | 0.01% | 0.01% | 2.06% | 1.83% |
| KBW Regional Banking Index | -18.67% | -17.50% | -17.50% | 5.28% | 5.81% |

[1]The inception date of both the Angel Oak Financials Income Fund A and I Class (ANFLX and ANFIX) was 11/3/14.
[2]Maximum Offering Price takes into account the 2.25% maximum initial sales charge.

**Performance quoted is past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. The investment return and principal value of an investment in the Fund will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance for the most recent month end for the Angel Oak Funds can be obtained by calling 855-751-4324 or by visiting www.angeloakcapital.com.**

**Angel Oak Financials Income Fund Top Ten Holdings (excluding cash) as of 12/31/18**

| Name | Weight |
|---|---|
| FINS 2015-1 PFD | 5.3% |
| Financial Institution Note Securitization 2015-1 Ltd | 3.0% |
| United Insurance Holdings Corp | 2.5% |
| Fidelity Financial Corp | 2.4% |
| Ameris Bancorp | 2.4% |
| First National of Nebraska Inc | 2.4% |
| RBB Bancorp | 2.3% |
| Silver Queen Financial Services Inc | 2.3% |
| Kingstone Cos Inc | 2.2% |
| MB Financial Bank NA | 2.2% |

**Angel Oak Financials Income Fund Expense Ratios by Share Class***

| | Class A | Class I |
|---|---|---|
| Gross | 1.38% | 1.12% |
| Net | 0.94% | 0.69% |

*Gross expense ratios are reported as of the 5/31/18 prospectus. The net expense ratios are reported as of the 1/31/18 Annual Report and are referenced in the 5/31/18 prospectus. The Adviser has contractually agreed to waive fees through 5/31/19.

**Alpha:** Measures the difference between a fund's actual returns and its expected performance, given its level of risk (as measured by beta). A positive alpha figure indicates the fund has performed better than its beta would predict. In contrast, a negative alpha indicates a fund has underperformed, given the expectations established by the fund's beta.
**Basis point (bps):** One hundredth of 1 percent; used to denote the percentage change in a financial instrument.
**Beta:** A measure of a stock's risk of volatility compared to the overall market.
**CAGR:** Compound annual growth rate.
**Correlation:** A statistical measure of how two securities move in relation to another. Index used for comparison is the Bloomberg Barclays U.S. Aggregate Bond Index.
**Forward Earnings Yield:** The projected earnings yield for the current fiscal year.
**Forward Price/Earnings Ratio:** A ratio that divides the current share price by the estimated future per share.
**KBW Regional Banking Index:** An index that seeks to reflect the performance of U.S. companies that do business as regional banks.
**Nonperforming asset (NPA) ratio:** The net NPA to loans (advances) ratio is used as a measure of the overall quality of the bank's loan book.
**NPA:** Nonperforming assets.
**Price/Earnings Ratio:** The ratio of a company's stock price to the company's earnings per share.
**S&P CoreLogic Case-Shiller 20-City Composite Home Price Index:** The Index seeks to measure the value of residential real estate in 20 major U.S. metropolitan areas.

**Mutual fund investing involves risk; Principal loss is possible. Investments in debt securities typically decreases when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower rated and non-rated securities present a greater risk of loss to principal and interest than higher rated securities. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of including credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Derivatives involve risks different from, and in certain cases, greater than the risks presented by more traditional investments. Derivatives may involve certain costs and risks such as illiquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. For more information on these risks and other risks of the Fund, please see the Prospectus.**

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Effective 12/16/18, the Angel Oak Flexible Income Fund changed its name to the Angel Oak Financials Income Fund.

Earnings growth is not a measure of the Fund's future performance.

It is not possible to invest directly in an index.

***Must be preceded or accompanied by a prospectus. To obtain an electronic copy of the prospectus, please visit www.angeloakcapital.com.***

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