Angel Oak
CAPITAL ADVISORS

2021 Financials Debt Mid-Year Outlook

Opportunities in corporate credit

- POSITIVE FUNDAMENTALS MAKE FINANCIAL SECTOR DEBT ONE OF OUR HIGHEST CONVICTION IDEAS
- TIGHTER FINANCIAL DEBT SPREADS DRIVE STRONG TOTAL RETURN OPPORTUNITIES OVER AND ABOVE ATTRACTIVE COUPON CARRY
- REACCELERATION OF LONG-TERM POSITIVE SECULAR TREND IN M&A SHOULD BE ACCRETIVE TO STRATEGY RETURNS

U.S. Financials

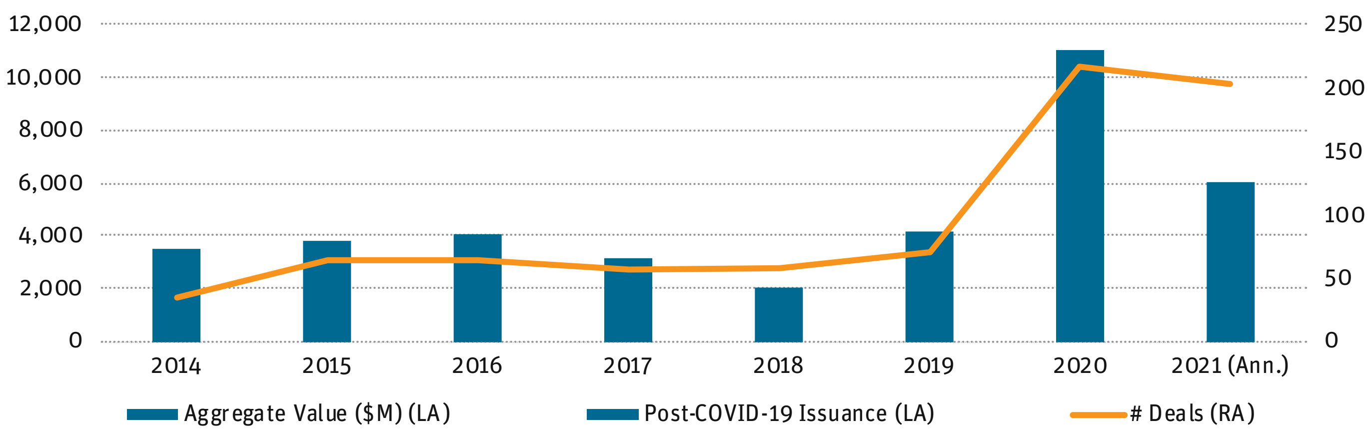
Going into 2021, the financial debt sector was one of our highest-conviction ideas. We expected improving fundamentals, particularly in terms of asset quality, a resurgence of M&A activity and normalizing issuance trends to drive a compelling risk/return profile with high current income, low duration and the potential for outsized total return. Our thesis has played out faster than expected, with banks already moving to release some of the excess reserves that were built over the course of 2020 and M&A rebounding more than 50% on an annualized basis from 2020 levels. Looking ahead, we see positive tailwinds to growth based on the economic recovery and higher rates, and continue to have high conviction in financial sector debt given the excess yield and positive risk/reward dynamics relative to investment grade corporate credit.

Looking ahead, we see positive tailwinds to growth based on the economic recovery and higher rates and continue to have high conviction in financial sector debt

Positive Fundamentals

Banks went into the pandemic with capital levels at or near multi-decade highs and took a proactive stance to shore up balance sheets through record subordinated debt issuance (Tier 2 Capital) coupled with the fastest loan loss reserve build in modern banking history. In stark contrast to the global financial crisis in which the government provided a capital backstop for banks, the community bank universe ($50 billion or less in asset size) raised a record $11+ billion of subordinated debt in 2020, with $10+ billion raised post-April 24. As the market reopened, spreads were at levels last seen in the infancy of the community bank sub-debt market. Moving through 2020, as supply was absorbed by the market, spreads normalized back toward 2019 levels. This trend accelerated through 2021 year-to-date, driving price appreciation in the bonds, in addition to the attractive coupons provided by these investment-grade instruments. Over $2.5 billion has been issued year-to-date in 2021, putting the sector on pace for $6 billion to $8 billion of issuance in 2021 (Figure1).

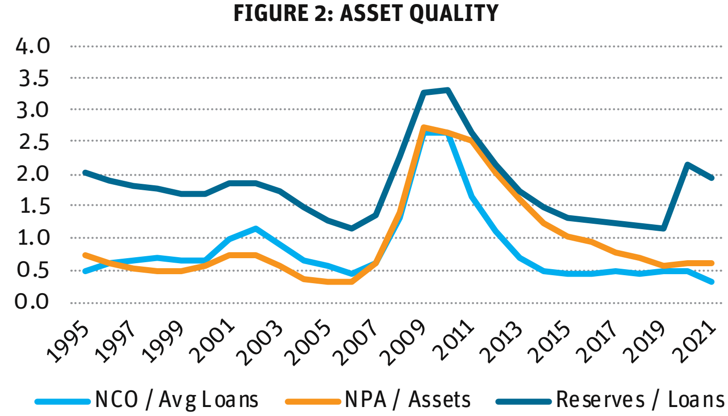
FIGURE 1: COMMUNITY BANK DEBT PRIMARY ISSUANCE



Source: Piper Sandler, KBW, Performance Trust as of 5/27/21. Post-COVID-19: Period after 3/31/20.

Fundamentally, banks exited the pandemic on stronger footing than they entered it. Capital and reserve levels are higher year-over-year while loan modifications have declined to de minimis levels. As the economic recovery strengthens, and with the likelihood of higher interest rates and accelerating M&A, the outlook for banks is bright. We see tailwinds to earnings growth from inflecting loan growth, capital optimization and excess reserve releases (Figure 2).

FIGURE 2: ASSET QUALITY



Source: S&P Global Market Intelligence as of 3/31/21.

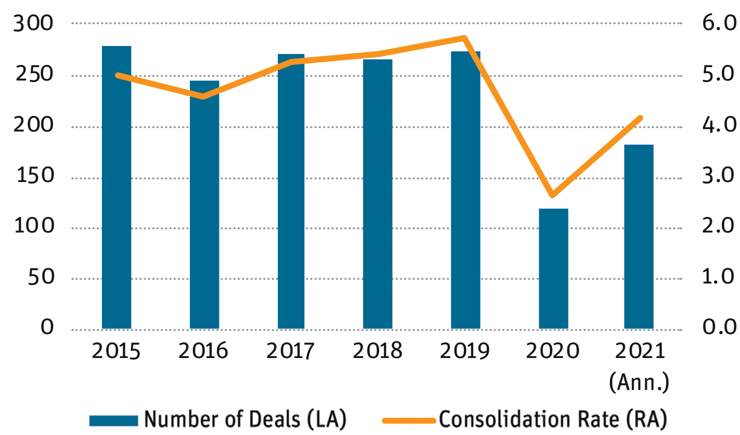
Stronger economic growth – with GDP growth largely expected by economists to be in the 7% range in 2022 – and the potential for Fed rate hikes in 2023 or earlier, given rising inflation expectations and a steeper yield curve, are all supportive of higher loan growth and net interest margins (NIM). In addition to inflecting loan growth and NIM, community bank earnings, in particular, will likely benefit in the near term from Paycheck Protection Program (PPP) forgiveness, cash/excess liquidity deployment, deposit share gains and excess reserve releases.

M&A on the Rebound

M&A has been a positive secular trend for the banking sector for a number of years, particularly following the global financial crisis, as the regulatory backdrop became more friendly. We have been expecting this trend to accelerate as banks focus on driving better scale and profitability in a still-low interest rate environment with high regulatory/compliance costs and rising technology costs. M&A can allow banks to reduce expenses, scale large fixed costs, improve funding costs, expand revenue growth opportunities and/or deploy excess capital. Importantly, cost savings from bank consolidation are tangible and meaningful, and typically range from 20% to 30% of the acquired bank's expense base.

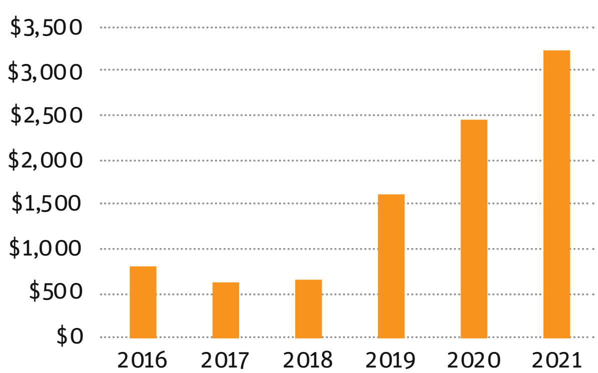
We are seeing a definitive reacceleration in M&A activity, following a pandemic-driven slowdown in 2020 when volumes were down approximately 60% from 2019. The reacceleration in 2021 has added back more than a percentage point to the consolidation rate (up to 4.1% from 2.6%) with volumes up more than 50% on an annualized basis versus 2020 (Figure 3). Total deal value year-to-date 2021 already exceeds the full year 2020 (Figure 4). Additionally, we are seeing a particular pickup in "megadeals" (deals over $500 million in transaction value) with 10 megadeals year-to-date versus six in 2020 and 12 in 2019 (Figure 5), suggesting that the need for scale is increasingly important at the large community bank/small regional bank levels. With still-low absolute levels of interest rates and slow loan growth, we believe banks will increasingly be focused on driving incremental earnings growth through enhanced efficiency (including M&A) over the coming years.

FIGURE 3: BANKING SECTOR CONSOLIDATION RATE



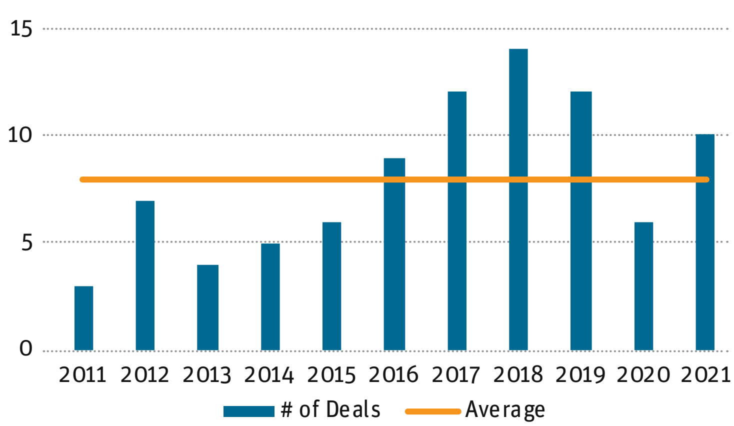
Source: S&P Global Market Intelligence as of 6/10/21.

FIGURE 4: BANKING SECTOR CONSOLIDATION: AVERAGE TARGET ASSETS ($MM)



Source: S&P Global Market Intelligence as of 6/10/21.

FIGURE 5: BANKING SECTOR CONSOLIDATION: # OF MEGADEALS



Source: S&P Global Market Intelligence as of 6/10/21.

M&A is a positive for our community bank debt strategies, as typically a smaller institution is acquired by a larger institution and the debt of the smaller bank is acquired by the bigger bank. This results in spread tightening and often very significant price appreciation in the bonds. Our portfolios have typically seen higher levels of consolidation than the banking sector overall, given the faster-growing and perhaps more capital-optimizing/strategically focused nature of the type of banks issuing debt.

Valuations Catching Up to Fundamentals

Valuations across financials debt and equity were slower to recover last year than other sectors, though both markets have outperformed in 2021. Bank debt saw a significantly lower drawdown at the height of the pandemic than corporate credit broadly; however, the recovery was slower due to two technical factors: 1) record issuance post-COVID-19 and 2) depository institutions being specifically excluded from Fed corporate buying programs. Bank debt spreads have moved significantly tighter in 2021 as issuance has normalized and fundamentals continue to prove out, driving strong total return opportunities over and above the attractive coupon carry.

Bank debt spreads have moved significantly tighter in 2021 as issuance has normalized and fundamentals continue to prove out, driving strong total return opportunities over and above the attractive coupon carry

On the equity side, while it took some time for investor sentiment to shift against the backdrop of an economic slowdown, bank stocks have also outperformed in 2021, with the NASDAQ ABA Community Bank Index up 24.87% year-to-date, while the larger S&P Regional Banks Select Industry Index is up 27.66% year-to-date. Compared to historical levels, the banking sector is still trading at a relative discount, as measured by both the price-to-earnings ratio multiple and price-to-tangible ratio. As is typical, small banks tend to lag the larger banks in a recovery, suggesting further upside to current valuations. Community banks proved their value last year, though the public markets were slow to acknowledge that a repeat of the global financial crisis was unlikely. Valuations bottomed last year at levels not seen since the credit crisis, though most signals suggested that banks were significantly better prepared to handle a downturn. Elevated levels of capital and liquidity enabled banks to manage through 2020 with a limited number of defensive capital raises and dividend cuts. Public banks especially are now back to playing offense, including using improved stock currencies to grow via acquisitions.

DEFINITIONS

M&A: Mergers and acquisitions.
NCO: Net charge-off.
NPA: Non-performing assets.
Carry: The return accruing to an investor from holding a higher-yielding security over a lower yielding security.
NASDAQ ABA Community Bank Index: A market capitalization-weighted index designed to track the performance of banks and thrifts, or their holding companies, listed on The NASDAQ Stock Market.
Price-To-Tangible Book Ratio: A financial ratio used to compare a company's current market price to its book value.
Price/Earnings Ratio: The ratio of a company's stock price to the company's earnings per share.
S&P Regional Banks Select Industry Index: An index that represents the regional banks segment of the S&P Total Market Index.
Spread: The difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.
Tier 2 Capital: A bank's supplementary capital including evaluation reserve, undisclosed reserves, hybrid security, and subordinate debt.

Index performance is not indicative of fund performance. To obtain fund performance visit www.angeloakcapital.com. Past performance does not guarantee future results.

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

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

Opinions expressed are as of 6/30/21 and are subject to change at any time, are not guaranteed, and should not be considered investment advice.

Investing involves risk; principal loss is possible. Investments in debt securities typically decrease when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss to principal and interest than do 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 lead to losses that are greater than the amount invested. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. The Fund may use leverage, which may exaggerate the effect of any increase or decrease in the value of securities in the Fund's portfolio or the Fund's net asset value, and therefore may increase the volatility of the Fund. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are increased for emerging markets. Investments in fixed-income instruments typically decrease in value when interest rates rise. The Fund will incur higher and duplicative costs when it invests in mutual funds, ETFs and other investment companies. There is also the risk that the Fund may suffer losses due to the investment practices of the underlying funds. For more information on these risks and other risks of the Fund, please see the Prospectus.

The Angel Oak Funds are distributed by Quasar Distributors, LLC.

Index performance is not indicative of the Fund's performance. Past performance does not guarantee future results. Current performance can be obtained by calling 855-751-4324.

For more information, or to learn how to invest in Angel Oak's structured credit and corporate credit funds, visit angeloakcapital.com.

info@angeloakcapital.com
Toll-Free: 888.685.2915

Angel Oak
CAPITAL ADVISORS