



Community Bank Debt: Attractively Priced Opportunity as Loan Deferrals Improve

Q3 2020

Angel Oak's positive view of community banks is predicated on the significant strengthening of capital ratios, credit underwriting, and risk management over the past decade. We believe the health of this underfollowed subsector of the financial industry is underappreciated by investors, and that current credit spreads provide a potentially attractive entry point to the community bank debt market.

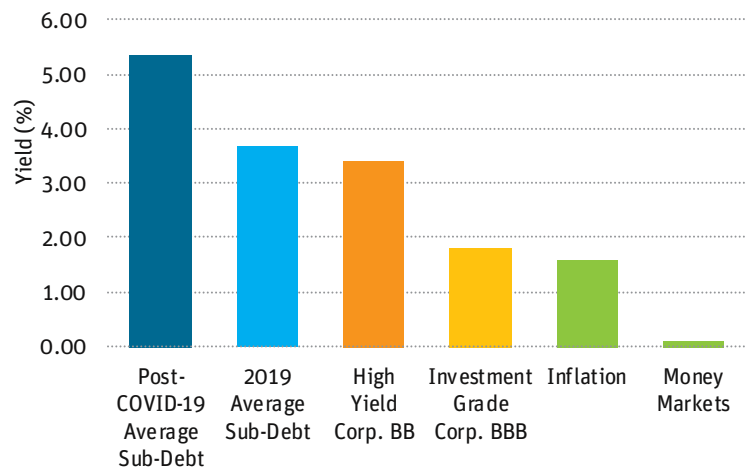
At the onset of the COVID-19 pandemic, the FDIC and other bank regulatory agencies allowed banks to make loan payment modifications for affected borrowers. The type of modification varied, depending on the nature of the borrower's business, the bank's preference, and other nuances; however, a 90-day deferral period was the most common form of relief. A majority of the initial deferral requests were granted in the March/April/May time frame; thus, many of those 90-day programs have expired or will be expiring soon.

Initial reports from community banks showed modifications generally in the range of 15%-20% of total loans for the first-quarter 2020 reporting period. However, we have seen measured improvement over the past several months. Second-quarter 2020 earnings as well as ongoing diligence with community bank management teams indicate deferral levels have improved towards levels in the range of 10% of total loans. Corroborating our primary research, KBW Research recently noted that the median deferral concentration among a sample of public community banks improved from 15% in March/April/May to 11% through July/August. Even more important, the number of borrowers requesting a second deferral is low. Our sample set from recent community bank debt issuers suggests second deferral requests are in a range of 10%-15% of original modification requests.

Credit cycles in the banking sector last longer than just a few quarters. During the global financial crisis (GFC), credit quality recovered gradually and varied depending on the geography, loan portfolio category, and institution size. Net charge-offs peaked at 2.7% of average loans in 2010 for all commercial banks, while the loss experience at smaller community banks was just 1.7%. Time will tell how long this cycle lasts, and the path of credit costs over the coming quarters will depend on the success of forbearance and deferral strategies, government stimulus, and reopening of economies. Nonetheless, we are encouraged by the short-term improvement in credit metrics, particularly considering the unprecedented macroeconomic environment. Additionally, the heightened focus on credit quality has resulted in bank management teams improving the level and frequency of disclosures to the investment community, a positive factor in our view, which over time could help generate increased interest in this subsector from new and existing market participants.

One key differentiator relative to the GFC is the strong capital footing of the banking system. Going into the pandemic, capital levels were at or near multidecade highs, and banks have been proactively shoring up balance sheets over the past several months. Share buybacks have been halted, in some cases dividends have been cut, and capital has been raised, most notably via subordinated debt (Tier 2 capital). The community bank universe (\$50 billion or less in asset size) has raised a record-level \$6.6 billion of subordinated debt thus far in 2020, with \$5.4 billion raised between April and August. Spreads are at levels last seen in the infancy of the community bank sub-debt market. As we move through the recent supply of bank debt, we expect spreads will normalize back toward 2019 levels, providing the potential for price appreciation in addition to the attractive coupons currently provided by these investment-grade instruments.

ENHANCED INCOME POTENTIAL



Source: BofA Global Research, Bloomberg, Bureau of Economic Analysis, U.S. Board of Governors of the Federal Reserve System (FRB), CPI YoY U.S. Money Market Yield as of 8/31/20.



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Bloomberg Barclays U.S. Corporate High Yield Bond Index: An unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.

Bloomberg Barclays U.S. Corporate Investment Grade Index: An index that measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Consumer Price Index (CPI): An index that measures the changes in the price of a certain collection of goods and services bought by consumers in an effort to measure inflation.

Money Market: Rate shown is a volume-weighted median of transaction-level data collected from depository institutions in the Report of Selected Money Market Rates. Money market investments are characterized by safety and liquidity, with money market fund shares targeted to \$1.

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