The RJ Report

Banking Issues, Insights and Information for Investors

Winter 2023

In This Issue

Fourth Quarter Performance Highlights

The Fourth Quarter saw a general decline in virtually all metrics and across the three industry sectors we follow. Decreases from the 3rd quarter are indicated in red, while improvements are green. The only metrics that showed an increase were per share numbers, as the rally in Q4 increased market valuations across the board. We score all our banks across multiple metrics to arrive at a rating. The average performance for each metric and sector is indicated on the chart, as well as the best and worst individual performer on each. Bank OZK (***OZK***) continues as our top scoring bank across all three industry sectors. It is interesting that OZK also hs the lowest PE, perhaps indicating a potential buying opportunity in this high performing company. Bank of New York (***BK***) was our lowest rated bank. For an in-depth analysis of all of our banks' performance across a full spectrum of metrics, download our Fourth Quarter report.

Sector	5 Yr ROE	NIM	COF	PE	Eff Ratio	Price/ Book	Yield	Score
Super Regional	10.15	2.57	3.03	10.70	64.16	113	4.46%	5.67
Regional	12.35	3.20	2.57	9.87	59.74	119	3.47%	5.44
Super Community	9.83	3.35	2.80	10.64	55.36	104	2.86%	6.03
Best Performer	WAL	OZK	RF	TCBI	OZK	CFR	COLB	OZK
Worst Performer	NYCB	STT	BK	OZK	KEY	NYCB	TCBI	BK

Key Industry Developments

- The Federal Reserve paused its rate increases and has indicated they expect three rate decreases in 2024. We, however, are not as bullish on rate decreases as other analysts and expect high rates to stick around for a bit.

- Inflation has come down significantly indicating the impact of higher interest rates. The consumer continued to spend throughout this cycle fueling economic growth and strong employment. Credit card debt has exploded, and personal savings balances declined, representing a potential risk going forward if consumer balance sheets deteriorate

- Many analysts and economic pundits have eliminated their recession forecasts as job growth and GDP remain robust. If this positive economic performance continues, it may offset some of the potential risks placing pressure on the banking sector.

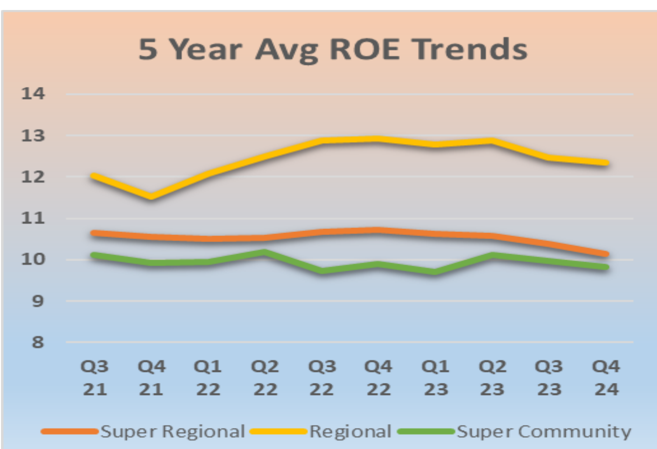
- Credit quality remains strong, although warning signs continue to flash in the Commercial Real Estate sector. We saw most banks increase reserves in the 4th quarter and expect that trend to continue through 2024 as the CRE market comes under additional scrutiny.

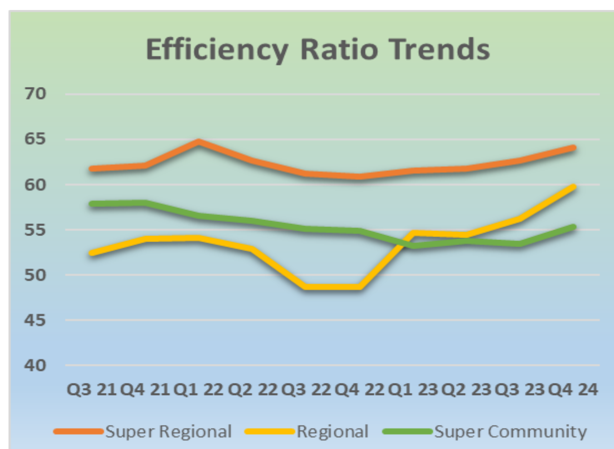
- Deposit funding growth and costs are the major issues confronting banks of all sizes. We expect that those banks that can grow and maintain a strong, stable core deposit portfolio will consistently outperform.

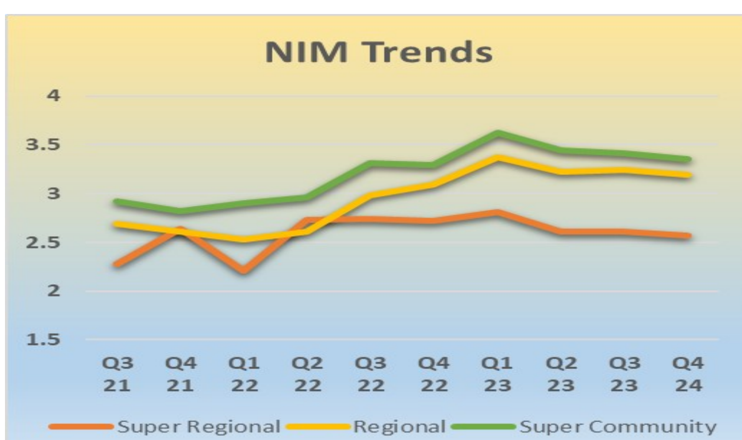
- The M&A environment has been quiet with a few notable exceptions. We expect consolidation activity to pick up over the next 12 to 18 months as bank stock prices increase and the search for funding intensifies.

Regional Banks Continue to Outperform on Key Metrics

Smaller Regional and Super Community banks continued to outperform on a few key metrics, most notably on both the Efficiency ratio and Net Interest Margin. While NIM leveled out and declined slightly across the board, it was encouraging that most banks were able to maintain somewhat healthy margins even in the face of significant increases in funding/deposit costs. This is counter to many analysts' expectations who predicted significant drops in NIM. However, we do expect continued pressure on both deposit balances and cost of funds over the next few quarters and believe both net interest margins and earnings will decline somewhat across the board. One troubling aspect is the continued increase in the average Regional Bank efficiency ratio. We expect an increased focus on cost reduction and industry consolidation to intensify as banks combine to achieve potential scale economies.







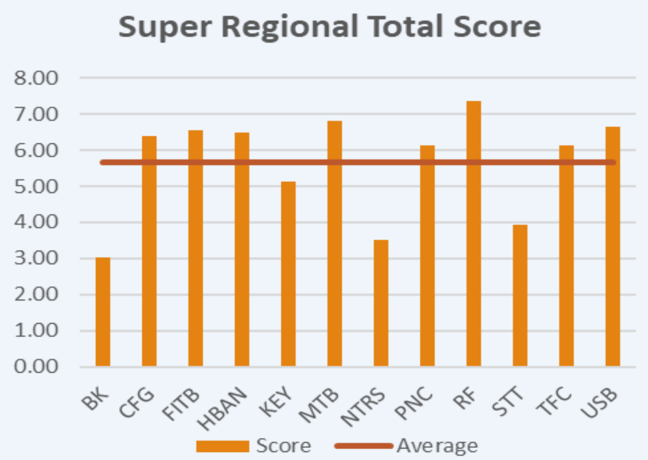
Market Valuation Summary

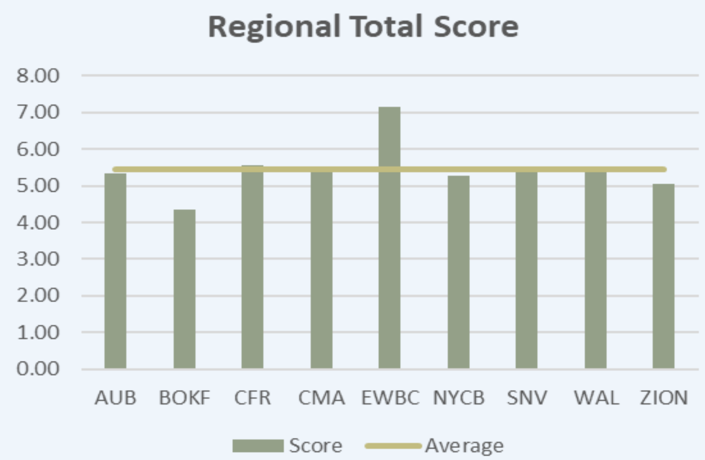
Based on our scoring and valuation models we believe the sector, as a whole, is now **FULLY VALUED** relative to the market overall. However, while we believe there is still risk in the market in the near term, a few banks represent attractive buying opportunities. Consequently, while conservative investors may want to keep their powder dry until the impact of a potential economic downturn is more discernible, others may want to take advantage of bargains that may deliver attractive returns over the next few months. While we rate most of our banks as fully valued, we have identified 5 companies that we believe are undervalued based on their performance and our score. If we invested in individual bank stocks (which we don't) we would focus our attention on the upper two right hand boxes and stay away from the bottom two left hand boxes. **As always, investment decisions should only be made after thorough analysis, due diligence on individual companies, and consultation with a qualified investment professional.**

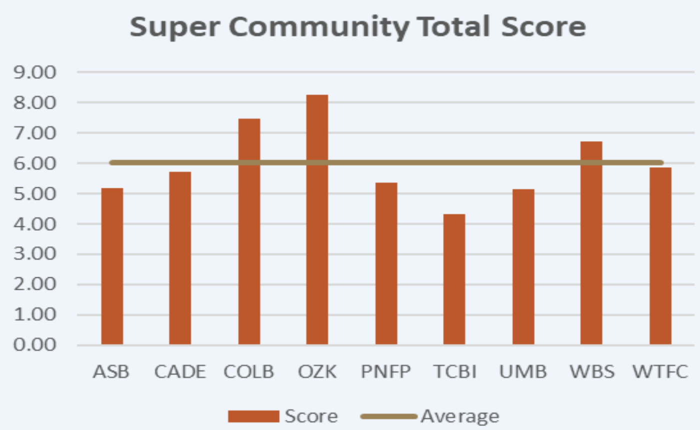
SCORE	OVERVALUED	FULLY VALUED	UNDERVALUED
HIGH	COLB	EWBC FITB RF HBAN	MTB OZK WBS WAL
MEDIUM	TFC	AUB KEY CFR ASB CADE CMA CFG USB PNC SNV	WTFC PNFP UMB
LOW	NYCB	ZION NTRS BOKF TCBI	BK STT

Q3 2023 Heroes and Zeros

Our goal is to identify high quality companies that may be undervalued relative to the industry and their peers. As a result, we use a scoring model based on individual performance metrics and market factors. We weight each variable based on our outlook for the industry and economy to arrive at a total score. These weightings may change from time to time as economic and market conditions change. Currently, we are expecting interest rates to rise and are weighting the ability to generate net interest income, manage funding costs, and control expenses somewhat higher than other performance factors. More specialized companies such as ***BK, NTRS, and STT*** typically rank low on these metrics so should evaluated relative to each other, rather than against more traditional banks. Our scores help to determine overall valuation. Just because a company receives a high score does not mean that we are necessarily expecting higher returns than the market, overall, and vice versa. Currently, our highest rated companies are ***MTB, RF, EWBC, WAL, COLB, WBS, and OZK***.

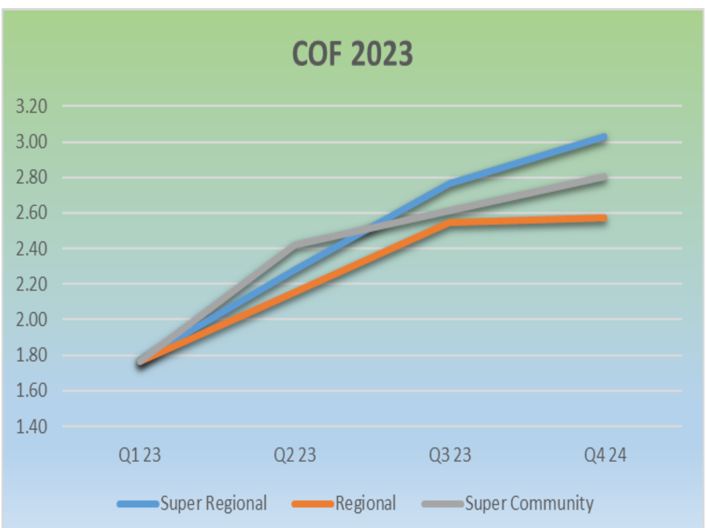


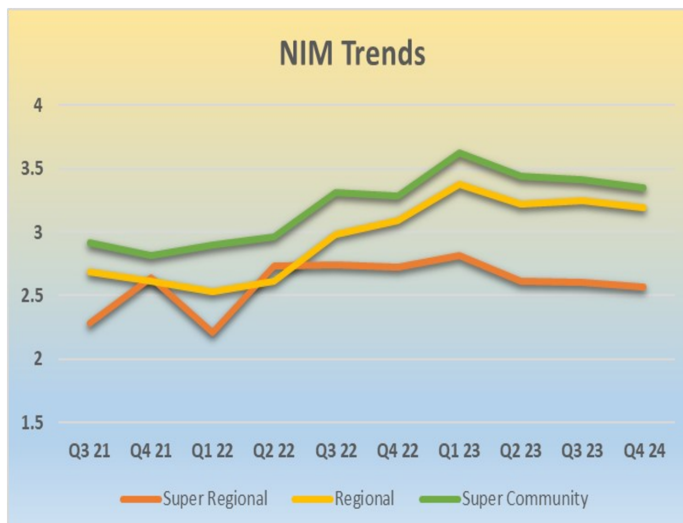




Funding Costs Continue to Climb

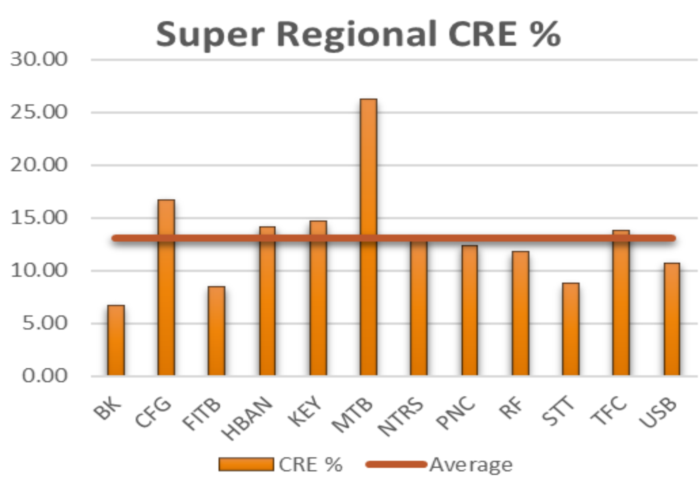
During the quarter, funding costs continued to increase but at a slower pace. The largest increase was in the largest banks where funding costs increased 27 bps on average. However, even though many banks had to increase deposit rates to attract funds, net interest margins did not deteriorate significantly as rising interest rates helped loan pricing. While all sectors increased deposit balances, performance varied significantly by individual bank. We expect funding and funding costs to be the top priority in most banks throughout 2024.

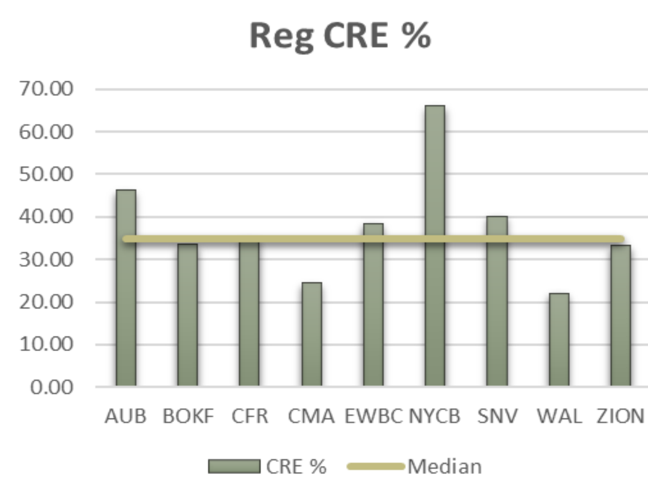


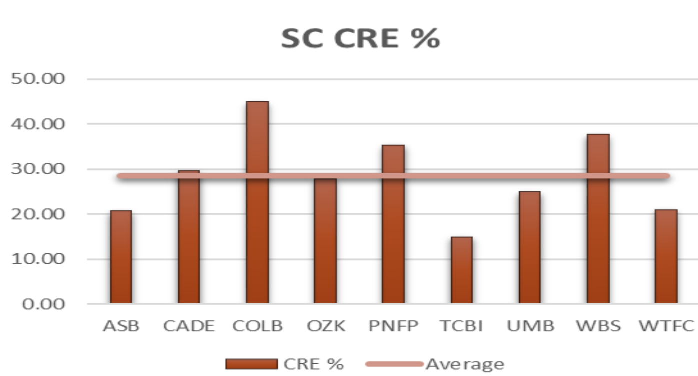


Commercial Real Estate: Look Out Below

Over the past year, we, along with many other industry analysts, have identified Commercial Real Estate (CRE) concentration as a major area of risk. Rising interest rates and continued remote work arrangements have created higher vacancy rates and lower profit margins in both the apartment and office sectors. While significant write-offs and losses have not yet occurred, a few banks with very high exposure have come under pressure. Most notable was New York Community Bank, ***NYCB***, which reported a surprise loss for the 4th quarter, driven primarily by additional reserves in the CRE portfolio. We had identified ***NYCB*** as a highly risky and overvalued stock earlier in 2023, with the only thing supporting valuation was its dividend. Understanding that all CRE lending is not created equal, we do expect banks with large CRE concentrations to experience market, and perhaps regulatory, pressure over the remainder of the year. Most of these are in the Regional sector with an average concentration of **35%,** vs the Super Regional and Super Community averages of **13%** and **28%,** respectively.







The RJR Indicator Has Turned Neutral

The RJR Indicator is a metric we use to identify potential overall market moves. The indicator looks at the performance of our banks rated undervalued relative to those rated overvalued. A positive indicator occurs when our undervalued banks outperform those rated overvalued. A positive indicator signals an upward trending market and a negative indicator a downward trend. Positive movement began at the end of April signaling significant buying opportunities. It then turned negative in August and back to positive in November confirming the Fourth Quarter rally. It then turned neutral at the beginning of the year. The chart below shows the banking index relative to the S&P, as well as the timing of our RJR Indicator calls. Weekly movements of the RJR Indicator are available on our website ***therjreport.com***

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