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Community Banking 101

FINANCIAL SERVICES SECTOR REPORT

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Buy-rated Bank Stocks Followed by Edward Jones:

- **Bank of America*** - (BAC; $24.36)
- **Citigroup** - (C; $51.27)
- **JP Morgan***- (JPM; $97.32)
- **Regions Financial** - (RF; $10.54)
- **Truist Financial** - (TFC; $36.87)
- **Wells Fargo** - (WFC; $25.53)

*Stock is included on the Edward Jones Stock Focus List (SFL).

Source: Reuters. Prices and opinion ratings are as of market close 7/29/2020 and are subject to change.

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Community Banking 101 Overview

Community banks serve a vital role within our local economies by providing a significant portion of the localized financing required by small business, construction, and commercial real estate projects. According to the Federal Deposit Insurance Corporation (FDIC), there were about 4,400 community banking institutions at the end of 2019, each varying by size, scope of operations, and loan composition.

Community banks differ from large banks in many ways, which include, but are not limited to, the following:

- Community banks operate locally (as opposed to regionally or nationally) and derive a larger portion of overall revenue from traditional banking activities (lending and borrowing);
- Community banks have a smaller percentage of overall revenue derived from fee-based business lines;
- Community banks generally have higher expense-to-revenue ratios; and
- Community banks have loan portfolios that are more highly concentrated (fewer borrowers).

As a result of these differences, we believe community banks offer a lower degree of diversification than larger banks. Furthermore, we note community bank shares are more likely to be thinly traded and subject to a lower amount of public scrutiny due to a lack of institutional ownership.

Despite the drawbacks noted above, we do believe community banks enjoy some attractive advantages when compared with larger peers. These include the following:

- Better capitalized community banks are likely to report above-average growth rates due to the long-term trend of consolidation within the banking industry, and
- Community banks are less exposed to higher-volatility business lines such as investment banking and trading.

So while less diversified than larger banks, in our view, some community banks may still offer an attractive investment opportunity for long-term investors, particularly those banks that are better capitalized.

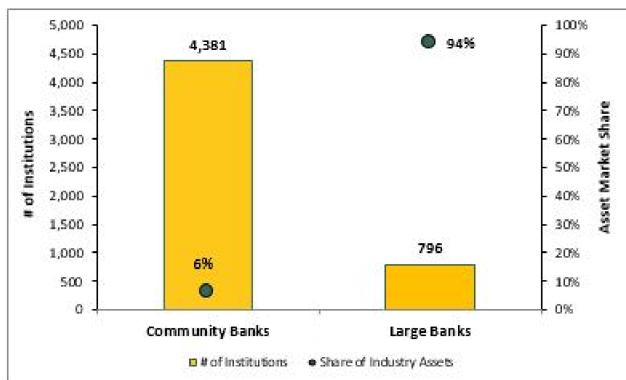
In order to find these opportunities, we recommend investors perform proper due diligence procedures on any particular community bank.

What Is a Community Bank? - We define community banks as locally based institutions that have total assets of less than $1 billion and derive a majority of deposits from the communities where they operate.

What Makes a Community Bank Different From a Large Bank? - There are numerous characteristics that differentiate community banks from large banks. We discuss a number of the characteristics we have deemed to be the most pertinent below:

Size, Geography, and Number of Institutions - Community banks are smaller than large banks (as measured by deposit share), operate locally as opposed to regionally/nationally, and have a larger population of institutions that make up the category. As illustrated in **Figure 1**, community banks are numerous. Based on FDIC data, there were about 4,400 individual institutions at year-end 2019, 3,000 fewer than 10 years ago. While community banks accounted for over 84% of total banking institutions, community banks hold less than 7% of total domestic banking assets.

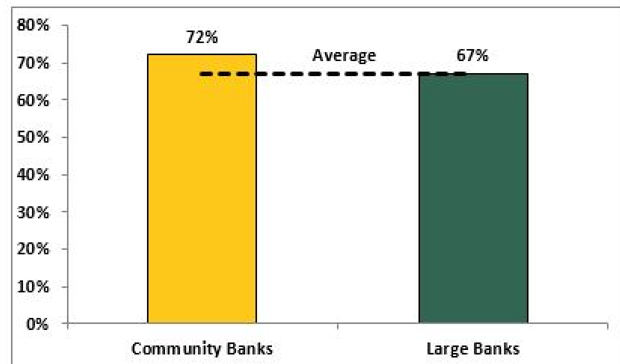
Figure 1: Number of Institutions and Deposit Share - 12/31/2019



Source: FDIC

Scope of Operations - A greater proportion of a community bank's overall revenue is generated from traditional banking activities than large banks. This is because large banks generally have auxiliary fee-based business lines that accompany the traditional borrowing and lending business. Examples of fee-based business lines include investment banking, trading, insurance, asset management, and brokerage. **Figure 2** depicts this differentiation visually. As you can see, on average, net interest income (revenues generated by traditional lending and borrowing activities) makes up approximately 72% of overall revenue at community banks, compared with 67% of revenues at large banking institutions and 67% for the entire banking industry.

Figure 2 - Percentage of Overall Revenue Derived From Net Interest Income -12/31/2019

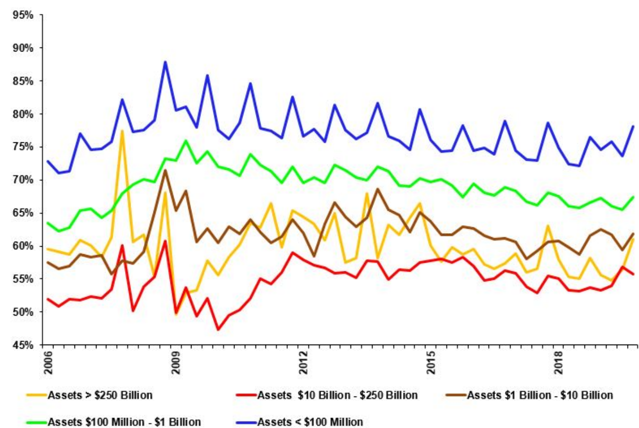


Source: FDIC. Past performance is no guarantee of future results.

Due to the difference in revenue mix, the ability of a community bank to underwrite loans at a profit is extremely important, because revenues from other activities are smaller.

Expense-to-Revenue Ratios - Because community banks derive a larger portion of overall revenue from traditional banking activities, they generally have higher ratios of expenses-to-revenue (efficiency ratios) than large banks. **Figure 3** depicts expense-to-revenue ratios for different sized banks as defined by the FDIC. Please note a lower ratio means lower expenses and is therefore better.

Figure 3 - Expense-to-Revenue (Efficiency) Ratios by Asset Size Group - 12/31/2019



Source: FDIC. Past performance is no guarantee of future results.

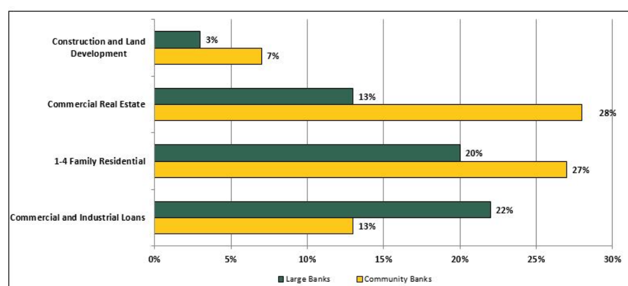
To put this chart into perspective, a community bank with less than a $100 million in assets incurs $0.78 in expenses for every $1.00 in revenue. In contrast, a bank with over $250 billion dollars in assets incurs $0.61 in expenses for every $1.00 in revenue. The lower (better) efficiency ratios at large banks are

a result of the size advantages and scope of their operations, and, on average, lead to better (higher) returns on equity at these institutions.

Loan Composition & Quantity - Community banks tend to have a larger percentage of overall loans in real-estate-secured categories, including construction and land-development loans, commercial real estate loans and residential mortgage loans.

Figure 4 depicts this relationship as of 12/31/2019 per the FDIC.

Figure 4 - Average Loan Exposure by Asset Size Group - 12/31/2019



Source: FDIC

As you can see in **Figure 4**, community banks (on average) have a higher percentage of their loan portfolios exposed to commercial real estate (28%) and construction loan & land development (7%) than large banks. This distinction is important because construction and commercial real estate loans tend to have higher principal balances than the typical residential loan. As a result, community banking loan portfolios tend to be less diversified than larger banks (community banks often have fewer loans which are larger in value versus large banks with more loans but each smaller in value) and are also more sensitive to the health of the local economy.

What Role Do Community Banks Serve?

Historically, community banks have operated a relationship-driven model, where a borrower's creditworthiness is assessed based upon quantitative measures, such as credit scores, debt ratios, liquidity, and qualitative measures, such as previous business with the bank, personal characteristics, and potential local market contribution. This differs from larger banking peers where quantitative data dominates the lending decisions. Because community banks tend to have a lending model that relies significantly more on qualitative data, they play a vital role in community development by filling the financing gap left unfilled by quantitatively focused larger banks. Community banks are a key source of funding within the communities they operate.

What Makes the Community Banking Model Attractive?

In our view, the community banking model has a number of attractive characteristics. These include, but are not limited to, the following:

Attractive Growth Prospects - We believe better capitalized community banks are likely to grow faster than larger banks due to the secular trend of consolidation within the banking industry. As of 12/31/2019, the number of banks included on the FDIC's "Problem List" totaled 51 institutions, down from approximately 900 following the financial crisis. We believe many of the banks included on this list are community banks. Thus, we expect stronger community banks to absorb not only problem institutions but also weaker institutions that may be on the verge of becoming problem banks. We believe the likely consolidations will drive stronger growth rates for the better-capitalized banks.

Exposure to Volatile Business Lines - The community banking model is less exposed to volatile business lines such as trading and investment banking. Products associated with these business lines are what many blame for the severity of the financial crisis. Because community banks do not have exposure to these businesses, we believe the earnings stream these banks generate is less volatile and more predictable than larger peers.

If I Own or Am Thinking About Owning Shares of a Community Bank, What Should I Look at to Evaluate the Investment?

The statistics presented in **Figure 5** should serve as a set of general comparative guidelines for evaluating your current or potential investment in community banks. They are by no means a definitive set of statistics, and should not be used to make investment decisions. Rather, they should serve as a starting point before conducting thorough due diligence procedures. For example, when evaluating community bank XYZ an investor could access bank-specific information included on regulatory filings for comparison to the amounts noted in **Figure 5.** The arrows indicate whether it is a positive (green) or a negative (red) relative to industry averages.

If the statistics warrant an additional review, the investor should then conduct thorough due diligence procedures, including an analysis of current loan and security exposures, future growth and profitability prospects, quality of management, capitalization and valuation.

Figure 5: Comparative Average Statistics by Size Group - 12/31/2019

Asset Size Group	Percent of Loans and Leases Noncurrent (Lower % is Better)	Loss Allowance to Noncurrent Loans and Leases (Higher % is Better)
Assets > $250 Billion	0.93%	125%
Assets $10 Billion - $250 Billion	0.97%	127%
Assets $1 Billion - $10 Billion	0.70%	152%
Assets $100 Million - $1 Billion	0.81%	151%
Industry Average	0.91%	111%

Asset Size Group	Tier 1 Risk-Based Capital Ratio (Higher % is Better)	Quarterly Return on Equity (Higher % is Better)
Assets > $250 Billion	12.7%	10.4%
Assets > $10 Billion	13.2%	11.0%
Assets $1 Billion - $10 Billion	14.2%	10.6%
Assets $100 Million - $1 Billion	16.1%	10.4%
Industry Average	13.3%	10.6%

Source: FDIC

Valuation

When valuing financial services companies, we use various methods, including, but not limited to, price-to-earnings ratios (P/E), price-to-book ratios (P/B) and return-on-equity calculations (ROE). During times of depressed earnings, we feel it is most appropriate to rely more heavily on price-to-book ratios and normalized earnings estimates. During times of more normalized earnings we focus on both the price-to-earnings ratio and price-to-book ratio. The P/B measurement analyzes the value of equity (or book value) a financial company has on its balance sheet. Most financial companies are in the business of borrowing and lending, so the value of the assets, liabilities and equity on a company's balance sheet are paramount to determining what the shares are worth. Lastly, return on equity is another useful measure to gauge what an appropriate price is for a company based on what it can earn on its capital.

Risks

While we believe there are attractive investment opportunities within the financial services sector, it is important to note, as with all investments, that there are some potential risks involved with investing in the sector:

- The potential for high costs related to legal settlements could hurt firm profitability and capitalization, reducing the firms' ability to generate returns and consequently hurting share prices.
- Should financial reform and capital requirements be overly severe and punitive, financial services companies may not be able to grow earnings as they have historically, the result being lower returns on equity and the possibility for negative returns.
- Financial services companies are highly sensitive to changes in interest rates, meaning that greater volatility in interest rates may lead to greater stock-price volatility.
- Financial services companies are highly sensitive to the overall health of the economy. During challenging economic times, the share prices of financial services companies have the potential to be negatively affected.

Conclusion

We view the community banking model as less diverse relative to larger peers. Community banks generally have loan portfolios that are less diverse (proportionally smaller quantity of borrowers, principal balance due to higher concentration of construction and commercial real estate loans, geographic-specific nature of operations). This issue is exacerbated by a lack of diversifying fee-based revenue business lines and higher expense-to-revenue ratios. Furthermore, we note publicly traded community-banking shares are likely to be less liquid than larger peers due to a lack of institutional ownership.

Despite these drawbacks, we believe it is inappropriate to conclude all community banks are inappropriate investments for Edward Jones investors. In fact, we believe better-capitalized community banks are likely to be attractive investments for long-term investors.

However, appropriate due diligence procedures must be conducted to determine the attractiveness or unattractiveness of a particular community bank before taking investment action.

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I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. Kyle Sanders, CFA and James Shanahan, CFA

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