ValueInvestor INSIGHT

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January 31, 2024

On the Money

Expert financial-sector investors Chris Davis of Davis Advisors, Hunter Doble of Hotchkis & Wiley and Derek Pilecki of Gator Capital Management describe why they consider the sector fertile investing ground, where "outsiders" may be prone to err, and why they see unrecognized value in Bank of New York Mellon, ING, Citigroup and OneMain Holdings.

It's not uncommon to hear more investors who once regularly invested in financial companies beg off the practice today. Reasons vary, but they tend to include that the investment cases are too reliant on macro factors, there's too much leverage, or there's too much regulation. Especially for those who lived through the financial crisis of 2008/2009 and its aftermath, all are understandable and reasonable concerns.

Which may reinforce the fact that financials can still be fertile investment ground. The sector makes up 11% of the Russell 3000 index and includes many companies critical to the U.S. and global economies. Among areas of interest to experts in the sector today: commercial banking in the U.S. and Europe, trust banking and specialty finance.

Editor's Note: *To assess the opportunity set in the financial sector today, we recently spoke with three eminently qualified experts on the subject. Davis Advisors' Chris Davis is a member of the Berkshire Hathaway board of directors and co-manages his firm's market-beating Davis Financial Fund, which launched in 1991. Hunter Doble is a co-portfolio manager of Hotchkis & Wiley's Mid-Cap Value fund, almost 30% of which is currently invested in financial stocks. Gator Capital Management's Derek Pilecki only invests in the financial sector, and his firm's long/short hedge fund has outperformed the S&P 500 by more than 800 basis points since its 2008 launch.*

Derek Pilecki
Gator Capital Management

"Financials is one sector of the market – similar to energy and biotech – where specialized knowledge is a real advantage."

You only invest in the financial sector. Why has that come to be your specialty?

Derek Pilecki: The basic reason is that I have accumulated some specialized knowledge about it, and I'd argue that it is one sector of the market – similar to energy and biotech – where specialized knowledge is required and a real advantage. I'd be too much of a novice in other sectors.

I wouldn't say that financials is the greatest sector overall from an investment standpoint. There are inherently good businesses in the sector – like asset managers, exchanges and retail brokers – but two of the biggest categories, banks and insurance, are essentially commodity businesses with high competitive intensity. That doesn't mean there aren't times when the prices at which you can buy banks and insurers are quite attractive relative to the strength and stability of their earnings and assets. But they aren't classically great businesses and you have to be decent about timing when to buy and sell them.

Your long exposure to banks is high today relative to your fund's history. Why is that?

DP: I think odds are that we're in the middle of a rally in bank stocks. Before the bond market turned around in November and December, bank stocks were at unusually low valuation levels of 6-7x earnings. Banks were paying more for deposits as interest rates rose and loans were slower to reprice. As loans continue to reprice and deposit rates stabilize or come down a bit, I expect bank margins to inflect higher, which should drive valuations above the 9x or so P/E level of today to closer to the midpoint of the historical range of 8x to 14x. That's the primary reason banks make up 65% of my long portfolio today, up from about 40% normally.

One of those is First Citizens Bancshares [FCNCA], whose stock has tripled since last spring. Why is it still interesting to you?

DP: We've owned First Citizens' stock since the company agreed to buy CIT Group in late 2020, and we added significantly to our position when it won the FDIC's auction – on unbelievably favorable terms – of the failed Silicon Valley Bank last spring. Despite the run up in the price, the stock today trades at less than 1.2x tangible book value, a discount to similar-sized banks in the Southeast like Regions Financial and Truist Financial, both of which trade at 1.75x tangible book.

Usually when a bank trades at a discount to peers like this it's because it has lower returns. At first glance that appears to be the case here, but when we adjust for the significant amount of excess capital First Citizens holds, its ROE is right in line with peers. Investors also get agitated that they don't buy back more stock, but I don't consider that a negative. This is a very well-run bank with very high insider ownership and I have no problem if they want extra capital on hand now to take advantage of opportunities that might present themselves. You don't have to buy back all the stock or pay all the dividends you possibly can right away.

We're somewhat surprised to see you own Robinhood Markets [HOOD], the discount broker of meme-stock fame.

DP: I like retail brokerage businesses, which don't require a lot of capital spending, tend to have sticky customer relationships, and have a lot of organic growth opportunities in providing additional products and services to clients whose balances tend to grow over time.

Robinhood is well capitalized and still at an early point in its lifecycle, adding new accounts and rolling out new products and services. They launched the platform in the United Kingdom. They now offer individual retirement accounts. The business is only intermittently profitable, but they are growing into their expense structure in a way that will drive margin improvement. I also think they're doing the right things to build a customer-friendly brand image that is still generally well regarded by younger investors.

This is a less established company than I usually invest in, but I think the downside with the stock trading at 1.4x tangible book value is relatively low. If you look at where the market – and acquirers – have historically valued discount brokers showing net account growth, the potential upside is extremely high. [*Note*: HOOD shares, which came public at $38 in July 2021, now trade at around $11.]

What makes you bullish on the prospects today for long-time favorite OneMain Holdings [OMF]?

DP: The company's core business is making unsecured subprime loans to working-class people who may be living paycheck to paycheck and have some sort of emergency expense and will need to borrow, say, $2,000 to cover it. They have a large branch network across the country of around 1,400 offices, and all the lending is done face-to-face in the branches. The branches also handle collections, so the same people making the loans are also calling their customers to collect.

Despite the brick-and-mortar network, the branches are small and not in A-plus locations, so the real estate costs and other capital spending needs are not high. That has translated into 30% returns on capital and a history of returning significant cash to shareholders. The dividend yield today is 8.2%.

The current story is the potential for growth. The company has earned high returns but hasn't had that much opportunity to grow because there are only so many people out there who want subprime loans and are credit worthy. One new line of business started several years ago that has been a success is making lower-interest loans that are collateralized by liens on customers' cars. The risk-adjusted return

INVESTMENT SNAPSHOT

OneMain Holdings
(NYSE: OMF)

Business: Specialty lender offering through its own branch network small, unsecured and secured loans to non-prime customers who may lack traditional banking relationships.

Share Information (@1/30/24):

Price	**48.93**
52-Week Range	32.79 – 50.02
Dividend Yield	8.2%
Market Cap	$5.87 billion

Financials (TTM):

Revenue	$2.56 billion
Operating Profit Margin	36.4%
Net Profit Margin	25.7%

Valuation Metrics
(@1/30/24):

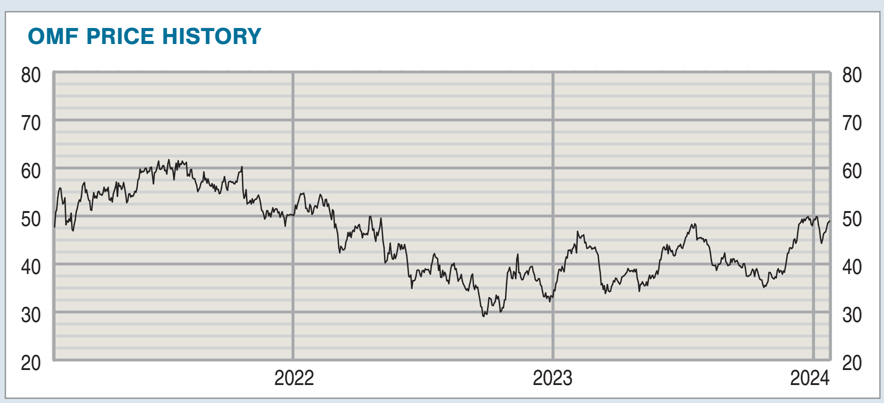
	OMF	S&P 500
P/E (TTM)	9.0	22.6
Forward P/E (Est.)	7.6	22.0

Largest Institutional Owners
(@9/30/23 or latest filing):

Company	% Owned
Vanguard Group	9.9%
Fidelity Mgmt & Research	9.0%
Capital Research & Mgmt	7.6%
Varde Partners	5.6%
BlackRock	5.0%

Short Interest (as of 1/15/24):

Shares Short/Float	2.9%



THE BOTTOM LINE

With well-established expertise in making personal loans to subprime borrowers, the company's new growth initiative to make auto loans could significantly increase its earnings power, says Derek Pilecki. At 6x his 2027 earnings estimate, the shares through appreciation and dividends over two years would deliver an 80% return from today's price.

Sources: Capital IQ, company reports, other publicly available information on this secured lending has been the same or slightly better than on the unsecured lending, and now the loan mix between secured and unsecured is roughly 50/50.

What's new is that last year OneMain bought a small, indirect auto lender that has relationships with dealers, so the company is now looking to make loans to its traditional type of customer for the purpose of buying cars. This expands the opportunity set and while I expect there to still be plenty of money to return to shareholders, this new business can significantly grow the balance sheet and expand earnings power.

What has your experience been here with management?

DP: It's been quite positive. They do what they say they are going to do. They have over time proven conservative in funding the business and always retain ample cash on the balance sheet. If capital markets shut down for them, the company today could fund the ongoing business for at least four years.

I also feel they're very disciplined about their credit metrics. In August of 2022 they didn't like how some of the metrics were trending coming out of Covid and started tightening underwriting as they worked through some of those older vintages. The loan portfolios turn over fairly quickly, so that type of responsiveness makes a big difference. The short tenure of the loans also limits interest-rate risk. They've done a lot of fixed-rate issuance, so they know their cost of funding and can reprice the loan portfolio fairly quickly to limit the risk interest rates go against them.

At a recent price of just under $49, how inexpensive do you consider the shares?

DP: The stock trades at 7.5x consensus estimated forward earnings. Assuming the company succeeds in building out the auto-loan business – growing the total loan book by 40%, with profitability improving slightly from 2023's below-average credit experience – we think by 2027 OneMain can earn up to $12 per share. Even if the shares traded at only 6x earnings, in three years you'd have a $72 stock and would have received by our estimate another $16 or so per share in dividends. From today's price that would result in shareholders earning a roughly 80% return.

You mentioned earlier the need to be "decent at timing" in buying and selling bank stocks. What does it take to be successful at that?

DP: A lot of it comes down to valuation and understanding why the sector might be expensive or cheap. I believe banks are generally much safer than they were pre-financial crisis, as a lot of marginal credit has been pushed off to non-banks and private credit markets where there's been high growth but also where there's relatively higher risk. But while I think there's much less credit risk in the banking system, when people get scared about recession risk the banks sell off and can trade as if they're going to have big credit problems. Those have been the times when I've tried to take advantage of what I consider undue pessimism.

Since I started my fund in 2008 when many credit issues were already obvious, I can't say that over the period since then I've proven myself in managing through a real credit cycle. If I'm normally a 2 on a scale of 1 to 5 in my level of concern about credit risk, I'd say today I'm at a 3. It will be interesting to see what the next credit cycle looks like. VII