



Idea Brunch with Derek Pilecki of Gator Capital

Derek Pilecki shares his approach to investing in financials, the opportunity in small banks, and his top three ideas

🔒 Edwin Dorsey 5 hr ago ❤️ 1 💬 1 ➦ ...

Welcome to Sunday's Idea Brunch, a weekly interview series with underfollowed investors and emerging managers. We are very excited to interview Derek Pilecki!

Derek is currently the portfolio manager of Gator Capital, a financials long/short fund he launched in July 2008. Since inception, Gator Capital has returned ~1,180% compared to ~340% for the S&P 500 and ~200% for the S&P 1500 financial index. Before launching Gator Capital, Derek was a portfolio manager at Goldman Sachs and an analyst at Clover Capital.

Derek, congrats on all your success with Gator Capital. What attracted you to the financials sector and what have been the keys to your success investing in that space?

Thanks, Edwin! I started Gator 10 weeks before they shot Lehman Brothers. It was a crazy time to start a Financials sector fund. But, the crash in 2008 presented a lot of opportunities. It was an exciting time. I think a lot of stock market investors still have scars from that time. Specifically, I think they still have scars from investing in Financials. Today, when every other PM is focused on Technology stocks, I find there's less competition in Financials stocks.

I decided to focus my fund on the Financials sector because I had industry experience at a major financial institution and had covered Financials while I was on the buy-side. Prior to business school, I worked in asset/liability strategy for Fannie Mae. My main responsibility was running the model that stress-tested the company's investment portfolio for extreme interest rate scenarios. I had to load Fannie's entire investment portfolio into the computer and set all the inputs for the interest rate scenarios. This was circa 1996, and we could only run one interest rate scenario at a time. It took 10 hours to run a single scenario on a Sun Sparc workstation, so if I made a mistake on setting up the inputs or inputting the portfolio, I would waste a chunk of time. This was a great motivator to get the portfolio and the inputs set correctly before starting a new rate scenario. I spent so many nights and weekends running

rate scenarios in the depths of Fannie Mae, that I got to know their investment portfolio very well at a CUSIP level.

While I was working at Fannie Mae, I decided I wanted to move to equity research, so I left Fannie to go to business school in Chicago. I was able to use business school as a transition to equity research, and I covered the Financials sector because of my experience at Fannie Mae. Prior to starting Gator Capital, I worked at Goldman Sachs Asset Management (“GSAM”) on their Growth Equity Team covering the Financials sector. When I started Gator, I had only covered the Financials sector, and I thought I could create the most value there.

I believe the Financials sector is one of those sectors like energy or biotech where you need specialization to really dig down deep within the sector. Within the Financials sector, there are many different business models. Each business model has its own income statement and balance sheet. Whether you look at a bank vs. a life insurance company vs. a property-casualty insurance company vs. a stock brokerage firm vs. a real estate investment trust vs. an asset manager, you have to deal with a different income statement and balance sheet. I think my specialization in the Financials sector allows me to know smaller companies in the sector. I also get to follow them closely over a long period of time.

I love investing in Financials because there are regular opportunities. I find that companies go in and out of favor for crazy reasons, which provide the opportunities. I think a lot of generalist investors avoid the sector altogether. Maybe they lost too much in Financials during the 2007-09 timeframe. I think other investors avoid the sector because they think the sector is a lot riskier than I do. I think the Dodd-Frank bill was a game-changer for the Financials sector. I don't think we'll have another timeframe like we did from 2007-09 during the next 30 years, but the market prices the sector like it is going to happen every other year.

More specifically on the Dodd-Frank bill, I believe that the reduction in leverage and the amount of lending that was pushed out of the banking system will make another debacle like 2008 very remote. Regulators are still all over the banks' loan portfolios during regulatory exams. The banks have significantly lower leverage than they used to. The scars from the 2007-09 losses run deep, so every time we get a little hiccup like December 2016 or March 2020, investors immediately price the sector like it is September 2008 again.

In your recent investor letter, you have a cool chart showing that larger banks are now trading at meaningfully higher premiums to book value than smaller regional banks. Why is this and what are the implications for the banking sector?

I think large banks have higher valuations than small banks right now because of the rally that started last fall. In stock market rallies, investors typically gravitate to the largest companies or the stocks with the most liquidity. We definitely have seen this in the bank stock rally of the last 12 months. The large banks have increased the most because they are the most liquid and investors are comfortable with the names and the liquidity of the big banks. I think this outperformance by the big banks is a temporary phenomenon. Having small banks as the cheapest segment of banks is not sustainable.

Small banks should trade at a premium to large banks because they can grow faster than large banks. Small banks can have specialized lending units that generate outsized growth. The big banks are so large that they have very generic growth rates. Also, small banks can deliver value through mergers and acquisitions that the big banks cannot.

I believe the low valuations of small banks will lead to more mergers and acquisitions. With low valuations, the merger math of acquisitions works better and can create value for acquirers. I also think the M&A environment for banks is strong due to the increased regulatory and technology costs of running a bank. Increased scale through M&A can mitigate these increased costs.

In October 2020, you wrote that "there is a 'once in a decade' opportunity in regional bank stocks." Since then, the KBW Nasdaq Regional Banking Index is up around 90%! Why did you think regional banks were great back in October 2020 and are they still attractive to you now? Where should an individual investor look to deploy capital in the financial sector?

When I wrote about the 'once in a decade' opportunity in October 2020, regional banks were trading the lowest valuations since the Fall of 1990. Back then, we were at the peak of the Savings and Loan Crisis, we were in a Commercial Real Estate-led recession, and Saddam Hussain had invaded Kuwait. Although we were in the middle of the pandemic, the environment was considerably more favorable in October 2020. The economy was clearly recovering from the March shutdown. Scores of banks had spoken at conferences in August and September saying that credit quality was improving. But, we were trading at the same valuation as the Fall of 1990, which was a tremendous buying opportunity in its own right.

I think regional banks are still attractive because loan growth is inflecting higher and you get the free option on higher interest rates. We don't foresee credit problems in the near- or intermediate term. Banks have a huge opportunity to cut expenses through closing branches and moving to less expensive core technology solutions. We balance this view with the belief

that the competitive intensity of banking is increasing over time and customer capture is not as robust as in some other industries.

I think there are many attractive areas in the Financials sector. Besides the few names discussed below, I like microcap banks, mortgage insurers, and specialty property & casualty insurers as areas of interest. The mortgage insurers are super cheap and housing losses should be minimal for a while. The Specialty P&C insurance companies are benefitting from a pretty good pricing cycle.

What are two or three interesting ideas on your radar now?

I like Realogy, the residential real estate broker. I like First Bancorp Puerto Rico, and I like Royal Bank of Canada, the leading bank in Canada.

Realogy Holdings Corp (NYSE: RLGY — \$1.86 billion) is cheap because stock market investors think commissions for residential real estate brokers will get disintermediated. With the company trading at 5x EBITDA and debt now down to just 2.3x, I think the shares are too cheap. On top of the cheap shares, Realogy is benefitting from the current housing boom, especially the high level of activity in the NY Metro area. In the intermediate-term, Realogy will benefit from demographics as the Millennial generation buys homes and home building accelerates from the decade-long pull-back after the Great Financial Crisis. We think the next catalyst for Realogy will be a stock repurchase once the management team refinances two debt issues by mid-2022. We believe the stock can trade at 8x EBITDA. At that valuation, the stock would double from current levels. Five years ago, the stock routinely traded for 12x EBITDA.

I like the Puerto Rican banks, and my largest position is **First Bancorp Puerto Rico** (NYSE: FBP — \$2.94 billion). We have seen massive consolidation of the banking market in Puerto Rico. In fifteen years, the number of banks on the island has declined from 11 to 3. We point to another island market in Hawaii where they have 4 banks and each bank earns above-average margins and returns. We believe we will see the same thing happen in Puerto Rico. We don't foresee any U.S. mainland banks entering the Puerto Rico market unless they acquire one of the existing banks. FBP trades for 10.2x 2022 earnings and 1.4x tangible book compared to the average regional bank trading valued at 13.6x 2022 earnings and 1.7x tangible book. FBP is massively over-capitalized and has started returning capital to shareholders through increased dividends and share repurchases. FBP is integrating its recent acquisition of Banco Santander. We like how FBP is taking advantage of the expense synergies of this acquisition. We think FBP will return 100% of earnings for the next 5 years and still fund its loan growth. We also believe there is a case to be made of a bullish Puerto Rican economy over the next few years.

Puerto Rico has received billions of dollars of cash in aid for the hurricanes and Covid. We believe this cash will lead to job growth on the island. We are also hopeful that Puerto Rico will benefit from the onshoring of pharmaceutical and health care supplies.

I like **Royal Bank of Canada** (NYSE: RY — \$149 billion). The Canadian banking system is an oligopoly. Royal is the largest Canadian bank and has the highest returns. Canadian banks have a long history of higher and more consistent returns than U.S. banks. Historically, this has allowed Canadian banks to trade at a premium to the large U.S. banks. In the last ten years, this premium has disappeared, RBC now trades at a discount to Bank of America. For example, RBC trades at 12x 2022 earnings and 2.5x tangible book versus Bank of America at 15x 2022 earnings and 2.2 tangible book. We also note that Canada seems to be closer to raising short-term interest rates before the U.S. does. While this idea is not a barnburner, I think you can depend on RBC to produce solid returns for your portfolio. Over the last 20 years, RBC has compounded at 14.4% vs. the S&P 500 Index at 9.6% vs. the S&P Financials at 5.5% versus Bank of America at 4.7%.

Derek, what are some of the first things you do when researching a financial institution? What does that first hour of research look like? Is there anything you do that most people don't?

I think management is the most important aspect of analyzing a stock. Management teams in Financials stocks are capital allocators. So, when I look at a company, I need to understand its management team. I read the last two years of conference call transcripts to understand how they answer questions. I try to gauge how they think and who they are.

I think there are two things that differentiate me from other investors. First, I'm pretty good at making buy or sell decisions on stocks without having complete information. I think of this as having 60% or 70% of the picture complete, but I recognize a pattern and can move forward with a decision. Of course, when I do this, I try to maintain flexibility in case I come to a different conclusion as I continue to gather information. The second way I'm different than other investors is I am more optimistic and more trusting of management. I think many investors are more skeptical than I am. Sometimes, I see them become paralyzed because they can't independently verify the information given to them by management teams. I recognize that this view can sound naïve, but I also think it is harder for management teams of Financials companies to mislead investors for a period of time.

How do you come up with new ideas to research? Are there any publications, websites, or tools that help you find off-the-beaten-path banks that are interesting?

Look, I'm a value investor. Nothing gets me more excited than buying a cheap stock and seeing the multiple expand because the issue(s) investors were worried about goes away.

For capital-intensive businesses like banks and insurance companies, I pay attention when they trade at 8x or less. For capital-lite businesses like asset managers, insurance brokers, and advisory investment banks, I get excited when they trade below 12x.

For banks, if you buy them at 8x, there will be a time in the cycle that they trade at 12x. If they grow 8-10% annually and you get a 50% multiple appreciation, that is an attractive return. Look at Bank of America, in the last 10 years, it has traded at 8x twice. Once was February 2016 and the other was March of 2020. It traded up to 12x within 12 months both times! There is a fallacy out there that cheap stocks stay cheap.

Since I focus solely on the Financials sector, I try to learn about as many stocks as I can to continue to build my knowledge. There have been more newly public Financials stocks in the last 12 months than I can remember, so I've been spending time learning about those businesses. A lot of mortgage banking and "disruptive" insurance stocks have come public. I think a lot of the new public stocks within the Financials sector are garbage.

For sources, I use the old SNL Bank Data Source that is now part of CapIQ. On Twitter, I created a list of bank investors that I follow that you can view [here](#).

Derek, thank you for the great interview! What is the best way for readers to follow or connect with you?

I appreciate your time! I can be reached at or on Twitter, you can follow me [@GatorCapital](#)

You can subscribe to our investment letters on our website [here](#).

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