

Credit Where Due

Asked to characterize today's market environment, financials-sector expert Derek Pilecki of Gator Capital Management first calls it "super confusing" – but then is quick to add that he considers that more of a positive than a negative.

INVESTOR INSIGHT



Derek Pilecki
Gator Capital Management

Editor's Note: In a business populated largely by generalists, Derek Pilecki of Gator Capital sees plenty of reason to specialize, as he's done on the financials' sector since starting his firm in 2008. "Generalists are less likely to invest in financials, even more so since the 2008 crisis," he says. "Business models are different, balance sheets are different, and industry players often don't have moats in the classic sense. Rather than compete in trying to buy compounders with the best business models, I'm more apt to find value in a pond where less people are fishing."

He's translated that theory beautifully into practice. His long/short Gator Financial Partners hedge fund since inception in July 2008 has earned a net annualized 19.1%, vs. 10.3% for the S&P 500. At a time when top-of-mind subjects include interest rates and inflation – important to all companies' prospects, but even more so for financials – we caught up with him recently to find out where he's uncovering opportunity, and risk, in today's market.

Let's set the stage first by having you delineate your field of play as an investor.

Derek Pilecki: I have a fairly broad view of financials, including banks, non-bank lenders, insurers, investment banks, asset managers and real estate investment trusts. I tend not to have significant positions in payments processors, financial technology and exchanges, which is somewhat arbitrary, but stems from when I was a buy-side analyst and someone else covered those areas. I've never felt I had the expertise there to have an edge.

How would you describe the opportunity set in your world today?

DP: The market is super confusing at the moment, but that also presents opportunities. Coming into this year the consensus was that interest rates would go higher and the financial sector would benefit. That played out in January and February, but when Russia invaded Ukraine there was a definite downgrade in investor risk appetite and the focus shifted to the risk of recession and credit losses. That resulted in financials in March giving back a lot of the previous outperformance. Since then the stocks have mostly tracked the broader market as it sold off and, more recently, came back.

It's also not clear that when investors decide to take on risk, will financials be where they go first or last? The Fed seems insistent that it's going to raise rates until headline inflation comes down, which is generally good for financials. But again, what if it overshoots and causes a recession, which would be bad for financials?

All that has led to a lot of very inexpensive stocks. The 25 long positions in my portfolio today trade at a median 6.7x forward earnings. The two most expensive stocks I own have forward P/Es of 9x. Those valuations are pretty remarkable, and I have an increasingly long watchlist with stocks that are as inexpensive.

How attractive that is must depend somewhat on your take on interest rates and on the threat of recession.

DP: I don't want the portfolio to be just an interest-rate bet. Many financials benefit from higher rates, but they don't all respond to rates in the same way. There are more asset-sensitive banks, for example, that are reliant on floating-rate commercial loans so will see earnings incrementally improve as short-term interest rates rise. On the other hand, more liability-sensitive banks tend to be fixed-rate lenders and for them short-term rates going up aren't great because their cost of funds increases relative to their rates on loans.

I tend to own a mix of both, and in any event want to own companies that have other drivers of value creation. Maybe an asset manager has done an acquisition and is successfully deleveraging in a way that creates value. Maybe a regional bank has an opportunity to profitably grow as big banks in its market lose focus. Knowing how difficult it is to forecast rates, I don't want to be overly exposed if my view on rates – or my view on the market's view on rates – turns out to be incorrect.

That said, it is difficult in financials not to have quite a bit of asset sensitivity, so I generally welcome higher rates that will

improve earnings. I believe, like most do, that the Fed is committed to raising rates, but I'm less pessimistic about their ability to do so without crashing the economy. The general economic environment entering all this has been quite strong, with high employment and good levels of consumer spending. I think it's unrealistic to expect we go from that to a deep recession. As the economy cools and the housing market slows and supply chains repair themselves, I'm fairly confident that the Fed will be able to pause at the appropriate time without slamming the brakes on the economy. If that turns out to be true, the low valuations in the financial sector should turn out to be very attractive.

Your portfolio seems particularly weighted toward banks. Why is that?

DP: I own more banks than usual, now about 70% of the portfolio. The valuations in regional banks are as cheap as I've ever seen them. Earnings are likely to materially improve from higher interest rates. Credit quality is very good. Many regional banks are trading at maybe 8x 2023 estimated earnings and I'd argue the estimates are too low. I think it's an unusually opportune point for smaller banks right here.

When we spoke five years ago [VII, August 31, 2017], you were high on alternative-asset managers like Blackstone and Carlyle. They appear to be absent from your portfolio today – are you cool on the prospects for asset managers in general?

DP: I'm finding some traditional asset managers that are more interesting. Everyone knows about the headwinds from the shift from active to passive, but valuations of traditional asset managers are very interesting and we think in some cases overly discount the headwinds that are there.

One example of a firm we think will take advantage of the current environment is Victory Capital [VCTR]. It originally was the asset-management arm of KeyCorp, but was carved out by private equity and then came public in early 2018. They've proven to be very good at

acquiring independent asset managers, keeping the investment side autonomous but consolidating all back-office, distribution and sales functions. They use debt to make acquisitions for cash and then use improved cash flows from operations to pay down debt. Once they get debt down to a reasonable level they pursue other acquisitions. That's resulted in strong and profitable earnings growth since they went public and we believe that formula has a lot of room to run. But you wouldn't know it from how the stock trades. The P/E on forward earnings [at a recent price of \$27.70] is just 6x.

Describe the broader investment case for one or your favorite regional-bank ideas, Bridgewater Bancshares [BWB].

DP: This is the type of growth bank we've spoken about in the past. It was founded in 2005 to serve the Minneapolis/St. Paul market in Minnesota, not trying to be everything to everybody, but targeting affluent business owners to be their commercial as well as personal bankers. Top management came out of big banks where they ran into issues with bureaucracy, lack of risk-taking and very little pay for performance. They wanted to build a bank

INVESTMENT SNAPSHOT

Bridgewater Bancshares
(Nasdaq: BWB)

Business: Founded in 2005, provides deposit, lending and other related services to commercial and individual clients primarily in the Minneapolis/St. Paul area of Minnesota.

Share Information (@7/29/22):

Price	17.48
52-Week Range	14.97 – 20.04
Dividend Yield	0.0%
Market Cap	\$480.6 million

Financials (TTM):

Revenue	\$113.9 million
Operating Profit Margin	56.5%
Net Profit Margin	41.5%

Valuation Metrics

(@7/29/22):

	BWB	S&P 500
P/E (TTM)	11.0	22.2
Forward P/E (Est.)	9.9	18.0

Largest Institutional Owners

(@3/31/22 or latest filing):

Company	% Owned
Thrivent Asset Mgmt	7.1%
BlackRock	5.0%
Fidelity Mgmt & Research	3.9%
Vanguard Group	3.3%
Punch & Assoc	2.5%

Short Interest (as of 7/15/22):

Shares Short/Float	1.4%
--------------------	------

BWB PRICE HISTORY



THE BOTTOM LINE

A small regional bank sporting this company's growth potential, lending prowess and profitability should not trade for the 10x forward earnings multiple the market currently offers it, says Derek Pilecki. At what he considers a more reasonable 14-18x his 2023 EPS estimate of around \$1.90 per share, the stock would trade between \$27 and \$34.

Sources: Company reports, other publicly available information

that didn't have those issues, and have proven to be a good home for similarly disaffected teams of bankers from bigger competitors.

Over the past 17 years they've delivered significant asset growth, with excellent credit quality and a branch-lite operating model that translates into higher profitability. Most big banks have efficiency ratios in the mid-50s, while Bridgewater's is in the low-40s. Higher profitability means more capital to grow loans.

Minneapolis has a dynamic economy with a thriving corporate sector – it's said to have the highest number of *Fortune* 500 headquarters per capita of any city in the country – and the population trends are positive. There's also been some upheaval in the city's banking market. Wells Fargo and U.S. Bancorp are the biggest local players, but Wells has been struggling due to its well-documented run-ins with regulators and U.S. Bank is more focused at the moment in solidifying its presence in California with the acquisition of MUFG Union Bank. Huntington Bancshares, which is based in Ohio, last year bought TCF Financial, which has a strong presence in Minneapolis. Old National Bancorp, based in Indiana, has been expanding through acquisition in Minneapolis as well.

I mention all that because this type of disruption tends to be good for Bridgewater. They hire bankers looking for a new home from those institutions and they also have more opportunity to land new customers whose legacy banks are no longer as responsive to their particular needs.

Our basic case here is that the company can continue to grow its loans at 20% per year, credit is totally fine, and earnings are likely to incrementally benefit from higher interest rates. For that you're paying 10x next year's consensus earnings estimates – estimates we think are too low, by the way.

What do you think the shares, now around \$17.50, are more reasonably worth?

DP: We think Bridgewater can continue to grow loans at around 20% per year for at least the intermediate term. Because it's

less asset sensitive, the benefit from higher rates may take a bit longer to show up and earnings next year may only increase 12-15%. Growth banks like this normally trade at 14-18x earnings, so on our \$1.90 per share earnings estimate for next year, that would result in a share price from roughly \$27 to \$34.

One general point I'd make about smaller banks is that because they tend to grow faster and have more of an M&A takeout premium, they typically trade at higher valuations than larger banks. We're not seeing that today, but would expect that premium to return going forward.

Turning to maybe somewhat more of an idiosyncratic idea, what do you think the market is missing in insurance company Genworth Financial [GNW]?

DP: We look at the company as having three main assets. The first is its 81.6% ownership of Enact Holdings [ACT], which is one of six large mortgage-insurance companies in the U.S. The second is its wholly owned life insurance subsidiary, which is best-known – and not in a good way – for its franchise in long-term care insurance. The third asset is its tax-sharing arrangement with the two subsidiaries,

INVESTMENT SNAPSHOT

Genworth Financial
(NYSE: GNW)

Business: Provider, through subsidiary Enact Holdings, of residential mortgage guaranty insurance in the U.S.; life insurance division focuses primarily on long-term care policies.

Share Information (@7/29/22):

Price	4.25
52-Week Range	3.28 – 4.61
Dividend Yield	0.0%
Market Cap	\$2.13 billion

Financials (TTM):

Revenue	\$7.74 billion
Operating Profit Margin	17.4%
Net Profit Margin	11.2%

Valuation Metrics

(@7/29/22):

	GNW	S&P 500
P/E (TTM)	2.5	22.2
Forward P/E (Est.)	5.1	18.0

Largest Institutional Owners

(@3/31/22 or latest filing):

Company	% Owned
BlackRock	13.4%
Vanguard Group	10.9%
River Road Asset Mgmt	3.3%
Dimensional Fund Adv	2.5%
Donald Smith & Co.	2.4%

Short Interest (as of 7/15/21):

Shares Short/Float	3.0%
--------------------	------

GNW PRICE HISTORY



THE BOTTOM LINE

Its majority stake in publicly traded mortgage-insurance subsidiary Enact Holdings is worth the company's entire current market value, says Derek Pilecki. Ascribing what he considers to be a more reasonable value to Enact while also adding in the value of its tax-loss assets, he estimates the company's fair value per share today to be around \$8.30.

Sources: Company reports, other publicly available information

which essentially allows it to use its past losses to offset any taxable income from the operating businesses. We think this conservatively could produce \$100 million in tax savings per year over the next five years.

We wouldn't make the case that Enact is a great business, but we think it's improved a lot since the debacle of the financial crisis. Fannie Mae and Freddie Mac require mortgage insurance when a borrower makes a down payment of less than 20% of the home's purchase price. That's a tailwind for growth when rising home prices make it harder to come up with a big down payment. Another tailwind is that the Millennial generation is moving through the peak buying years for first homes, and first-home buyers tend to disproportionately need mortgage insurance. It won't be all in a straight line, but we expect mortgage-insurance volumes to grow between 6% and 10% annually over the next several years.

The industry also benefits from much improved mortgage underwriting practices and the fact that mortgage insurers are now able to offload significant risk of default to reinsurers. Credit losses have been running very low – 20 to 50 basis points of loan principal – but if there is one day another crisis, reinsurers are absorbing much of the losses above 2.5%.

How would you describe Enact's competitive environment?

DP: All the players are very similar, with long-tenured relationships with lenders who typically choose the insurance provider. Price competition is high, but I wouldn't say irrational. Some would argue the industry should further consolidate, but our general impression is that Fannie and Freddie are comfortable with the current set up and what has been a pretty disciplined level of competition.

Are you concerned about the potential for a housing market downturn?

DP: Underlying our growth outlook for mortgage insurance is the expectation that

the housing market in the U.S. becomes more balanced as rates move up, but that rates won't get so high that they choke off solid longer-term growth in housing demand, driven by demographics and lifestyle choices as people increasingly work from home. The days of multiple bids over asking price may be over, but as long as people have jobs they'll still be looking to buy homes and will pay their mortgages when they do.

Describe your outlook for Genworth's insurance business.

DP: I should first make clear that we're assigning zero value to this business. The vast majority of it consists of long-term care policies that were sold at terribly mispriced rates and are now in runoff. The youngest policy holders are in their early 60s, so it will be some time before the runoff is complete.

We believe the value here won't end up being less than zero, and there is some possibility that management can salvage some material upside. The company has had some success in getting price increases approved on the existing policies, which is a colossal undertaking involving regulators across all 50 states. The net present value of the price increases allowed so far is not a small number, around \$22 billion, but so far that's just going to cover losses from extant policies. They're also coming out with a new product for long-term care insurance that has annual repricing similar to health insurance. That may catch on, but even if it's not a huge success, the effort likely makes regulators who would like to see this type of coverage in the market more amenable to helping Genworth work through issues on its older policies.

How are you looking at valuation from today's \$4.25 share price?

DP: The Enact stake at today's market value, minus net debt, is worth about \$4.30 per Genworth share. The roughly \$500 million in tax benefits are worth another \$1 per share. We also believe Enact is undervalued. It is the least-expensive stock

of the publicly traded mortgage insurers, trading for 85% of tangible book value and roughly 6.7x forward estimated earnings. Mortgage insurers have historically traded in the range around 1.3x book value, which we don't think would be at all unreasonable in today's industry environment. At 1.3x, the Enact stake would be worth an additional \$3 per Genworth share. That brings our estimate of overall fair value to around \$8.30 per share.

As I said, we put no value on the life insurance business, but the subsidiary still has close to \$11 billion in reported book value. If things work out better there than expected, for Genworth stock with a current market value of \$2.1 billion, even salvaging a percentage of that book value would translate into real upside.

The last thing I'd mention here would be around capital allocation. Enact generates more capital than it needs for growth, so we expect later this year for it to raise its annual dividend, which could represent up to 40% of run-rate earnings. That would translate into a current yield on its stock of about 6%. In addition, Genworth in May announced it planned to buy back 15% of its shares. Given the discount at which we think the stock trades, that to us is an excellent use of capital.

You've been active on the short side since starting Gator. Describe your general approach to shorting and why you do it.

DP: There are three main reasons I've maintained a commitment to shorting. One is that I'm a sector manager and my sector is not always going to have a favorable outlook. Every 30 years or so you may want to sell everything in the sector. I don't think we're anywhere near that right now, but I want to have the flexibility when I'm concerned about credit quality or any number of excesses in the system to make bets against that.

Another reason I short is that if you look at my track record, the financials' sector through the end of 2021 returned about 9% per year. My shorts returned 8%, so I had a little bit of alpha there. But my longs increased more than 25%

per year. By shorting I can run the portfolio gross long and get more money in my long ideas. Typical for me would be to run about 130% gross long, with a net exposure of 75-80%.

The last reason for shorting is simply that in the course of my research I always come across names where I think headwinds are stronger than people think and the stocks are overpriced. If I see that, I want to try to take advantage. All my shorts are individual names.

Are there areas on the short side you're finding particularly interesting today?

DP: I'm short a few REITs, like Vornado [VNO] and Boston Properties [BXP], that are heavily exposed to commercial office space. These companies are well run, but I believe with changing work habits going forward there are going to be significant headwinds for both big and small players in the industry.

I also have some short positions in regional banks whose stocks for reasons I don't understand have held up very well in this year's market decline. An example would be Stock Yards Bancorp [SYBT] in Kentucky. Its stock currently trades near its 52-week high, but when the sector rebounds fully I think there's a good chance it's unlikely to keep up.

Fintech companies perceived to be disruptive were until recently extremely well regarded by investors. Have you tended to find such companies attractive on either the long or short sides?

DP: Not to any great degree. Some of the new companies like Square, now Block [SQ], did meaningfully disrupt existing markets, in this case the merchant-processing space. That really woke up a lot of banks. Banks in general, though, have been fast followers in technology. From an analytical perspective, I think of fintech more as driving lower margins across the board than killing incumbents outright.

I'd make a distinction on the credit side, where innovation, such as it is, has tended to be a loose-money phenomenon. Companies get funding because capital markets are wide open and then build high-tech credit models based on the last ten years of good times and then everyone's surprised when they run into problems. Buy Now, Pay Later is a good example, which at least from a capital-markets perspective has been largely discredited. It's hard to disrupt credit. In most cases it's already super competitive, with players who have been doing it for a long time and make just okay returns at it. There just aren't a lot of excess profits to skim off.

I mostly stayed out of the way when some of the fintechs like Upstart Holdings [UPST] and SoFi Technologies [SOFI] kept going up and up. As a short seller I respect momentum, so even though I didn't believe they were fundamentally disrupting their markets and that they were likely to be exposed when the cycle turned, I only shorted them – and only modestly at that – after it was fairly clear they were starting to crack. In companies like these, you can typically wait for that and still have time to benefit.

Have you become a blockchain and/or cryptocurrency expert?

DP: I wouldn't say that, but these are obviously areas of high interest relevant to financial companies. I would say I'm not yet as sold on blockchain as a disrupter as many are. It's touted as being super secure and efficient, but for now transactions using blockchain technology seem to be slow to process, slow to verify, and hard to reverse. I realize applications are very much in the early stages, and I continue to follow it all closely.

I'm probably a bit more positive on the prospects for bitcoin, not because I know how to value it, but because other people seem to value it and are likely to continue to do so. It may very well be a store of value like gold. Or I think of it like impressionist paintings – there may not be productive value in them, but people like them and are willing to pay a lot for them. If the government regulates bitcoin without outlawing it, that's going to legitimize it and perpetuate its role as a store of value. There was way too much leverage in the cryptocurrency system that has had to unwind, but once the community works through it I can imagine bitcoin still having an important role. **vii**