Emerald Advisers, LLC
Small Cap Value

Q3 2020 | Economic & Portfolio Commentary

The "V" shape stock market recovery continued in 3Q, however, many industries are still feeling the pain from the ongoing pandemic.

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Stock market indices continued to climb in the third quarter thanks to a super-accommodative monetary policy pursued by the Federal Reserve, and massive fiscal stimulus programs passed by the government to support the economy. However, the strong performance was not broad based, as the majority of the upside since the market bottomed in March has come from a handful of large cap companies and a few industries that benefited from the current social distancing environment. For example, big technology firms have been the main beneficiaries of the transformation and the surge in digital demand due to COVID-19. To illustrate this dichotomy, the top five companies in the S&P 500 (Amazon, Apple, Facebook, Google, and Microsoft) aggregate weight is almost a quarter of the index, and their total market cap is almost three times greater than the entire Russell 2000.

In 3Q20, large caps continued to outperform small caps, and growth beat value by a wide margin. Unfortunately for small cap value managers, this theme has been prevalent throughout the year. So far, small cap growth outperformed small cap value in every month of 2020, and the performance gap between large cap growth (Russell 1000 Growth) and small cap value (Russell 2000 Value) stands at a staggering 4,587 bps year to date.

Portfolio Review

For small caps in 3Q20, Consumer Discretionary and Industrials sectors relatively outperformed. The Energy sector was the worst performer giving back a large chunk of last quarter's huge rally. Also, bond proxies like Utilities and Financial Services continued to underperform the broader market. Factors that worked during the quarter were high ROE, high share price and high market cap which are considered higher quality. However non-earners, high leverage, and high beta which are considered lower quality metrics also performed well. The Emerald Small Cap Value's portfolio once again was significantly ahead of the Russell 2000 Value Index total return in the third quarter. Emerald's outperformance was mostly due to stock selection.

Within the Russell 2000 Value benchmark, Consumer Discretionary and Materials sectors had very strong performance. Conversely, Energy, Utilities and Financial Services (mainly banks) sectors had the weakest performance during the quarter.

Key Points:

- At the portfolio holdings level, Healthcare and Materials detracted from performance. However, positive stock selection in Financial Services, Technology, Utilities, and Producer Durables contributed significant alpha to the portfolio.
- We continue to invest in high quality companies that generate prodigious amounts of free cash flow, as well as in financial services enterprises that trade significantly below their terminal value.
- As value investors, we see many investment opportunities at this point in time, and will continue to focus on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

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This has been another challenging quarter for banks, with broad underperformance for all size segments as they lagged their broad market peers across the board. Additionally, small cap banks underperformed both mid and large caps banks in 3Q20.

Our approach has been to evaluate community banks during the coronavirus pandemic through a spectrum that views the pandemic as having a four stage process. We believe that four stage process includes the original lockdown, pre-therapy/vaccine, post-therapy/vaccine, and the rebuilding of the economy. While no one knows with certainty the timing of phases three and four, what we do know is that the community banking sector has transitioned from stage one into stage two, pre-therapy/vaccine in better shape than even the most optimistic investors and management teams could have expected. We believe that the plethora of governments aid and transfer payments have been beneficial to the community banking sector to date. However, we remain cautious as we move forward into stage three, post-therapy/ vaccine. Our abundance of caution exists due to the uncertainty around credit migration and the low interest rate environment.

As banks dust off their game plans used after the great financial crisis of 2007-2008 (GFC), we expect community bank management teams to turn their focus to reducing expenses and we believe the low hanging fruit to be branch reductions. We believe the first stage of the pandemic, the lockdown, has led to an accelerated adoption of digital banking tools by both retail and business customers and we believe this adoption will lead to another wave of branch closures. We believe banks of all sizes are re-evaluating their branch footprints, and some have announced plans to close up to 20% of their networks. U.S. banks and thrifts opened 61 branches in August and closed 118, according to S&P Global Market Intelligence data, which does not include temporary bank closures, such as those caused by the COVID-19 pandemic. Over the last year, U.S. banks and thrifts have closed 2,303 branches and opened 1,110, leaving 85,143 active branches in the U.S. at the end of August.

Following the GFC game plan we have seen community banks shore-up capital levels with inexpensive funding. According to S&P Global, dozens of banks have taken advantage of the subordinated debt markets in recent months. Total capital issuance peaked in May and the demand has remained steady with over a dozen issuances each month. From May through August, there have been 85 issuances of subordinated debt in the banking sector, totaling $4.48 billion. In the year ago period, there were 19 issuances totaling $923.3 million.

As community bank management teams began to feel more comfortable with future cumulative loan loss rates ahead of the potential third stage, post-therapy/vaccine, but not yet confident enough to acquire another bank's loan portfolio, bankers have felt the best use of their capital to be share buybacks given the reduced valuations in the bank sector. While the Federal Reserve has prohibited the nation's largest banks from stock repurchases, many community banks have either not suspended buybacks or have reintroduced them in recent weeks. According to S&P Global, from the start of the third quarter and through September 10th, a total of 24 community banks have announced buybacks. We believe that with many community bank stocks trading below tangible book values, community bank management teams see buybacks as a prudent use of capital since it is immediately accretive to book value. Eventually, management teams will return to mergers and acquisitions as a priority over share buybacks. We believe that amid the COVID-19 outbreak in the U.S., banks were forced to shift their attention to internal operations, pausing M&A discussions and terminating pending deals. But as banks gain more clarity around the coronavirus' economic impact, discussions are starting to pick back up to the point that bankers and deal advisers believe next year could turn out to be a banner year for M&A. As deferment rates decreased at community banks during the third quarter bank M&A activity began to return. According to S&P Global, U.S. banks and thrifts announced 14 deals in September, the highest monthly tally in 2020 after January. During the first three quarters of this year, the industry saw 81 deal announcements worth an aggregate $7.75 billion, compared to 200 deals worth $47.05 billion over the same period in 2019. The median deal value to tangible common equity ratio for deals announced in 2020 was 134.2%, down from 157.7% in all of 2019. We believe that as management teams get more clarity into credit quality, M&A activity will return to 2019 levels in 2021.

As we approach earning season for the third quarter our expectations are for margins to remain under pressure. Deposits have flooded into the banking system, leaving bank managers with few attractive options to put the cash to work. Since late February, commercial bank deposits have jumped by about $2.3 trillion, or 18%, with a large amount of the inflows landing directly in consumer and business accounts because of direct government payments, including checks to households of $1,200 each and PPP loans. Business accounts also reflect the cash reserves accumulated during the pandemic, first through borrowing against credit lines and then through bond issuance. The buildup in deposits helped banks cut deposit rates pretty substantially in the second quarter and the trend has continued in the third quarter. Banks' cost of interest-bearing deposits dropped to 0.45% in the second quarter, down 40 basis points from the linked quarter and 57 basis points from a year earlier. Even with the substantial declines in deposit costs, earning-asset yields dropped at a quicker pace, leading to margin pressure.

Given the most recent disclosures from community bank management teams that we have met with credit quality has been a bright spot in the quarter as community banks generally have indicated that loan deferrals are down significantly since the end of the second quarter and we anticipate a positive yet cautious narrative as it relates to credit when the community banks report. However, as we look forward to the third phase of the pandemic we will return to a more traditional credit pipeline, exhibited by measures of early-stage delinquencies, accruing TDRs, risk rating downgrades, criticized and classified loans, nonaccrual loans, and OREO.

We believe the decline in lending that began in May appears to have continued throughout the third quarter, with community bank management teams indicating that they have tightened underwriting amid weak loan demand.

As a result of the strong deposit growth and slower loan growth, management teams have been forced to look to their investment portfolio for yield, no matter how small, and are investing in bank sub debt and corporate bonds in an effort to partially unwind the cash stockpiles accumulated during the early months of the pandemic. Banks' securities portfolios increased rapidly, growing by $197.14 billion, or 4.7% from June 24 to $4.396 trillion at Sept. 23. Average securities during that period jumped $278.45 billion, or 6.9%, from the month prior according to the FDIC.

At the same time, cash at commercial banks fell $49.64 billion, or 1.6% from June 24 to $2.976 trillion at Sept. 23, and average cash balances over that time fell $240.19 billion, or 7.7%, from the month prior.

Given the uncertainty around the economy, government transfer payments, forbearance and credit quality in the second half of 2020 many bank management teams were not giving formal guidance for 3Q and 4Q of 2020 on their 2Q earnings calls. We believe that management teams are now more optimistic and have better clarity into future credit deterioration. As a result, we believe management teams will attempt to reinstate guidance. Given the updated guidance we would expect sell side estimates to reset post bank earnings. However, we will continue to rely on our fundamental research driven investment process at Emerald combined with our proprietary earnings model which we believe will provide us with clarity as we navigate the bank sector for investment opportunities that will allow us to outperform the sector as a whole.

We continue to invest in high quality companies that generate prodigious amounts of free cash flow, as well as in financial services enterprises that trade significantly below their terminal value. These companies should outperform their peers and the market, as the economy continues to recover from the short but deep recession brought by the COVID-19 pandemic.

Market Outlook

In A very accommodative Federal Reserve coupled with trillions of dollars in federal aid to households and businesses have allowed the U.S. economy to emerge from the first six months of the coronavirus pandemic in far better shape than anticipated. However, many uncertainties still exist and several important industries are still reeling from the economic and psychological damage caused by the virus and the ongoing mandates of social distancing. We believe it will take several quarters for the U.S. economy to get to pre-COVID-19 levels, and absent additional fiscal stimulus, the recovery could be measured in years.

On the positive side, domestic industrial metrics bounced back from their historical 2Q20 declines as much of the nation continued to reopen in 3Q20. Industrial manufacturing and materials processing can be carried out safely at a social distance, and there was plenty of pent up demand from 2Q20 to be satisfied. Businesses became used to working with enhanced sanitary, disinfection, and personal protection protocols. After having reduced expenses through layoffs and furloughs, production curtailments, and maintenance outages, the industrial economy began to recover during the quarter aided by the Federal Reserve's measures to support consumers, businesses, and the economy.

We believe that housing construction will be robust for the foreseeable future, and given extremely tight inventories and constrained supply chains, autos, boats, and RVs sales should remain strong as should many other categories of recreational products. Both Presidential candidates have been campaigning on bringing manufacturing, including pharmaceuticals, back to the US. All of this could provide a meaningful boost to capital investment over the next few years. There also remains the possibility for an infrastructure spending bill post-election. These are all potential tailwinds for domestic small cap companies.

The industrial economy is recovering earlier than the services economy as social distancing is more safely and easily implemented in a structured manufacturing or assembly environment. Air travel has recovered to only 48% of previous year's levels. Many restaurants are forced to operate at less than 50% capacity, and theaters are mostly shuttered. Hotels are seeing occupancy levels and rates slowly inching higher but still well below normal levels as both business and leisure travel are mostly on hold. The unemployment rate improved significantly since the peak in 2Q20, and currently stands at 7.9%. However, without the enhanced unemployment benefits that people had been receiving, we could soon see a meaningful impact on consumer spending.

The markets have reached new highs during 3Q20, and we continue to believe investors already priced-in a sharp rebound in revenues and profits. We now expect companies to once again start giving guidance, at least qualitatively if not quantitatively. Executives had enough time to reconfigure their operations and evaluate their end-markets demand and supply chains deficiencies. We believe investors will gravitate towards companies that have not participated in the recent rally off the bottom, but were able to adjust their business model to meet potential increase in demand while holding on to or improving their margins. As value investors, we see many such investment opportunities at this point in time, and will continue to focus on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

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