The Unfolding Credit Cycle

Rochester CFA Society

October 2023

The Advisor and Team

Sam Haskell is Managing Member of Colarion LLC, an investment advisory and fund manager focused on the financial sector based in Birmingham, Alabama. He is also Chief Investment officer of jhh wealth, an SEC-registered investment advisory in Charlotte, North Carolina. Sam began following the financial sector within Morgan Stanley's equity research group in 2001. He helped found the Financial Institutions Capital Markets Group at Sterne Agee, a regional broker focusing on community bank equities, where he worked from 2002 - 2014. In addition to Colarion, he is a board member at $600 million-asset CommerceOne Bank of Birmingham, AL, and Janover Inc., a Nasdaq-listed financial technology concern in Miami FL. Haskell also authors 5 Points, a popular bank-focused publication with several thousand subscribers. He has an established due diligence network within the banking and fintech community nationwide. Sam is a CFA charterholder and graduate of Princeton University.

Mr. Haskell is assisted by Laura Marshall as Head of Administration. Laura has over 25 years experience in financial services, working in public finance, investment banking, and fixed income trading and institutional sales at First Tennessee Bank, A.G. Edwards, and Wachovia. She has a B.S. in Finance from the University of Memphis (Laura@colarionpartners.com).

David Jackson lends additional assistance to Colarion in marketing and analytics. Mr. Jackson is a graduate of Wofford College, is a principal in the investment advisor jhh wealth, inc., and lives in Charlotte, NC.

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Colarion Profile

Named for the manager's daughters, Colarion LLC is an investment advisory begun in 2016. It specializes in the financial sector and in particular small banks.

Colarion advises separate portfolios for 50+ corporate and individual clients. The advisor also manages the Mint Financial Sector Fund (MFSF).

Colarion has assembled a record of strong performance with a focus on higher-quality, compounding microcap banks.

Mr. Haskell's direct tie to lending markets comes from loan committee membership at a $600mln bank, CommerceOne, and board membership at a fintech / loan broker, Janover Inc.

*"I've known Sam for over 20 years. I think so highly of his investment skills and hard work in digging to uncover useful information that I have entrusted him with managing some of my own capital." - Philip Timyan (Riggs Partners, retired financial sector fund manager)**

The Latest Word on Credit:

And I think your other question was where am I seeing softness in credit. And I think the answer to that is actually nowhere roughly or certainly nowhere that's not expected, meaning we continue to see the normalization story play out in consumer more or less exactly as expected.

And then, of course, we are seeing a trickle of charge-offs coming through the office space. You see that in the charge-off number of the Commercial Bank. But the numbers are very small and more or less just the realization of the allowance that we've already built there.

Jeremy Barnum, CFO J.P. Morgan
October 13, 2023

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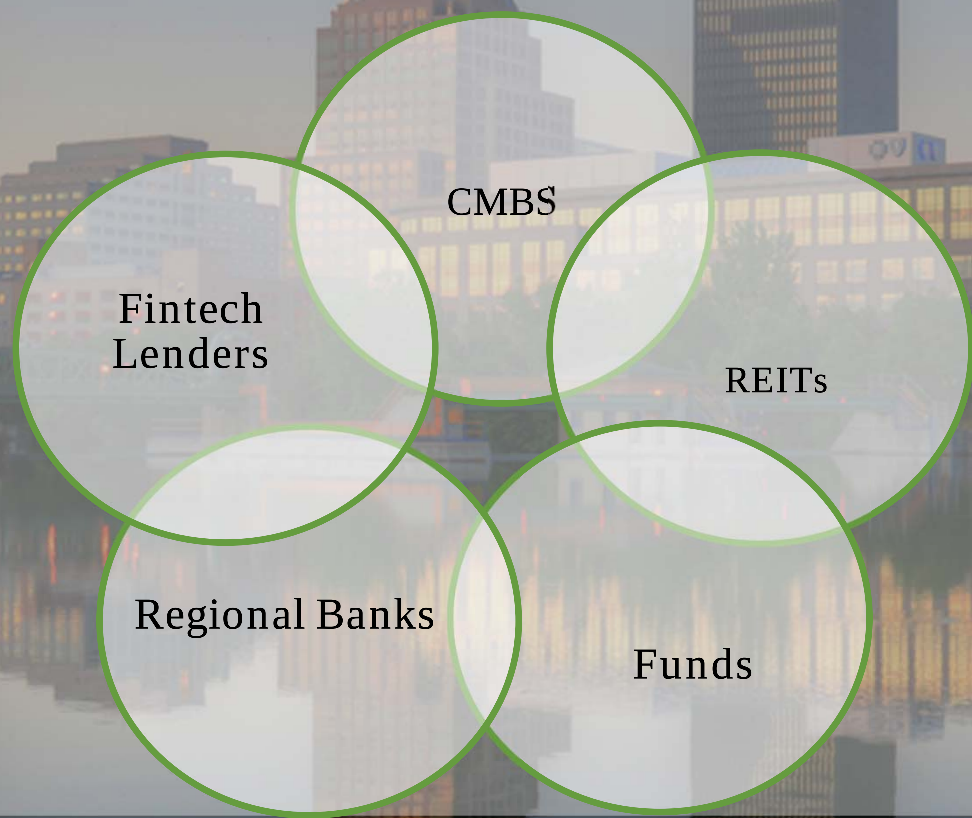
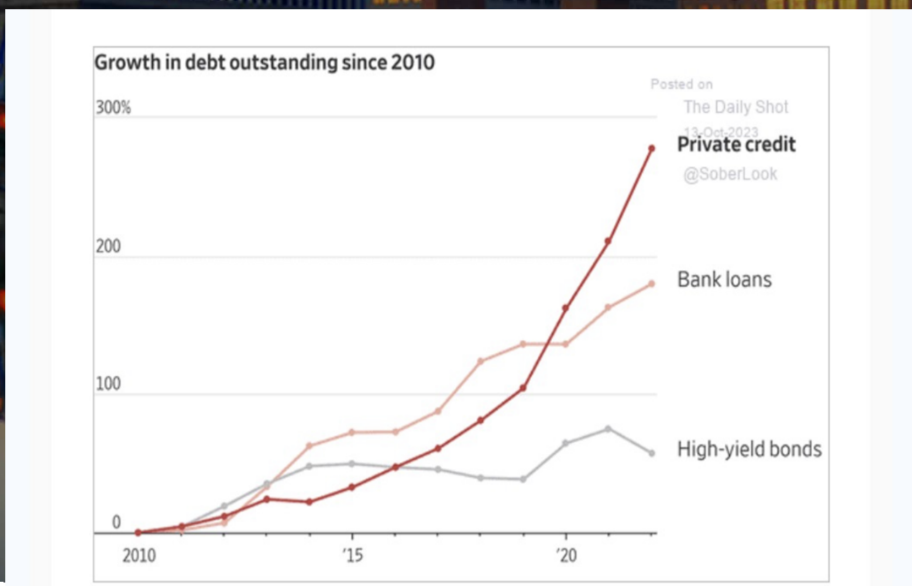
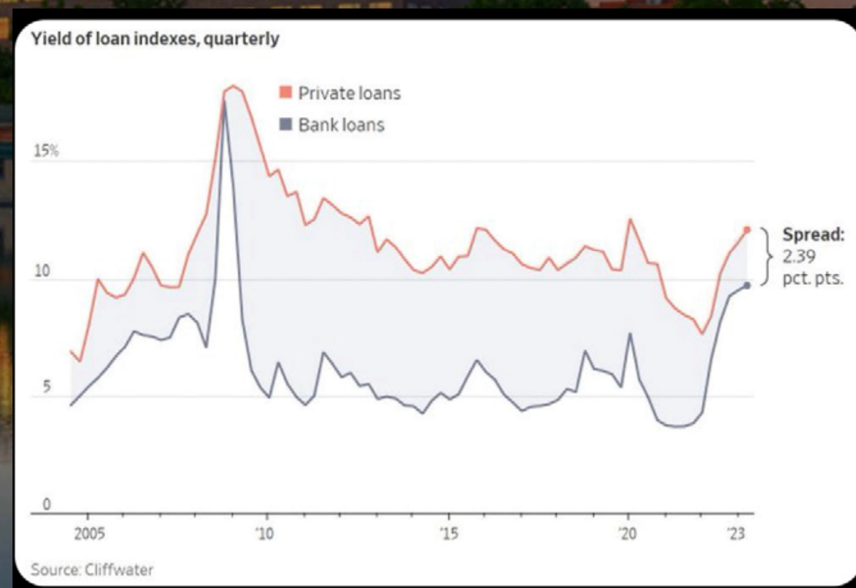
Who Holds the Old Maid?



Equity Markets Still Think Debt Market is “Banks”

Because of interest rate risk failures, the market has assumed banks will now fail on credit. However some banks failed interest rate risk largely due to lopsided focus on credit standards. This has also led to credit continuously transferring out of the banking system.





@soberlook

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Rethinking Where the Biggest Risks Lie

If we just used bankruptcy rates to predict high-yield spreads, then we'd expect high-yield spreads to be 7.0%, not the 4.4% we see today. It's not just small companies defaulting. Fourteen of the bankruptcies in 2023 have had over $1 billion of liabilities, including Mallinckrodt, Yellow Corp, Wesco Aircraft, Avaya, and Party City.

One reason we believe high-yield spreads haven't spiked yet is the migration of lower-quality borrowers—those most likely to default—out of high yield and into the private credit market. According to Moody's, the number of issuers with B3 debt has fallen as these issuers have departed for private credit. They do not mince words about this: "Ultimately, we believe the growth of the alternative asset managers will contribute to systemic risk. This group of lenders comprise both private equity and private credit segments and lack prudential oversight, as opposed to the highly regulated banking sector."

Verdad Capital, October 16, 2023

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Where Loans Are Gathering Losses?

Urban B-C Office: Short-lease, multi-tenant, tech-centric

Consumer / Fintech Consumer: Cards, Installment

LBOs

Multifamily / Some Student / Nursing

Select SBA Loans

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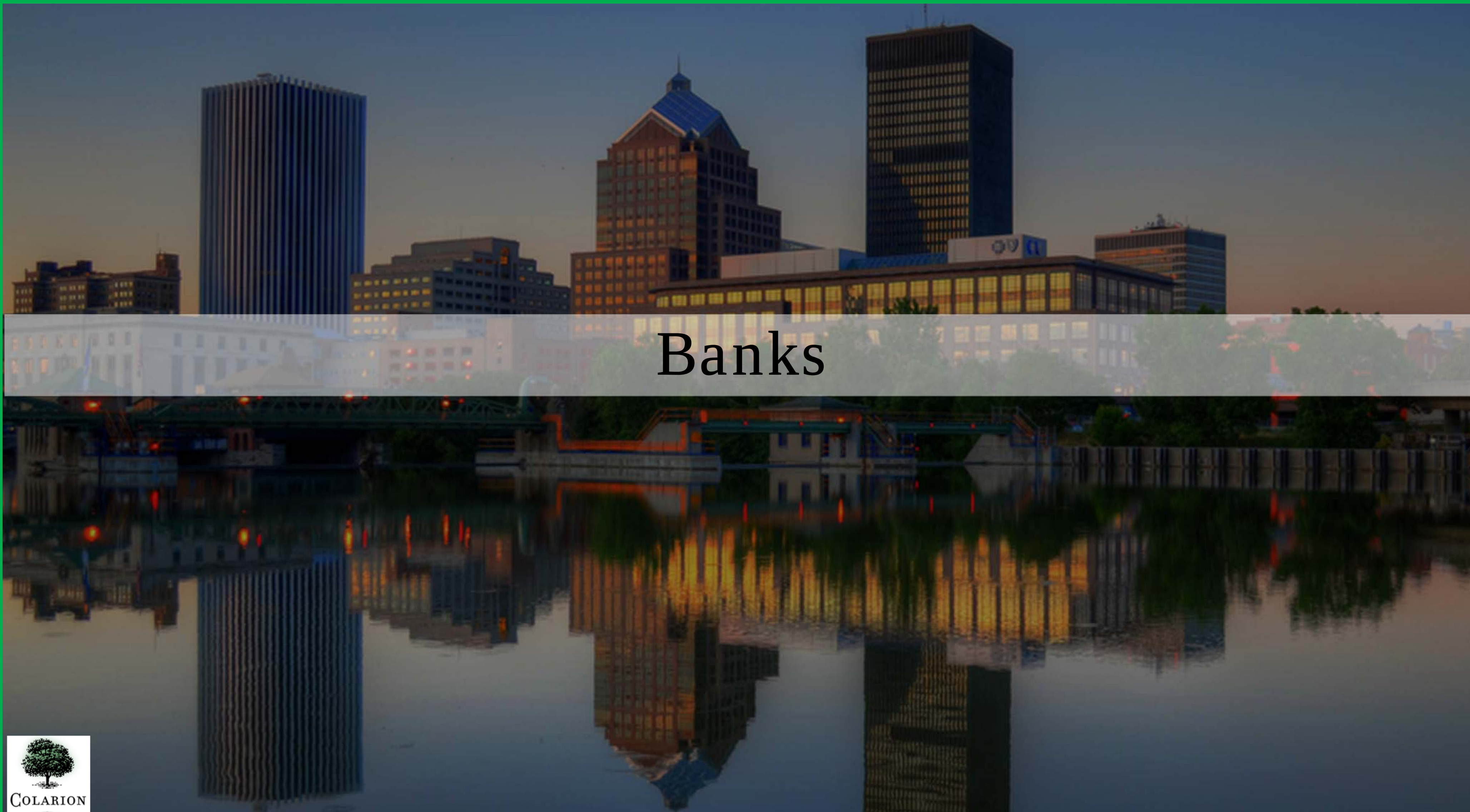
Banks



Why Hasn't Bank Credit Derailed Yet? An Example

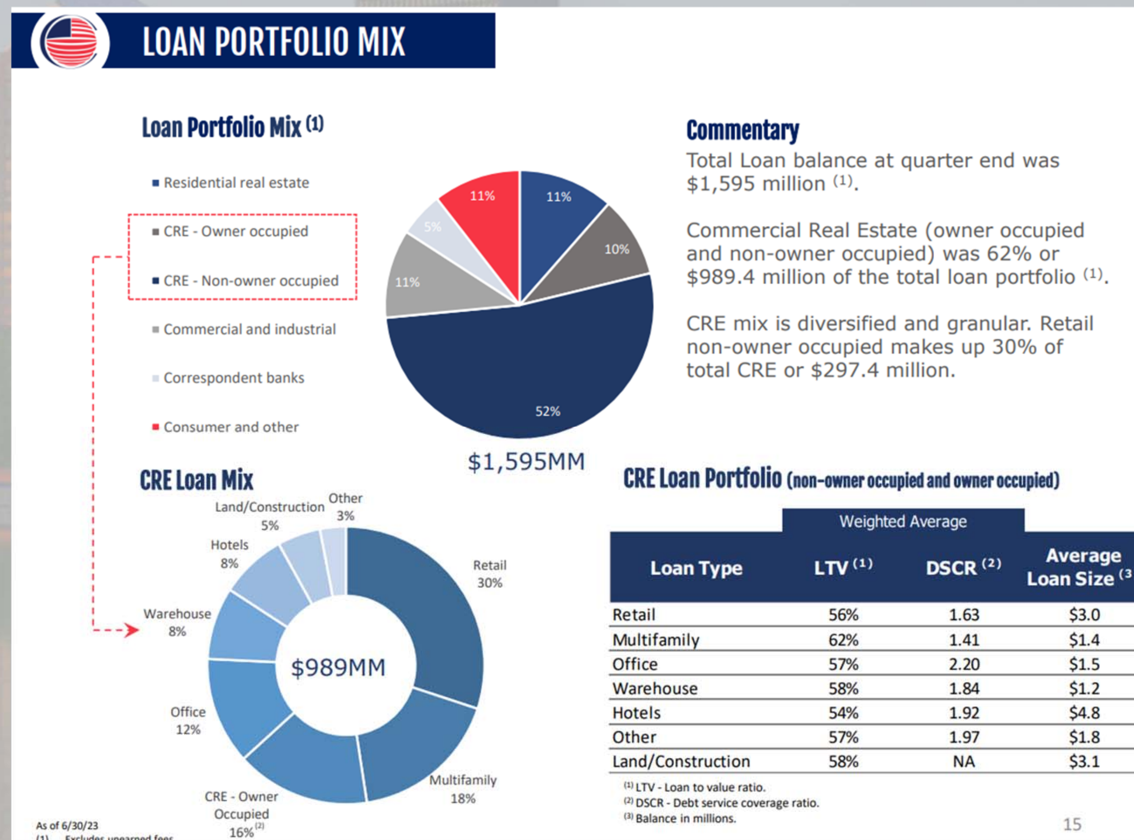
$2.3bn asset US Century Bank (USCB) in Miami is profiled at right. Key Features of this bank's commercial real estate loan book include:

- Heavy use of recourse

- Where recourse is not used, initial loan to value typically in the 50% range.

- Current loan to values from origination skew to 50-60%, meaning they may currently be closer to 70-80%.

- Office credit is less of an issue where people want to be, such as Miami.



Commentary

Total Loan balance at quarter end was $1,595 million (1).

Commercial Real Estate (owner occupied and non-owner occupied) was 62% or $989.4 million of the total loan portfolio (1).

CRE mix is diversified and granular. Retail non-owner occupied makes up 30% of total CRE or $297.4 million.

CRE Loan Portfolio (non-owner occupied and owner occupied)

	Weighted Average		
Loan Type	LTV (1)	DSCR (2)	Average Loan Size (3)
Retail	56%	1.63	$3.0
Multifamily	62%	1.41	$1.4
Office	57%	2.20	$1.5
Warehouse	58%	1.84	$1.2
Hotels	54%	1.92	$4.8
Other	57%	1.97	$1.8
Land/Construction	58%	NA	$3.1

(1) LTV - Loan to value ratio.
(2) DSCR - Debt service coverage ratio.
(3) Balance in millions.

15

Source: USCB

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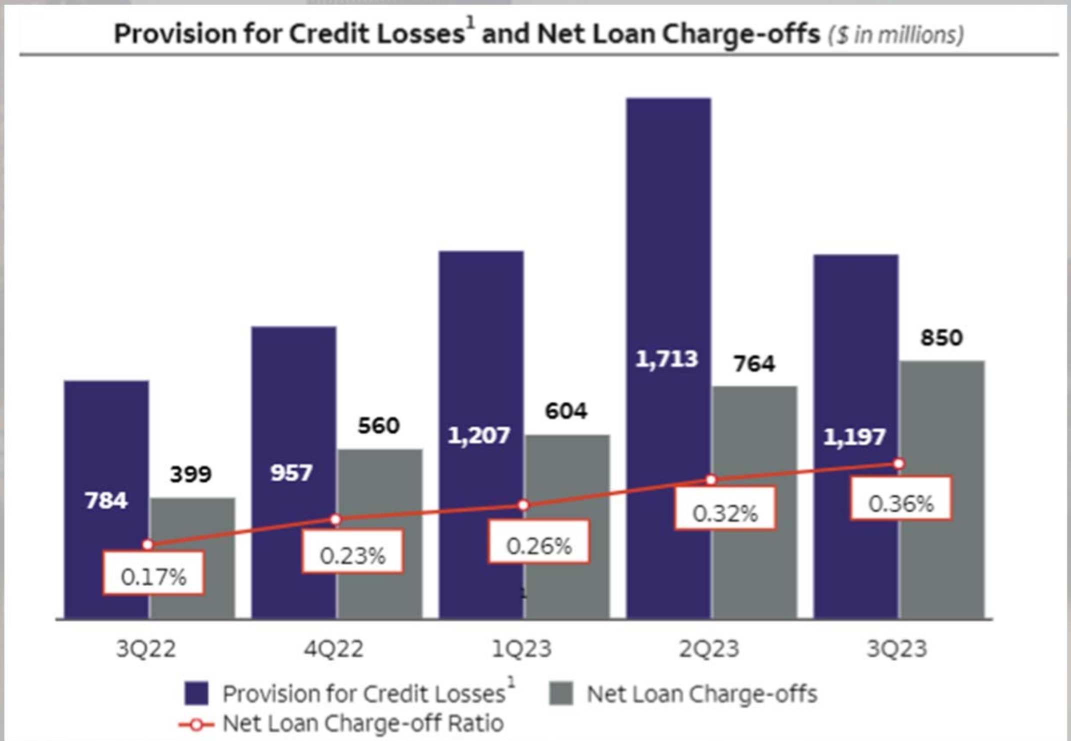
Typical Bank Case Study: Wells Fargo

Slow(er) credit progression, driven by:

- Credit cards
- Auto
- Large office, including California. Note below that reserves for the corporate / investment banking portfolio are 5x that for the retail bank.

CRE Allowance for Credit Losses (ACL) and Nonaccrual Loans, as of 9/30/23

($ in millions)	Allowance for Credit Losses	Loans Outstanding	ACL as a % of Loans	Nonaccrual Loans
CIB CRE Office	$ 2,322	21,472	10.8%	$ 2,666
All other CRE Office	237	10,729	2.2	124
Total CRE Office	**2,559**	**32,201**	**7.9**	**2,790**
All other CRE	1,283	120,285	1.1	1,073
Total CRE	**$ 3,842**	**152,486**	**2.5%**	**$ 3,863**



Source: PNC

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Bank Office Lending

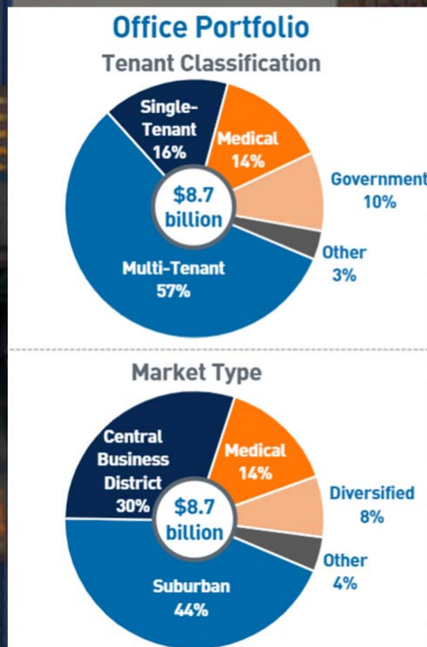
Regionals have greatest exposure to central city multi-tenant high rise. Many loans will extend or trade hands into maturity in 2024-2026. Office tends to be ~5% of loans books and is diverse.

PNC

Key Office Portfolio Metrics

Conservative Underwriting Methodology

$ in millions	9/30/23	6/30/23
Total Loans	**$8.6**	$8.7
Avg. Loan Commitment	**$35**	$35
Reserves / Loans	**8.5%**	7.4%
NCOs / Average Loans	**1.6%**	1.4%
Delinquencies / Loans	**0.0%**	0.0%
NPL / Loans	**7.7%**	3.3%
Criticized Loans / Loans	**23.2%**	22.5%



M&T Bank Corporation	2023 Outlook	Comments
Net Charge-Offs	Near LT Avg 33 bps	• Near long-term average, timing of NCOs may be lumpy

Office Risk Likely to Play Out Over Long Horizon

- Permanent office IRE represents 4% of total loans and is well diversified geographically (NYC approximately 0.5% of total loans)
- Approximately 75% of the portfolio matures in 2025 or later
- Approximately 75% of the underlying leases mature in 2025 or later

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Source: PNC, MTB

Banks Issues: Beyond the Regionals

Thus far, issues have not been driven by rate but by client mismanagement. Rate issues are emerging, but more slowly than at other lender classes. Most banks see "normalized" problems in portfolios into 4Q23.

Cut and run: Rent-stabilized landlord sells at 44% haircut

Deal shows blow 2019 rent law dealt to valuations

Home insurance skyrockets to 'astronomical' rates for many on the MS Coast. 'It's scary.'

CASE PROFILE: Alpine Summit Energy Partners will look for buyer in Chapter 11

Sept. 12, 2023, 3:41 PM

First Horizon Sees $70 Million Charge-Off From Bankrupt Firm (1)

First Horizon Corp. told investors to expect roughly $100 million in aggregate charge-offs for the third quarter, with about $70 million of that tied to one company getting sold for parts.

Chief Executive Officer Bryan Jordan said Tuesday during a Barclays Plc financial-services conference that the loan is an "individual credit" tied to a company that filed for Chapter 7 bankruptcy in mid-August. He said valuations on the company were "good" prior to its current troubles.

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Tricks of the Trade

- Extension
- More Collateral
- Refi with hard money
- Additional Guarantor
- Swap to fixed or floating
- Use straw buyer, wipe out equity

Non-Banks Lenders: CMBS, REITs, Funds…

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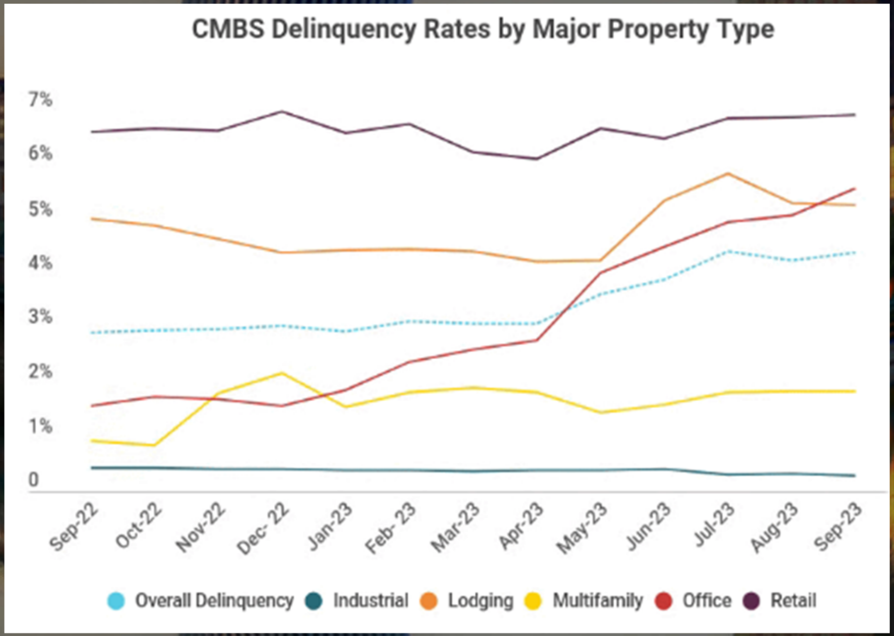
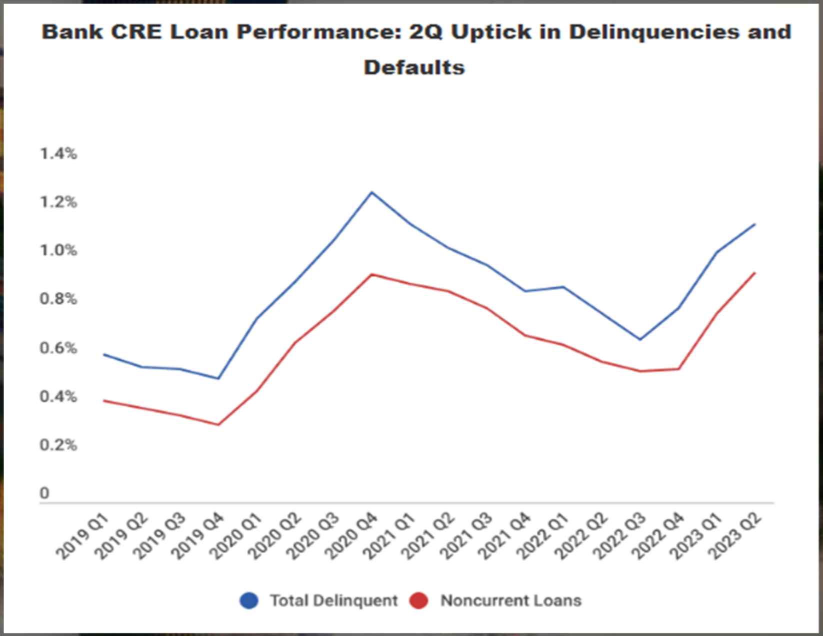
CMBS vs Banks

CRE Delinquencies have risen much faster at CMBS than at banks.





Source: Trepp

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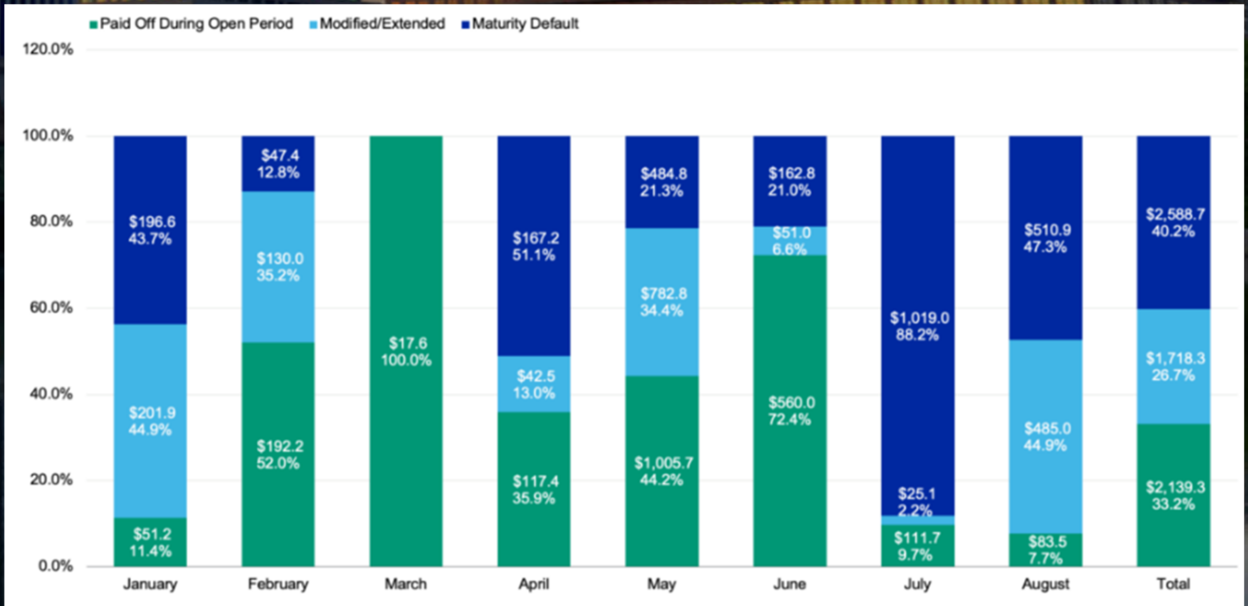
CMBS is Rolling Downhill

Thus far, issues have not been driven exclusively by rate but also leverage, bad pro formas, vacancy, and insurance.

CMBS Office Maturities (as of 8/31/23)



Sources: Moody's Analytics CRE, data via Moody's Analytics CMBS

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Funds vs. Banks: Middle Market Example

Deal Component	September 2023	September 2022
Cash Flow Senior Debt (x EBITDA)	Micro Cap 1.50x-2.00x Small Cap 2.00x-3.00x Midcap 2.50x-4.00x	Micro Cap 1.50x-2.50x Small Cap 2.75x-3.25x Midcap 3.50x-5.50x
Total Debt Limit (x EBITDA)	Micro Cap 2.50x-3.50x Small Cap 3.50x-4.50x Midcap 4.00x-5.00x	Micro Cap 3.75x-4.25x Small Cap 4.00x-5.00x Midcap 5.00x-7.00x
Senior Cash Flow Pricing	Bank: S+3.75%-5.00% Non-Bank: <$10.0MM EBITDA S+6.50%-8.50% Non-Bank: >$40.0MM EBITDA S+5.50%-6.50%	Bank: S+3.00%-4.50% Non-Bank: <$10.0MM EBITDA S+6.50%-8.50% Non-Bank: >$40.0MM EBITDA S+5.50%-6.50%
Unitranche and Second Lien Pricing	Micro Cap S+8.00%-10.00% Small Cap S+6.50%-8.00% Midcap S+6.25%-7.50%	Micro Cap S+8.00%-10.50% floating Small Cap S+7.50%-8.50% floating Midcap S+5.50%-8.00% floating
Subordinated Debt Pricing	Micro Cap 14.00%-16.00% Small Cap 13.00%-15.00% Midcap 12.00%-14.00%	Micro Cap 12.00%-14.00% Small Cap 11.00%-13.00% Midcap 9.50%-11.50%

*Micro Cap= <$7.5mm EBITDA / *Small Cap= >$10mm EBITDA / *Midcap= >$20mm EBITDA / *Changes from last month are in red

Source: SPP Capital Partners

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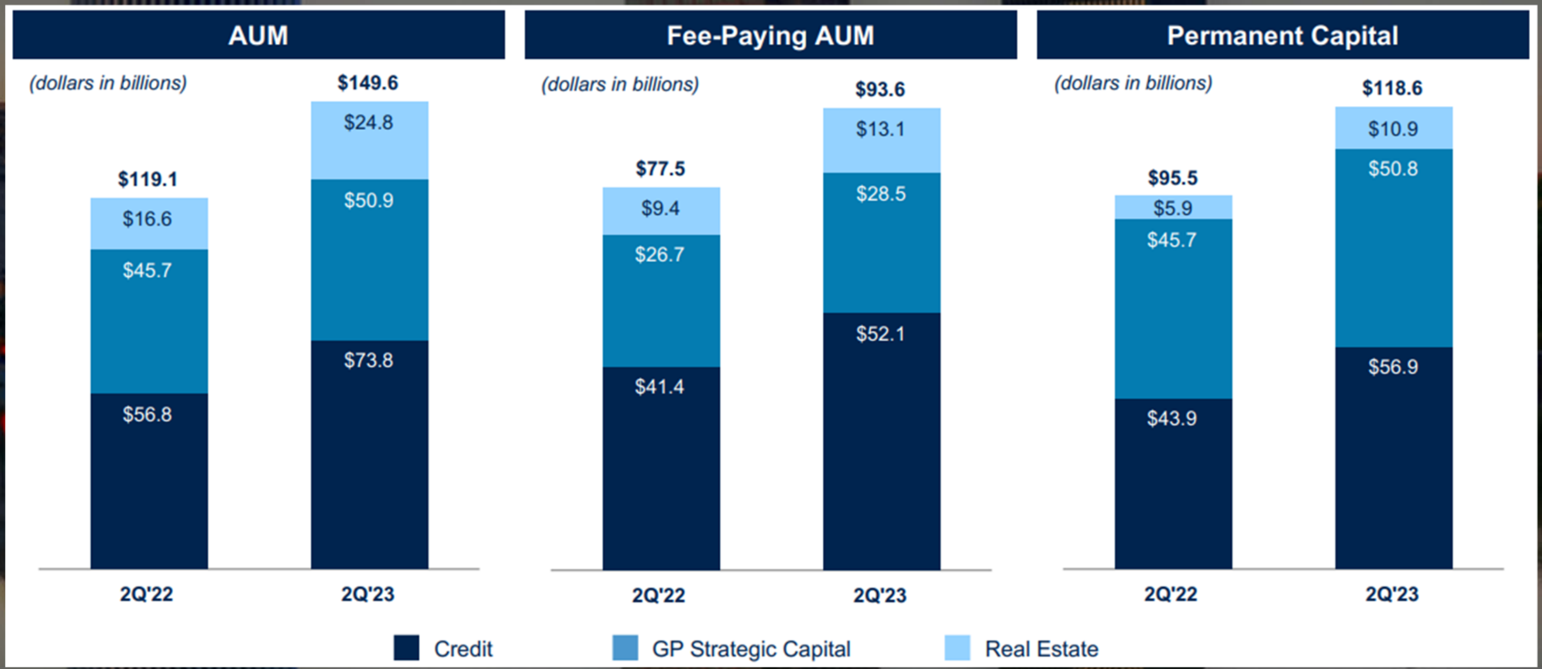
Funds are Where Credit Growth Happens

Blue Owl Capital (OWL)



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Source: Blue Owl Capital:

The Market Reward Funds, Not Banks

Conventional wisdom is that funds are smart and nimble and banks are over-levered and less nimble. That thesis will be tested in the quarters ahead.

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BDCs: A Different Approach

Chart 1 - Non-Accrual Exposure by Asset Type (1Q23)

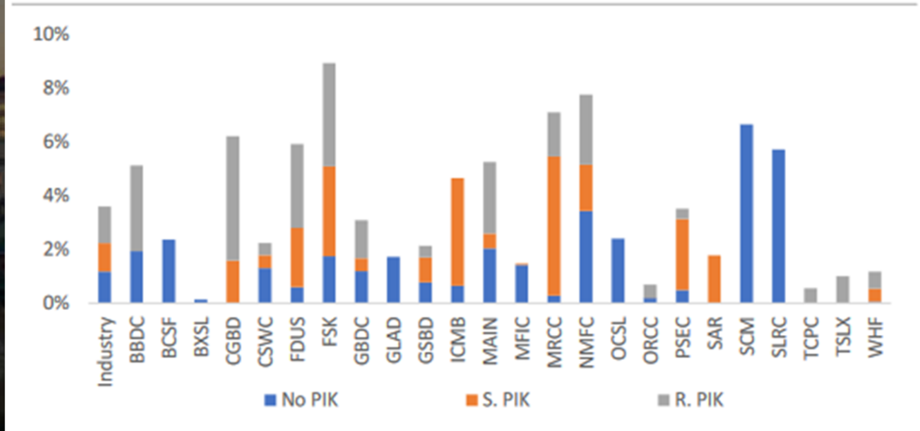
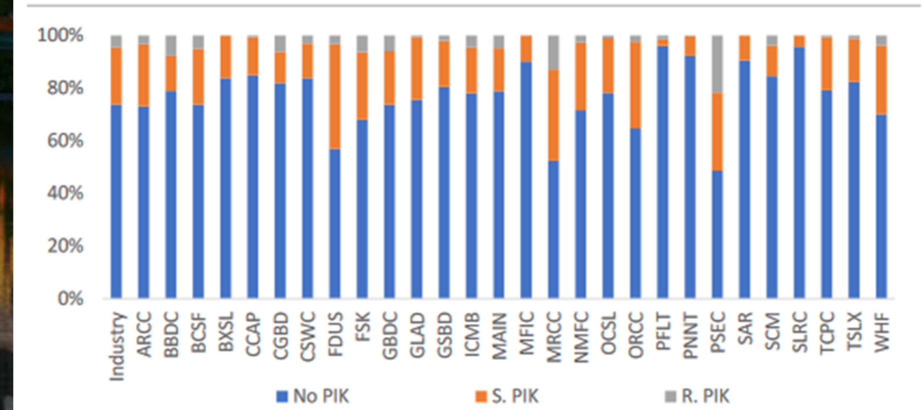


Chart 2 - Portfolio Structure, ex. Common Equity (1Q23)



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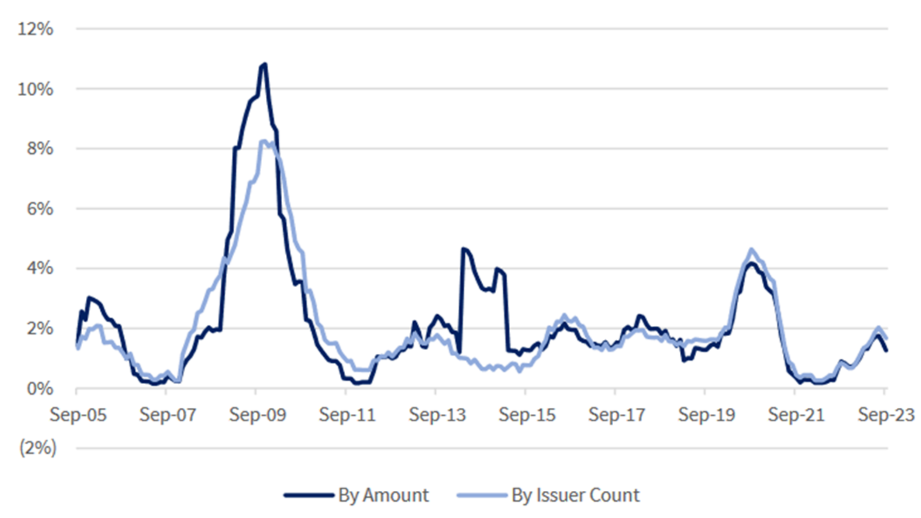
Source: Raymond James

BDCs: A Keg So Far Without a Spark

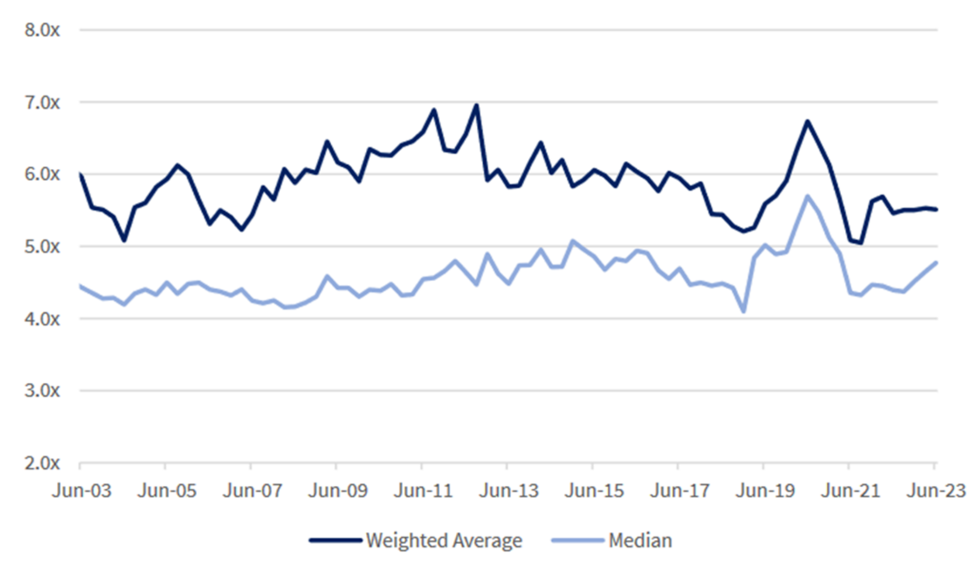
LEVERAGED LOANS: DISTRESS, DOWNGRADES & DEFAULTS

Chart 9 - LTM Default Rate



Source: PitchBook LCD and Raymond James research.

Chart 13 - Debt/EBITDA Multiples of Outstanding Loans



Source: PitchBook LCD and Raymond James research.

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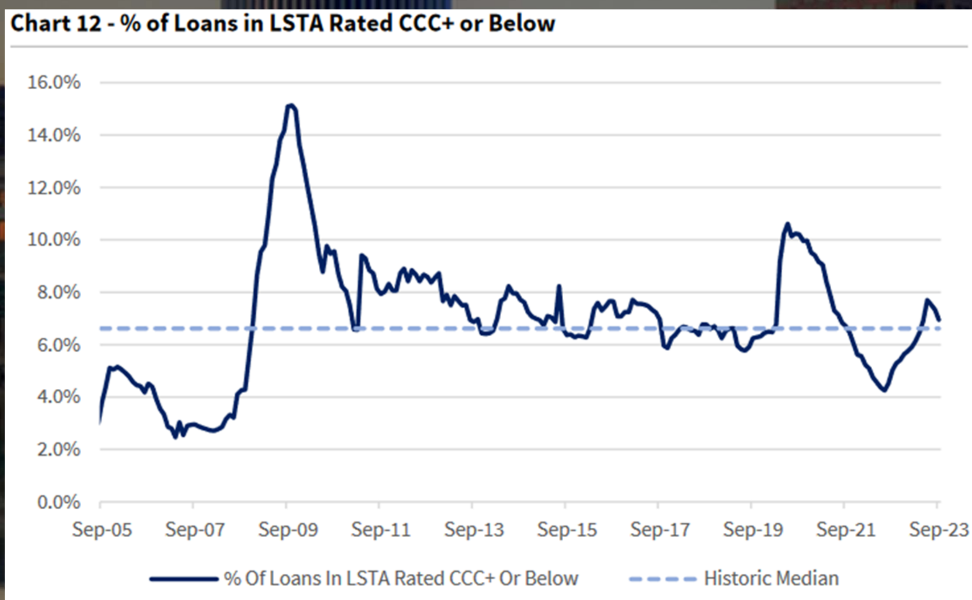
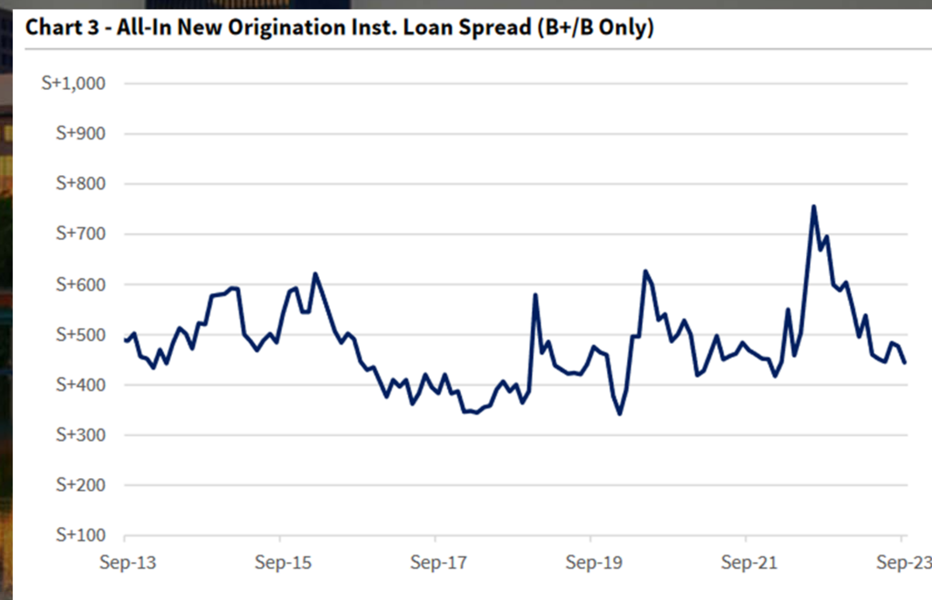
Source: Raymond James

BDCs Seek Greater Risk / Reward





Source: Raymond James

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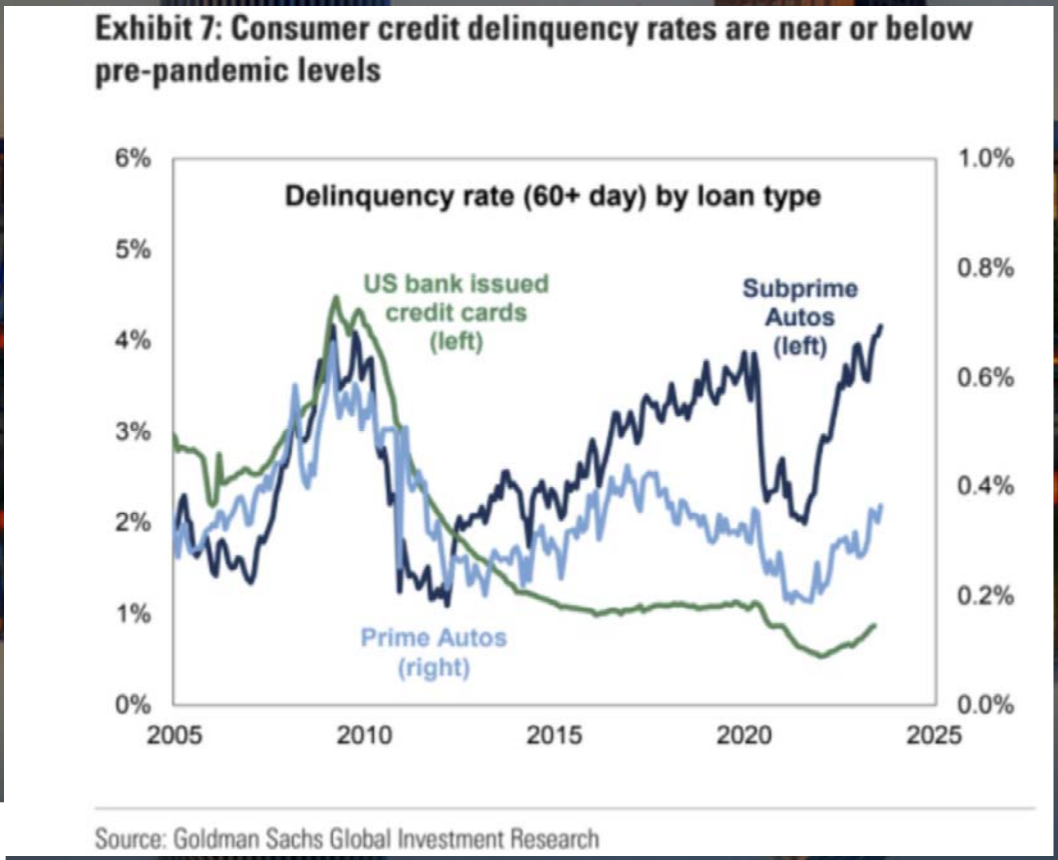
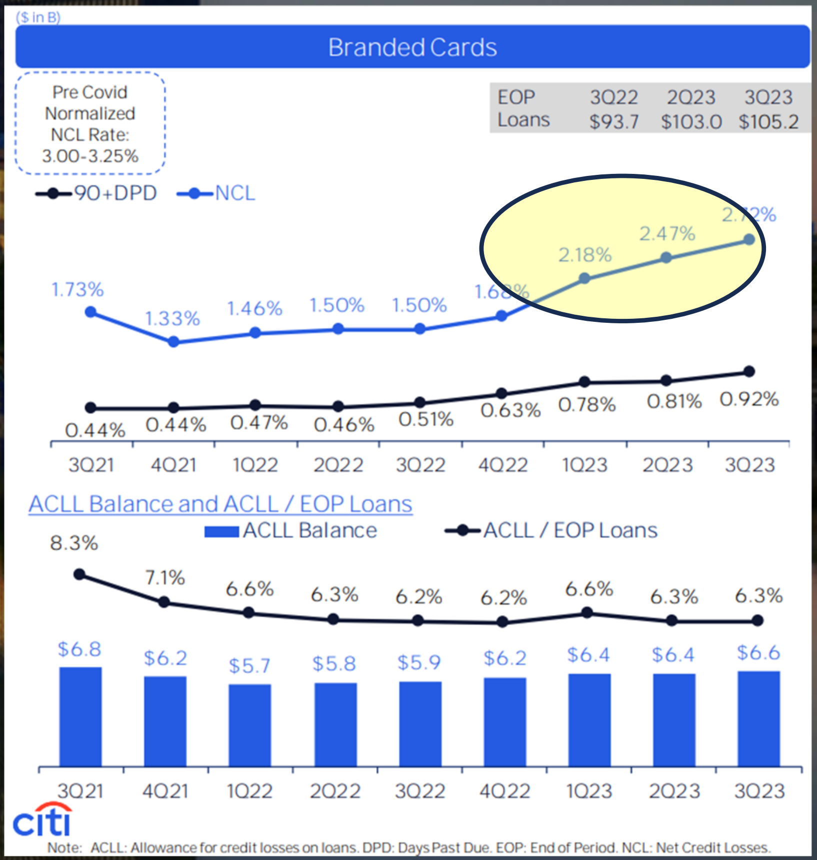
Consumer Credit





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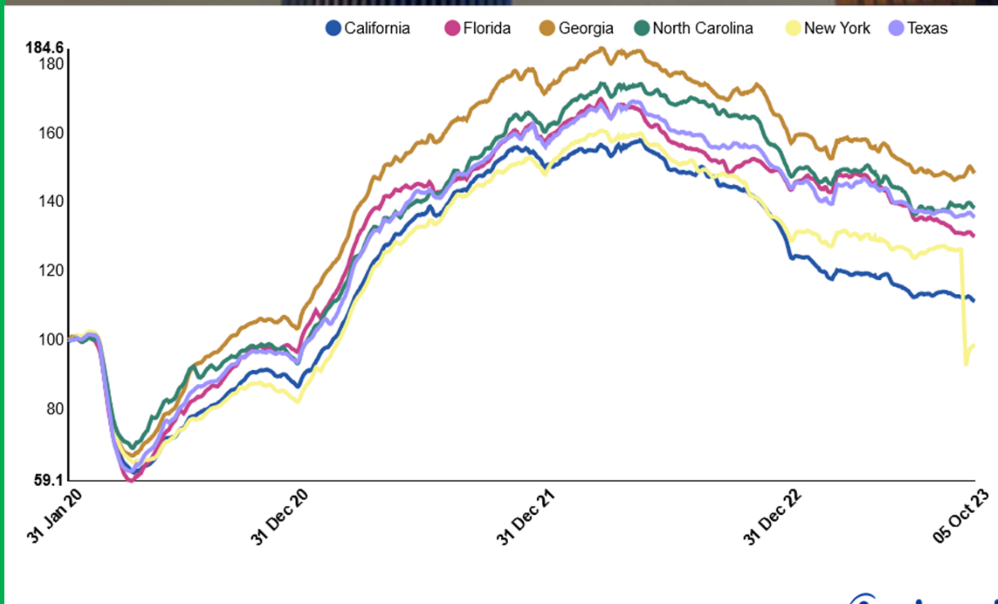
Jobs: Hospitality Rebound, Declining Availability



urce: Indeed - Last Updated: 06 Oct 2023

ESTABLISHMENT DATA
Summary table B. Establishment data, seasonally adjusted

Category	Sept. 2022	July 2023	Aug. 2023p	Sept. 2023p
EMPLOYMENT BY SELECTED INDUSTRY (Over-the-month change, in thousands)				
Total nonfarm	350	236	227	336
Total private	344	145	177	263
Goods-producing	44	12	47	29
Mining and logging	2	2	0	1
Construction	16	12	36	11
Manufacturing	26	-2	11	17
Durable goods[1]	14	12	13	13
Motor vehicles and parts	4.3	2.6	-2.6	8.9
Nondurable goods	12	-14	-2	4
Private service-providing	300	133	130	234
Wholesale trade	8.3	15.4	0.0	11.7
Retail trade	-11.1	12.6	0.4	19.7
Transportation and warehousing	9.7	-6.8	-18.9	8.6
Utilities	0.1	-1.5	2.4	4.8
Information	3	-19	-21	-5
Financial activities	2	15	2	3
Professional and business services[1]	48	-29	11	21
Temporary help services	11.2	-17.4	-13.3	-4.2
Private education and health services[1]	80	104	97	70
Health care and social assistance	71.7	102.5	94.1	65.9
Leisure and hospitality	139	38	44	96
Other services	21	4	14	4
Government	6	91	50	73

Source: BLS

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