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Angel Oak's Pate Sees Opportunities In Banking As Rate Cycle Pivots

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Cheryl Pate, senior portfolio manager at Angel Oak Capital and manager of the Angel Oak Financial Strategies Income Term Trust. Read the Q&A below as Cheryl says that 2024 "will bring a still somewhat tough operating environment for the banks but net interest margins are abating, valuations are cheap and [mergers and acquisitions] activity should accelerate from here." That gives banks an attractive opportunity set, particularly by focusing on credit quality and looking for "a fundamental mispricing of bank debt" that is creating some compelling bargains for investors.

Cheryl Pate

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CHUCK JAFFE: We're talking about the outlook and investment prospects for the banking sector with Cheryl Pate, senior portfolio manager at Angel Oak Capital, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're heading to the bank, or at least the banking sector, with Cheryl Pate, senior portfolio manager at Angel Oak Capital, where she runs the Angel Oak Financial Strategies Income Term Trust, that's ticker symbol FINS. Also the Angel Oak Financials Income Fund, that's ANFIX. Get more information on the firm and the funds at AngelOakCapital.com, and if you make it AngelOakCapital.com/FINS, you'll learn specifically about the closed-end fund. And to learn more about closed-end funds, interval funds, and business-development companies generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, it's great to have you back on the NAVigator.

CHERYL PATE: Great, Chuck. Always great to be on the show.

CHUCK JAFFE: Let's dig into banking for 2024, because lord knows 2023 was a tumultuous year, we had of course well publicized bank failures, there was a lot of talk that there was going to be more trouble ahead, and then it kind of just dissipated. But that doesn't mean we're out of the woods, there's been a lot of talk about what could happen if commercial real estate gets into trouble and how that could endanger the banking sector, so what's your outlook for banking for the rest of this year?

CHERYL PATE: Well, investing in banks in 2023 was certainly not for the faint of heart. The regional bank failures in the spring of last year certainly highlighted some concerns really around the rapid rise in interest rates and the impact to banks' investment portfolios. But that said, we view the bank failures of the spring really more idiosyncratic than systemic in nature given that they were fairly unique business models, and we have a positive view on the fundamental backdrop heading into 2024 for the system broadly. What we've seen over the past couple of quarters really has been that contagion risk has faded as bank earnings have proved resilient and stricter regulation is anticipated. Additionally, we did have the rate rally into year-end which really helped bank AOCI and capital levels. Despite that, bank debt and equity markets still remain fairly dislocated, which presents an opportunity for the sector in 2024. But what I would say from a fundamental perspective, we're really focused on, number one, net interest margins, and number two, credit quality for the coming year. So 2024 I would say will bring a still somewhat tough operating environment for the banks, but net interest margin pressures are abating, valuations are cheap, and M&A activity should accelerate from here. So really I think the question management teams are really going to be grappling with is navigating through the rate and credit environment, as well as managing expenses.

CHUCK JAFFE: Higher rates normally lead to waves of defaults and other problems. We haven't really seen that anywhere in this economy, but that's also an effect that happens later, like it doesn't, oh, raise rates and people start going out of business. Are you worried that we will wind up seeing a significant change in the defaults and how that will impact credit going forward?

CHERYL PATE: I would say credit quality is always our number one concern, and especially given the rapid rise in interest rates over the past several quarters, we worry about pressure on the consumer and corporates in terms of debt servicing capacity, and we do expect that credit costs will continue to normalize higher from today's still low level, sort of pre-pandemic levels. And consumer cycles I would say typically play out faster than commercial credit cycles, we have seen delinquencies increasing for both credit card and auto portfolios, but interestingly, early signs from some of the monthly data we're seeing is a deceleration in the pace of delinquencies, so that gives us comfort. We are also seeing signs that consumers still have excess savings that will potentially last longer than previously anticipated, so I think the consumer is still in good shape. And commercial real estate is really the number one concern, but I think it's important to understand banks' exposure to commercial real estate. More than half of the commercial real estate resides outside of the banking system, and banks tend to be the more conservative underwriters in the space in terms of cap rates and loan to values, so we feel pretty good about overall exposure. Office CRE is top of mind in the problem child list, but you'd be hard pressed to find a bank that has more than 5% of their total loans to office CRE. So certainly it's on our watch list, but the other thing I would highlight is commercial real estate cycles do play out over time as you highlighted, and so you have the ability to earn through them to some degree. If we look at the Financial Crisis as an example, commercial real estate, and particularly in the smaller banks that we focus on, had accumulative loss in the low single digits over a multi-year period, that's pretty manageable for a bank. So certainly on the watch list, but we feel pretty good about banks abilities to manage through a credit cycle which is at their heart their core business.

CHUCK JAFFE: You mentioned in passing that the general outlook for bank merger and acquisition activity is reasonably good, but you also just mentioned a moment ago that you specialize in really the smaller banks. Given the banking outlook that we've got and these conditions, will we see a significant increase in M&A activity this year?

CHERYL PATE: I think absolutely we are looking for M&A to reaccelerate in 2024. You have a sector that's been grappling with elevated expenses for some time, and what we're going to see now is really the impact of adding more regulatory costs on top of that as well as higher deposit costs. So while we think the biggest changes from a regulatory regime shift will be in those regional banks, between the hundred and $250 billion asset size, all banks will really need to operate under a stricter regime. So you'll see incremental costs relating to compliance, risk management, et cetera, and you've still got high compensation expense, you've got investments spend on technology, a focus on cyber security. So against this backdrop, banks are really going to be looking to focus on improving their scale and profitability, and on just the math side you've got better M&A deal math as valuations improve, we've got better clarity into the economic cycle, you've got regulatory support for M&A, so I think that will really re-accelerate what has been a secular trend for a number of years.

CHUCK JAFFE: Let's finish this up by bringing this back to your closed-end fund, Angel Oak Financial Strategies Income Term Trust, what does this have you looking at for FINS right now and for 2024?

CHERYL PATE: I think the opportunity set across the banking spectrum is attractive going into '24. From a debt perspective we think there's a fundamental mispricing of bank debt, really these are instruments that are issued for regulatory capital treatment, and you start to lose capital treatment as they get closer to maturity. And so right now these bonds are priced as in they'll never call them, they'll hold them to maturity, and we think that's just not the case. So what we're seeing is the opportunity to add to our portfolio at pretty attractive yields, so sort of high single digits, yield to maturity, mid-teens, yield to call, pretty compelling for investment-grade debt. And if we look at our overall portfolio, we have a nice seasoned portfolio that has about 60% of the bonds moving into a repricing position in the next 36 months. What that means is average coupons are moving up more than 400 basis points, and the bonds in that cohort with an average price of about 92 should see price appreciation to par as they move to floating rate and into their call period. So from a fundamental perspective we think that's a great opportunity, but for FINS specifically we've also got low-rate leverage that we locked in back in 2021, fixed-rate, we've got dry powder to deploy into the secondary market today, we recently increased the distribution rate based on this opportunity set. We're paying out 9.5% on NAV and almost 11% on market price, so we think it's a pretty attractive entry point for what we think will be an attractive opportunity set into 2024.

CHUCK JAFFE: Cheryl, really interesting. I know we'll get a chance to chat down the line to see how it all plays out and catch up on what's been happening and changing. Thanks so much for joining me, I'm looking forward to the next conversation already.

CHERYL PATE: Thank you, me as well.

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everybody. *Recorded on January 18, 2024*

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