Community Banking 101

FINANCIAL SERVICES SECTOR REPORT

For more information:

If you have any questions, please contact a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131.

Community banks serve a vital role within our local economies by providing a significant portion of the localized financing required by small business, construction, and commercial real estate projects. According to the Federal Deposit Insurance Corporation (FDIC), there were just over 4,200 community-banking institutions at the end of March 2023, each varying by size, scope of operations, and loan composition.

Community banks differ from large banks in many ways, which include, but are not limited to, the following:

- Community banks operate locally (as opposed to regionally or nationally) and derive a larger portion of overall revenue from traditional banking activities (lending and borrowing);
- Community banks have a smaller percentage of overall revenue derived from fee-based business lines;
- Community banks generally have higher expense-to-revenue ratios; and
- Community banks have loan portfolios that are more highly concentrated (fewer borrowers).

As a result of these differences, we believe community banks offer a lower degree of diversification than larger banks. Furthermore, we note community-bank shares are more likely to be thinly traded and subject to a lower amount of public scrutiny due to a lack of institutional ownership.

Despite the drawbacks noted above, we do believe community banks enjoy some attractive advantages when compared with larger peers. These include the following:

- Better capitalized community banks are likely to report above-average growth rates due to the long-term trend of consolidation within the banking industry, and
- Community banks are less exposed to higher-volatility business lines such as investment banking and trading.
- Deposits at community banks are more oriented toward retail and local business customers, with smaller balances covered by FDIC insurance limits.

So while less diversified than larger banks, in our view, some community banks may still offer an attractive investment opportunity for long-term investors, particularly those banks that are better capitalized.

In order to find these opportunities, we recommend investors perform proper due diligence procedures on any particular community bank.

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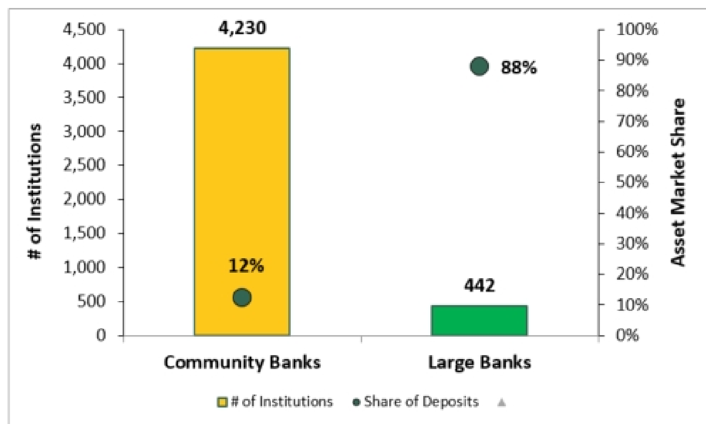
Please see important disclosures and analyst certification on page 4 of the report.

What Makes a Community Bank Different From a Large Bank? - There are numerous characteristics that differentiate community banks from large banks. We discuss a number of the characteristics we have deemed to be the most pertinent below:

Size, Geography, and Number of Institutions - Community banks are smaller than large banks (as measured by share of industry assets and deposits) and operate locally as opposed to regionally or nationally. As illustrated in **Figure 1**, community banks are numerous. Based on FDIC data, there were 4,672 FDIC-insured banking institutions as of March 31, 2023. Of those, 4,230 are classified as community banks. While community banks account for nine out of 10 FDIC-insured banking institutions, community banks hold only a small percentage of total banking assets and deposits (roughly 12% of each).

Figure 1: Number of Institutions and Deposit Share - 3/31/2023

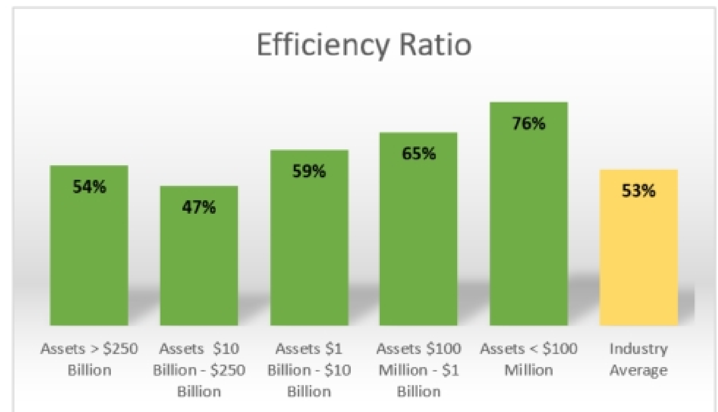


Source: FDIC

Scope of Operations - A greater proportion of a community bank's overall revenue is generated from traditional banking activities than large banks. This is because large banks generally have auxiliary fee-based business lines that accompany the traditional borrowing and lending business. Examples of fee-based business lines include investment banking, securities trading, insurance, asset management, and wealth management. Without these other revenue sources, community banks are more reliant upon consistent growth in loans. In addition, overall revenues are more sensitive to expanding and contracting lending margins (the difference between yields on loans and investments and costs for deposits and other borrowings). Finally, the ability of a community bank to avoid credit losses is also relatively more important, because revenues from other activities are smaller.

Expense-to-Revenue Ratios - Because community banks derive a larger portion of overall revenue from traditional banking activities, they generally have higher ratios of noninterest expenses-to-revenue (efficiency ratios) than large banks. **Figure 2** depicts efficiency ratios for different-sized banks as defined by the FDIC. Please note a lower ratio means lower expenses relative to revenues, and is preferred, everything else constant.

Figure 2 - Expense-to-Revenue (Efficiency) Ratios by Asset Size Group - 3/31/2023



Source: FDIC. Past performance is no guarantee of future results.

To put this chart into perspective, a community bank with less than a $100 million in assets incurred $0.76 in expenses for every $1.00 in revenue during the quarter ended March 31, 2023. In contrast, a bank with over $250 billion in assets incurred less than $0.54 in expenses for every $1.00 in revenue. The lower (better) efficiency ratios at large banks are a result of the size advantages and scope of their operations, and, on average, lead to better (higher) returns on equity at these institutions.

Loan Composition & Quantity - Community banks tend to have a larger percentage of overall loans in real-estate-secured categories, including commercial real estate loans and residential mortgage loans. As a result, community-banking loan portfolios tend to be less diversified than larger banks (community banks often have fewer loans which are larger in value versus large banks with more loans but each smaller in value) and are also more sensitive to the health of the local economy.

What Role Do Community Banks Play?
Historically, community banks have operated a relationship-driven model, where a borrower's creditworthiness is assessed based upon quantitative

measures, such as credit scores, debt ratios, liquidity, and qualitative measures, such as previous business with the bank, personal characteristics, and potential local market contribution. This differs from larger banking peers where quantitative data dominates the lending decisions. Because community banks tend to have a lending model that relies significantly more on qualitative data, they play a vital role in community development by filling the financing gap left unfilled by quantitatively focused larger banks. Community banks are a key source of funding within the communities they operate.

What Makes the Community-Banking Model Attractive?

In our view, the community-banking model has a number of attractive characteristics. These include, but are not limited to, the following:

Attractive Growth Prospects - We believe better capitalized community banks are likely to grow faster than larger banks due to the secular trend of consolidation within the banking industry. As of 3/31/2023, there were 4,672 FDIC-insured banking institutions, down 33% from the same quarter 10 years ago. We expect stronger community banks to absorb potential problem banks and weaker institutions that may be on the verge of becoming problem banks. We believe the likely consolidations will drive stronger growth rates for the better-capitalized banks.

Less Exposure to Volatile Business Lines - The community banking model is less exposed to volatile business lines such as trading and investment banking. Products associated with these business lines are what many blame for the severity of the financial crisis. Because community banks do not have exposure to these businesses, we believe the earnings stream these banks generate is less volatile and more predictable than larger peers.

Potentially "Stickier" Deposit Base - Deposits at community banks are largely composed of retail and local business customers who tend to carry lower average account balances. This compares favorably with larger banks that tend to carry higher average account balances with a lower percentage covered by FDIC insurance. A greater percentage of deposits covered by FDIC insurance may prevent customers from pulling their accounts during times when there are concerns around the broader banking system.

If I Own or Am Thinking About Owning Shares of a Community Bank, What Should I Look at to Evaluate the Investment?

The statistics presented in **Figure 3** should serve as a set of general comparative guidelines for evaluating your current or potential investment in community banks. They are by no means a definitive set of statistics, and should not be used to make investment decisions. Rather, they should serve as a starting point before conducting thorough due diligence procedures. For example, when evaluating community bank XYZ an investor could access bank-specific information included on regulatory filings for comparison to the amounts noted in **Figure 3.** The arrows indicate whether a higher or lower ratio is preferred.

If the statistics warrant an additional review, the investor should then conduct thorough due diligence procedures, including an analysis of current loan and security exposures, future growth and profitability prospects, quality of management, capitalization and valuation.

Figure 3: Comparative Average Statistics by Size Group - 3/31/2023

Asset Size Group	% of Loans & Leases Noncurrent (Lower % is Better)	Loss Allowance to Noncurrent Loans & Leases (Higher % is Better)
Assets > $250 Billion	0.83%	213%
Assets $10 Billion - $250 Billion	0.77%	219%
Assets $1 Billion - $10 Billion	0.58%	235%
Assets $100 Million - $1 Billion	0.47%	278%
Assets < $100 Million	0.84%	172%
Industry Average	**0.75%**	**219%**

Asset Size Group	Tier 1 Risk-Based Capital Ratio (Higher % is Better)	Quarterly Return on Equity (Higher % is Better)
Assets > $250 Billion	14.01%	12.81%
Assets $10 Billion - $250 Billion	13.20%	18.66%
Assets $1 Billion - $10 Billion	13.53%	11.92%
Assets $100 Million - $1 Billion	15.48%	12.87%
Assets < $100 Million	22.50%	7.97%
Industry Average	**13.75%**	**14.42%**

Source: FDIC

Valuation

When valuing financial services companies, we use various methods, including, but not limited to, price-to-earnings ratios (P/E), price-to-book ratios (P/B) and return-on-equity calculations (ROE). During times of depressed earnings, we feel it is most appropriate to rely more heavily on price-to-book ratios and normalized earnings estimates. During times of more normalized earnings we focus on both the price-to-earnings ratio and price-to-book ratio. The P/B measurement analyzes the value of equity (or book value) a financial company has on its balance sheet. Most financial companies are in

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the business of borrowing and lending, so the value of the assets, liabilities and equity on a company's balance sheet are paramount to determining what the shares are worth. Lastly, return on equity is another useful measure to gauge what an appropriate price is for a company based on what it can earn on its capital.

Risks

While we believe there are attractive investment opportunities within the financial services sector, it is important to note, as with all investments, that there are some potential risks involved with investing in the sector:

- The potential for high costs related to legal settlements could hurt firm profitability and capitalization, reducing the firms' ability to generate returns and consequently hurting share prices.
- Should financial reform and capital requirements be overly severe and punitive, financial services companies may not be able to grow earnings as they have historically, the result being lower returns on equity and the possibility for negative returns.
- Financial services companies are highly sensitive to changes in interest rates, meaning that greater volatility in interest rates may lead to greater stock-price volatility.
- Financial services companies are highly sensitive to the overall health of the economy. During challenging economic times, the share prices of financial services companies have the potential to be negatively affected.

Conclusion

We view the community-banking model as less diverse relative to larger peers. Community banks generally have loan portfolios that are less diverse. This issue is exacerbated by a lack of diversifying fee-based revenue business lines and higher expense-to-revenue ratios. Furthermore, we note publicly traded community-banking shares are likely to be less liquid than larger peers due to a lack of institutional ownership.

Despite these drawbacks, we believe it is inappropriate to conclude all community banks are inappropriate investments for Edward Jones investors. In fact, we believe better-capitalized community banks are likely to be attractive investments for long-term investors.

However, appropriate due diligence procedures must be conducted to determine the attractiveness or unattractiveness of a particular community bank before taking investment action.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Kyle Sanders, CFA; James Shanahan, CFA

Required Research Disclosures

Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Other Disclosures

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