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ANALYST INTERVIEW

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Favorable Outlook for Banks as Long as Political Outcomes Match Expectations

A A R O N J A M E S D E E R — S A N D L E R O ' N E I L L + P A R T N E R S L . P .



AARON JAMES DEER is a Managing Director and Equity Research Analyst for Sandler O'Neill + Partners L.P., covering West Coast financial institutions. His focus areas include commercial banks and thrifts, financing of venture capital and private equity-backed enterprises, and innovation among financial intermediaries. He has provided research support on numerous stock underwritings and IPOs for clients ranging from community banks to global institutions. In 2014, Mr. Deer was recognized by StarMine to be among the world's top

sell-side analysts for stock picking within the U.S. banking industry based on the returns of his buy/sell recommendations.

Prior to joining Sandler O'Neill + Partners L.P., Mr. Deer worked for RBC Capital Markets providing research coverage on a variety of regional and national banks. Before that, he supervised research and valuation teams for RSM EquiCo Capital Markets — now part of D.A. Davidson & Co. — specializing in middle market mergers and acquisitions. He also has worked with business and political leaders from around the world as a Communications and Strategy Adviser in Washington, D.C., and Paris, France. He began his career serving in a variety of frontline and back-office positions at regional and community banks. Mr. Deer is quoted frequently in national media on banking issues and the economy, and he advises management teams and boards on strategy and industry trends. He holds a Master of Business Administration with an international business concentration and an Master of Arts in international affairs — trade and investment policy concentration — from the George Washington University and a Bachelor of Business Administration in economics from the University of North Dakota. He also serves as a Director on the board of the GW Alumni Association.

SECTOR — BANKING

(AGV802) TWST: What is the focus of your coverage?

Mr. Deer: My coverage is mostly midcap Western banks headquartered in California, Washington, Oregon and Hawaii, though I do have some coverage outside that geography and in other areas of financial services.

TWST: Does the recent surge have further to go? Is this a sustainable uptrend?

Mr. Deer: I think it is sustainable as long as political outcomes match up with expectations. The U.S. economy continues to show gradual growth with more jobs being created. The quality of jobs isn't necessarily the best, and there are still a lot of people who remain underemployed or have just given up, but the unemployment rate continues to drift lower, and we're

starting to see that translate into higher wages.

So economically we are doing OK, but what's really driven the bank stocks higher over the past couple of months was the election of Donald Trump and expectations for an improved operating environment under his leadership. His election has the promise of increasing interest rates — we've already seen a little bit of that — as well as lowering the corporate tax rate and reducing regulation. Those are all shifts that would be positive for bank profitability. If those legislative and environmental expectations become reality, then yes, I think bank stocks can sustain or build on their current valuations, but there is bound to be some volatility along the way.

TWST: Have you guided higher in view of the expected improvements to the surrounding environment?

Mr. Deer: Generally speaking, yes, my earnings estimates

are rising. That stems partly from the upward shift of the yield curve and rising expectations for additional rate hikes by the Federal Reserve. But also, I reduced the projected corporate income tax rate in my models for 2018. I am now assuming a 25% statutory rate versus the current 35%. So that obviously had a big impact on my earnings estimates.

TWST: Do you see any other regional or secular trends that will be impactful to the space? Anything specific to the regional economy of your coverage?

Mr. Deer: I don't know that I see any new regional or secular trends developing among my coverage. I suppose among the West Coast banks that I cover, there is a higher level of international trade, and there are potential issues there to consider. Here on the West Coast, we have some very significant shipping activity with our ports, and many of the regional banks help finance imports and exports, perform the foreign exchange of currency and are conduits for foreign capital flows and investment. Arguably, we could see some noise in those areas depending on Trump's trade policies. Also, being here in the technology hub of Silicon Valley, I cover some banks that are active in venture lending, and that is an area that has seen huge investment in recent years followed by a reset in valuations, yet the overall VC market remains healthy.

So to some extent the banks here in the West do have regional uniqueness. But generally speaking, the banks out here are highly diversified, just like our Western economy, which, in addition to trade and technology, includes agriculture, construction, logistics, entertainment, health care, tourism, manufacturing and so much more. It's a very diversified economy, and the banks generally represent that. So I don't see any outsized differentiation, although certainly the growth here in the West tends to be a bit stronger than we see in some other parts of the country.

TWST: The small banks, especially, have been big post-election winners. Why so? Why have they performed better than the big banks?

Mr. Deer: Well, the smaller banks are more heavily impacted by the onerous regulations that were pushed down on the banking industry over the past several years, whereas the very large banks have greater assets across which to spread those costs. That is, the big banks have better economies of scale. If the expectation is that we see some of the regulatory burdens eased going forward, that will have a greater benefit for the smaller banks relative to the larger banks.

As an example, one of the big issues that has weighed heavily on the banks for the past several years is the cost of BSA/AML compliance. Even some very small banks have had to hire 10, 20 or sometimes 30 additional staff just to keep up with those compliance demands. For a small bank, that's a hefty cost to bear. So to the extent that we see some streamlining of regulation, the smaller banks will tend to be greater beneficiaries.

TWST: Could you give us a look at some of the banks that you see as best positioned to capture the expected tailwinds?

Mr. Deer: Probably the biggest shift that we've already started to see is interest rates trending higher. The banks that I cover that are best positioned for that change are **SVB Financial Group** (NASDAQ:SIVB), **East West Bancorp** (NASDAQ:EWBC) and **Preferred Bank** (NASDAQ:PFBC). In each of those cases, the banks have a very high percentage of variable rate loans in their portfolios, so their interest earned on loans rises as rates move higher. And in most cases, they tend to have more low-cost funding.

In particular with **SVB**, which is arguably the most asset-sensitive bank in the country, its funding is largely noninterest-bearing accounts, so its funding costs are extremely low. As a result, as rates go up, its margin, or the spread between its interest earned versus its interest paid, should widen and increase its profitability.

TWST: Last year you liked Live Oak Bank, which I believe you said was a completely digital bank with a national footprint. What's your current view of LOB?

Mr. Deer: I think **Live Oak Bank** (NASDAQ:LOB) has a very bright future. It's among the fastest-growing banks in the country, and its growth trajectory appears intact. Moreover, the management there is gradually shifting the revenue profile to one which should have greater stability. That is, they are taking less gain-on-sale income and shifting more of that into recurring interest income. Also, they have a new deposit platform that is coming online that has the potential to significantly lower the bank's funding costs.

After that stock had a nice rally last year, I pulled my rating back to "hold," but I still think the company is doing a great job, and I am forecasting a very significant ramp in their earnings over the next two years. At the moment, I think the stock is fairly valued, but I'm always watching for a good entry point for investors.

TWST: What about Preferred Bank? It was one of your top picks at the beginning of 2016, and it has shown robust growth over the past year. How much further can it go?

Mr. Deer: Yes, the shares of **Preferred Bank** had quite a 2016. That performance will be tough to repeat, but I am still recommending the stock. As I mentioned earlier, it's among the most asset-sensitive banks in my coverage, so if rates continue to tick upward, it should see a strong benefit. It also posts better-than-average growth and better-than-average profitability, so there are a number of factors that should count in its favor.

TWST: If you had to name just one bank to buy right now, which bank earns your highest conviction for 2017?

Mr. Deer: My top pick for 2017 is **East West Bancorp**. As I mentioned, this too is among the more asset-sensitive banks in the U.S. due to a largely variable rate loan book and a strong base of noninterest-bearing deposits. But there are a variety of other factors

Highlights

Aaron James Deer discusses his midcap Western bank coverage. Mr. Deer says the recent surge for banks is sustainable as long as political outcomes match up with expectations. He says that generally speaking, his earning estimates are rising, which stems from the upward shift of the yield curve and rising expectations for additional rate hikes by the Federal Reserve. Companies discussed: [SVB Financial Group](#) (NASDAQ:SIVB); [East West Bancorp](#) (NASDAQ:EWBC); [Preferred Bank](#) (NASDAQ:PFBC) and [Live Oak Bancshares](#) (NASDAQ:LOB).

that also should benefit the company this year.

For one, I expect to see its operating costs hold relatively flat. It had some pretty significant BSA/AML remediation costs over the past year or so, and many of those costs should go away. And it has a strong base of commercial and industrial customers, making up almost 40% of its loan book, including several specialized niches. If the economy continues to grow, **East West** should see strong demand for those loans. The company also should see a strong benefit from any cut in the federal corporate income tax rate, and that will serve to boost what is already above-average profitability at **East West**. So I think there are a lot of things working in **East West's** favor.

The one notable risk is its China exposure. With President-elect Trump taking a somewhat provocative approach to our trade with China, there is a possibility that **East West** stock could be affected, as it has a lot of customers that import from and export to China. And the bank also has offices in Hong Kong and Mainland China. But I think the risk is more one of perception than it is of reality. Notably, the direct exposure is less than many investors realize, as **East West's** loans in greater China are less than 4% of its total loans, and its trade finance loans are an even smaller percentage than that.

So I think the positives at **East West** significantly outweigh the negatives. Meanwhile, the stock trades at about a two or three multiple discount to peers. I would expect that discount to narrow or even flip to a premium as the year goes on.

TWST: What are some of the key impacts related to the shift to digitized banking? Have you seen any notable technologies that have made a difference?

Mr. Deer: The biggest shift in technology has been toward mobile banking, and I think almost all banks now have a mobile product for their customers, allowing them to do basic transactions, deposit checks, make transfers between accounts and pay bills all through their phones or other devices. And with fewer transactions in the branches, the banks have been able to reduce their brick-and-mortar footprint. So we've seen a lot of consolidation of branches, and that's lowered the related operating costs. But much of those savings have actually shifted into technology spending, which continues to climb at most banks.

The banks are constantly enhancing their technical capabilities, not just in terms of customer-facing technology, but also in the back office. Cybersecurity is certainly an area where the banks are spending very aggressively. And I think it's interesting, because a lot of people don't necessarily think of banks as being that innovative. They're often seen as these old stuffy institutions that

never change, but the reality is that banks have always been at the forefront of innovation and always looking to adopt new and more efficient technologies. It's just that because of the importance they place on protecting their customers' finances and personal data, the rollout of new technology sometimes take longer than people expect.

TWST: Do you like to see M&A in the current environment? What's the level you saw in 2016, and what do you expect going forward?

Mr. Deer: Over the past year, M&A activity ran a little slower than I expected going into the year. In addition, notwithstanding a few large mergers, most of the activity was centered in smaller deals. Now, with valuations up pretty sharply, I expect deal activity to accelerate. I think a lot of sellers, or potential sellers, have been holding out for a specific price, and so far there has been a gap between that price and what the buyers are willing to pay. But with overall valuations up, it's going to be easier to close that gap and for the buyers to pay a bigger premium and still hit their internal IRR and earn-back targets.

TWST: Are there any other off-the-radar trends you are keeping your eye on that prospective investors should know about?

Mr. Deer: I think at this point all eyes are on Washington. People are going to be watching to see what President-elect Trump's first 100 days are like, so we need to see how those shape up. And then people will closely watch the longer-term legislative agenda to see what kind of progress is made. If we see a rationalization of some of the regulatory overreach that came with Dodd-Frank and a reduction in the federal corporate tax rate, then as long as the economy holds up, the outlook for the banks remains favorable.

TWST: Is there anything else that you would like to comment on?

Mr. Deer: No, I think we covered a fair bit of ground here.

TWST: Thank you. (VSB)

Note: Opinions and recommendations are as of 01/09/17.

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