High Return Opportunities

Executive Summary

Every bank is looking for opportunities to increase yield without taking on more risk. Endurance Advisory Partners is always on the look-out for this kind of opportunity. That said, we don't find opportunities where there isn't any risk–what we find are situations where certain banks (and some of our clients) can manage the risk and/or get comfortable with it. This white paper runs through some of the opportunities that we've surfaced recently:

- Lending to under-served sectors – the case for marijuana lending
- Structured Tech lending – a deal where you lend against future receivables
- Buying pools of consumer installment loans
- Boosting yield and liquidity on investments by using a bank-only bond fund
- Buying seasoned B tranches for a great risk:reward trade
- Charging loan origination and structuring fees

Under-Served Sectors

Since marijuana related businesses, or MRBs, have been shunned by traditional banks, yields are sky high. Medical marijuana has been around for 20 years; recreational use for 8+ -- and there are only 6 states where it is wholly illegal. Widespread use and legalization by states has not translated to acceptance in the banking community for two primary reasons: federal laws and the compliance burden. Any bank directly serving MRBs must be prepared to invest in the infrastructure to support the gauntlet of compliance tasks, which make it hardly worthwhile unless it is built as a core competency with economies of scale. That is, except for participants in marijuana loans.

The MRB compliance burden is huge on the cash handling/treasury management side. Likewise, lenders need to be vigilant and face a material compliance burden, although it is possible for a participant to get a free ride on the compliance activities of the agent bank. Obviously, a participant must understand the agent bank's compliance program enough to confirm that it meets the participant's credit/risk requirements. If that is the case, the agent takes on the entire compliance burden both initially and ongoing. For the participant, it's like other loans where a good credit memo/monitoring suffices. But without many lenders, marijuana loans can offer yields that are 100-300 bps higher than comparable credits.

Structured Financing for Tech/Growth Companies

Most banks won't touch tech companies with operating losses, but they can be structured to be creditworthy. High growth companies often have customers and revenue – just not enough to cover the current cost of building their platform. Without tangible assets, you can't do a secured loan; without operating income, it's tough to do a cash flow loan. The answer is to identify companies that provide recurring service and lend against the creation of future receivables. Sort of.

This deal is a little more complicated than that, but it has a track record of zero losses since inception back in 2019. It's better than lending directly to the tech company and better than factoring their receivables. And it offers a sky-high yield compared to similar credit risk alternatives.

Buying Pools of Consumer Installment Loans

Several institutions are originating pools of high yield loans for sale to banks. Historically, the originate-to-sell business model was used primarily in mortgage operations and commercial loan syndications. Now, it is spreading into consumer lending. Firms have created origination platforms that out-strip their ability to fund loans (note the MRB opportunity above). Further, developing a distribution network – bank investors for the loans – requires a different skill set than originating, underwriting, and servicing the loans. As a result, banks have an opportunity to plug into such a network and take-down high quality, high yield loans. This is happening even with small, high yield, consumer loans.

Boosting Yield and Liquidity on Investments

Actively managing a community bank's security portfolio is often a waste of time. Trade sizes are too small to get good execution (whether buying or selling) and most community bank CFOs are far more comfortable with accounting than bond math. Despite these disadvantages, most community banks are still trying to build a laddered bond portfolio limited to agency bonds/MBS and high-rated munis. That's a tough call. Many of the securities chosen are also priced way above par, exposing the bank to a write-off if/when the issue prepays.

A better alternative is to invest in a bank-only bond fund where the yield pick-up comes from actively managed duration – code for buying medium term bonds when the yield curve is steep, thereby getting a yield well above short rates. Better yet, it frees up the CFO from the impossible task of beating the market.

Buying Seasoned B Tranches of Syndicated Loans

Most leveraged loans include an "institutional tranche" that is priced attractively. Institutional tranches are longer dated term loans. The bank portion of the deal is the revolver and the term loan A (amortizing by the end of year 5). The institutional tranche picks up where that leaves off and amortizes in years 6-8. But if you buy a seasoned issue – say 3 years old – it now amortizes in 3-5 years. These loans are pari passu with the bank debt and must be refinanced whenever the bank debt is restructured. This deal nets the lender incremental yield without incremental risk.

It's All About the Fees: Lessoned Learned from PPP

PPP lending spread like wildfire in 4Q20-1Q21 proving that lender fees are more important than yield. Of course, it also proved that giving away money is easy. Most community banks would participate in the program on any terms just for the goodwill built by enabling businesses to fund a forgivable loan. But PPP is better than that, lenders are paid 1% for helping small borrowers fill out the world's simplest application: name, address, loan amount (2.5 x monthly payroll) and about a dozen yes/no questions.

Community bankers leave a lot of money on the table when they don't charge borrowers upfront fees or restructuring fees. The lesson from PPP is to charge fees. Any reasonable fees boost yield with no downside.

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