Watchlist Investing Newsletter

Patiently finding and following great public companies to own at the right price.

Issue #1 | March 2021

"One person said to me, 'I have a list of 300 potentially attractive stocks, and I constantly watch them, waiting for just one of them to become cheap enough to buy.' Well, that's a reasonable thing to do. But how many people have that kind of discipline? Not one in 100." – Charlie Munger

In this issue:

Watchlist

DEEP DIVE:

Hingham Institution for Savings

(NASDAQ: HIFS; Disclosure: Long)

Price (3/9/21):	$275
Shares out (diluted):	2,183,000
Market cap:	$600m
Total assets (12/31/20):	$2.9 bn
Return on Assets:	1.65%
Return on Equity:	16.7%
Insider ownership:	32%

Overview:

- HIFS is a state-chartered savings bank headquartered in Hingham, Massachusetts.

- The bank was originally chartered in 1834. Present management took control in 1993.

- Large insider ownership (32%) aligns management with shareholders and serves as a powerful risk mitigant.

- HIFS is almost entirely focused on real-estate lending, with commercial real estate comprising about 60% of the loan book. Management focuses on keeping origination and management of its loans simple.

- A long history of almost zero loan losses is solid evidence of superior underwriting discipline.

- Relentless focus on cost control, coupled with scale economics of real estate lending, has pushed the efficiency ratio in the mid-20s.

- HIFS is unusual in the management of its investment portfolio, viewing it as a long-term investment as opposed to simply a pool of liquidity like other industry participants.

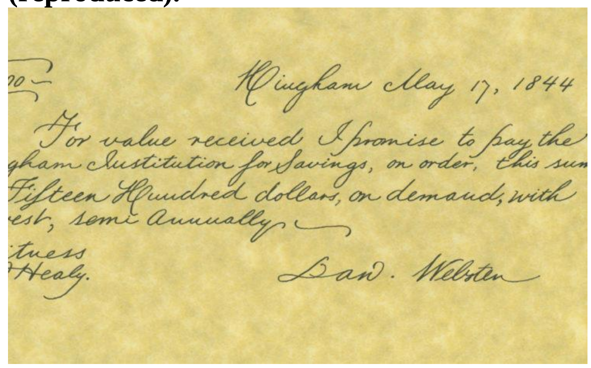
Balance Sheet Snapshot FYE 12/31/20 ($ millions, rounded)		
Cash & equiv.	$234	*8%*
Investment portfolio	56	*2%*
Loans, net	2,495	*87%*
Other	362	*13%*
Total assets	**2,857**	***100%***
Deposits (non int.)	313	*11%*
Deposits (int. bearing)	1,826	*64%*
FHLB advances	408	*14%*
Other liabilities	17	*0%*
Equity	293	*10%*
Total liab. + equity	**2,857**	***100%***

Income Statement Snapshot FYE 12/31/20 ($ millions, rounded)		
Interest & div. income	106	*100%*
Interest expense	21	*20%*
Net int. income	**85**	***80%***
Loan loss provision	2	*2%*
Gain on securities	8	*8%*
Other income	1	*1%*
Operating expenses	22	*21%*
Pre-tax income	**70**	***66%***
Taxes	19	*18%*
Net income	51	*48%*
Core net income	**45**	***42%***
Core EPS (diluted)	**$20.43**	

History:

The history of HIFS dates back to 1834, making it one of America's oldest banks. At the time of its founding Hingham, Mass. Was a town of 3,500 residents—twice the size of Chicago. Its very first loan, made in 1835, was a $400 real estate loan at 6%. One of the bank's first customers was Daniel Webster. The bank financed an expansion of Webster's farm into Marshfield, Mass.

Promissory note from Daniel Webster (reproduced).


Hingham May 17, 1844
For value received I promise to pay the
gham Institution for Savings, on order, this sum
Fifteen Hundred dollars, on demand, with
est, semi annually
tness
Healy.
Dan. Webster

Source: Company website.

In December 1988, the bank converted from a mutual bank to a stock bank. The conversion brought $9.6 million capital into the bank, a portion of which was used to purchase the building next door to its main office, which was to house its lending department.

Things were already heading south when the bank went public. The bank found itself with a Memorandum of Understanding (MOU) from the FDIC, lost $8 million between 1989 and 1991, and a growing amount of non-performing loans. The former president of the bank, Wilfred Creighton, was found to have engaged in numerous instances of bank fraud, including kickbacks. Management was more focused on enriching itself than running even an average-quality bank. It ignored a fruitful lending area in/around Boston and instead made loans outside of its market, including a $ 5 million loan to a dog racing track.

In 1993, Robert H. Gaughen, Sr., father of current chairman, Robert H. Gaughen, Jr., and a board member with a large personal ownership stake in the bank, waged and won a proxy battle for control of the bank. Out went the bad actors and in came an experienced and prudent banking team.

The dramatic fall and takeover of the bank are a constant reminder to management and shareholders of the risks of taking one's eye off the ball. HIFS today doesn't try to mitigate the risk of insider loans, for example, it simply forbids them.

The management philosophy at HIFS today is one of extreme focus. Its lending activities are almost exclusively in real estate, particularly multi-family commercial real estate. It focuses on controlling the two factors banks can control: loan losses and overhead costs.

While still relatively very small compared to leviathans like JP Morgan or Bank of America (or even midsize banks like Peoples United or PNC), HIFS found itself looking for a new market similar to Boston. It found it in Washington, DC, a market the bank entered a few years ago with an LPO and into which it expanded with a branch set to come online in 2021.

Governance/Insider Ownership:

Insiders of HIFS own 32% of the bank. Chairman and CEO, Robert Gaughen, Jr, (72) President, Patrick (his son, 40), and director Kara Gaughen Smith (his daughter, 37) control 14.9%. Other insiders with connections to the Gaughens include directors Kevin Gaughen, Robert Lane, and Julio Hernando, each of whom are Robert's nephews. Other key personnel include CFO, Cristian Melej, VP Commercial Lending, Shawn Sullivan, and VP Retail Lending, James Dell'Anno.

Management is paid well. Chairman Robert Gaughen is paid about $2 million per year and Patrick takes home about $750k per year. Robert's compensation is equal to about 5% of core net income (before his salary), which appears high (rich, even). I'd prefer to see some echoes of Charlie Munger with a bit more left on the table, but I can't fault a rich reward for creating so much sustained value for shareholders over the years.

Loan Portfolio:

The main show at HIFS, as with most banks, is its loan portfolio. HIFS has increased its loan book from $850m in 2011 to $2.5bn in 2020 (11% CAGR) through organic growth, funded through retained earnings. As a percentage of total assets loans have grown from 75% in 2011 to 87% in 2020.

The bank's focus is almost entirely real estate. Commercial and consumer loans make up a negligible amount of total loans. Within the loan portfolio residential loans make up 25%, commercial real estate 68%, and construction loans 6%. This is a shift from 45% residential, 48% commercial, and 5% construction in 2011.

This shift toward commercial vs. residential is another reason why the efficiency ratio can be so low at HIFS, as more dollars can be put to work in commercial deals (generally) than residential loans. As of FYE '20 HIFS is in the 93rd percentile in its class for assets/employee at $33m compared to $10m for peers. A look back to 2010 reveals HIFS at $10m/employee compared to $7m for its peer group (81st percentile).

Within the commercial portfolio the focus is on multi-family commercial real estate. This focus on a relatively stable, basic asset class reduces risks. As long as HIFS avoids over-extending itself and lends prudently, risks are substantially reduced. If/when it does have to take over a property (a rare occurrence) much less tenant fit up or concessions are needed (unlike other commercial real estate, which might need to be repurposed for other uses).

Having worked inside a bank, including as a commercial loan officer, I was impressed at some of the practices at HIFS. For example:

- *No loan authority resides outside the board*. This is highly unusual but focuses risk management at the board level. A member of the executive committee (and often times more individuals) visit every property. A board that owns one-third of the bank is going to make sure its investments are sound.

- *Hand on the hot stove.* Most loan documents contain default clauses that allow the lender to increase the interest rate to a default rate maximum, usually 18%. In my decade-long career at a bank I only *once* saw the provision used, and barely. Many banks are afraid of losing customers—yes even bad ones (it reduces outstandings). HIFS takes the hot stove approach. Either the borrower will go away or it will shape up and won't do it again – a win-win for HIFS.
- *Bank-adjusted appraisals.* HIFS does its own analysis of the value of its collateral properties. This is frequently down. I've seen firsthand too many appraisers too focused on sticking to appraisal guidelines instead of thinking for themselves. Even after this conservative approach HIFS lends to an average of 53% of a property's value for commercial loans and 52% for residential loans. Construction loans are limited to 75% but generally sell out at a 60% LTV.

- *No loan participations.* HIFS originates and holds all of its loans. It does not seek to "offload" risk to another bank by selling a portion of the loan or by participating in club deals and buying into loans. In this way it always holds the keys and can act quickly to modify a loan if/when it makes sense.

- *No swaps/hedging.* Oftentimes banks will offer back-to-back swaps that, through a counterparty, allow the bank to receive a floating rate and the borrower a fixed rate. HIFS as a rule does not do this as it creates complexity, monitoring requirements, and slows/complicates new deals that often incorporate existing deals into the mix. Related, HIFS generally doesn't engage in balance sheet-level hedging, but controls its funding mix through Federal Home Loan Bank advances, brokered deposits, and local deposits.

All of the above serve to significantly reduce risk in the portfolio. And while a bank may extend and pretend or otherwise fudge issues with the loan book short term, the long-term track record of write-offs tells the story. At HIFS loan losses over the past ten years have *totaled* $721k. The worst year for charge-offs was 2011 with 0.06% of the loan book. Most years are negligible or even have recoveries—very impressive!

Generating high ROE and retaining a large portion of earnings means HIFS can growth very quickly without stretching the balance sheet. That growth has begun to come from Washington, DC, a market it tiptoed into before taking the plunge with a branch in Georgetown slated to come online in 2021. The latest annual report hints at the largest loan in its history coming from the DC market. A bit of sleuthing around the registry of deeds revealed it to be a $40m loan secured by the AFL-CIO building near the White House in Washington, D.C.

Investment Portfolio:

As with other things at HIFS, the investment portfolio is unique. Unlike just about every other bank, HIFS views its investment portfolio not as a source of liquidity to be maintained at some arbitrary percentage of total assets. Instead, the portfolio is viewed as an asset to be managed for the long term. Beginning in 2014 the bank began shifting away from mostly fixed income investments and today has substantially all of the portfolio invested in equities. The 10K filing states that it is managed for the long term and views itself as an owner of businesses.

Management has used its position as a bank to inform its investments in its portfolio, which, not surprisingly, are concentrated into financial services and payments. It also uses what it learns by studying the companies in which it invests to apply in its core banking business.

While the exact composition of the portfolio is unknown (it's not required to be disclosed), management has given some clues. Visa, Mastercard are in the portfolio, as are payment systems, banks, financial services, and the like.

Deposits:

HIFS is largely a market-taker when it comes to deposits. Through its eleven locations (including DC), the bank has a physical footprint largely in/around Hingham and the south shore.

The bank's cost of funds is consistently higher than its peer group, a disadvantage more than offset by its superior efficiency ratio. Historically the bank has relied on FHLB advances and more costly CDs to fund the balance sheet.

Recently, the bank has undertaken the initiative to lower its COF by investing in electronic banking capabilities and formed a specialized deposit group to work with business clients.

HIFS does not rely on fee income. Fee income is modest and consists largely of interchange fees and some overdraft fees, etc. Management appears to recognize the risk that banking fees, like other fees in financial services, are headed toward zero.

Risks:

1. *Insider control*: There are two risks related to governance. One is the high degree of insider control, which would all but prevent outside shareholders from making any changes if that became necessary. Second, the bank engages Gaughen, Gaughen, Land & Hernando, LLP for a substantial amount of its legal expenses. These amounted to $2.1 million in 2019 plus $900k in agency fees for title insurance.

2. *Growth:* Maintaining a double-digit growth rate of assets means HIFS generally must take market share to grow. It's "solved" the problem of growing into the Boston market by expanding into Washington, DC. Management appears very aware to the risks that come with growth, not least of which is losing by "winning" a customer from a rival.

   While not necessarily a risk, there are limits to the amount of assets/employee, which would limit the ability of the bank to depress the efficiency ratio further. Related, as the bank adds additional lenders its unclear what this will do to the bandwidth of senior management/board members.

3. *Washington, DC:* In addition to general growth-related risks, management must stay attuned to the daily ebbs/flows of a similar but different market. Several of the bank's management team know the market well from past experience working there, and the new DC-based lending/deposit staff literally live in the area. Washington appears to be a well-thought-out expansion, with a huge government presence, height caps on buildings limiting vertical growth, and a dearth of midsize banks in the $1bn to $10bn range. All of these factors are unlikely to change soon or quickly.

Capital Allocation:

Capital allocation at HIFS has consisted of reinvesting in organic expansion and returning capital to shareholders through regular and special dividends.

As noted in the section on investments, management in 2014 began shifting the investment portfolio from bonds and into long-term equity holdings. It also invested $1.5m into DC-based Founders Bank in 2019, of which $500k was returned upon final capital raising.

The bank's physical footprint has changed modestly. In 2020 it sold its branch property in Scituate and closed its South Weymouth location. Management has used a 1031 exchange to move proceeds into the new Georgetown, Washington, DC branch slated to come online in 2021. In January 2021, the bank announced it filed to close its South Hingham branch.

Management has stated its desire to expand organically and not through acquisitions. Management has witnessed poorly executed acquisitions that frequently do not create any synergies.

Lastly, HIFS does not have a bank holding structure. This means it faces regulatory challenges when it comes to repurchasing shares. Management states that share repurchases are on the table but has not generally used this capital allocation option.

Competition:

In some ways the analysis of HIFS's competitors is easy. Banking is a fiercely competitive business with money being the ultimate fungible commodity. Banks will always face pressure to match their dumbest competitor, a group which waxes and wanes throughout cycles.

Large competitors in the Boston/Massachusetts market include the majors such as Bank of America and JP Morgan Chace, regional lenders such as Peoples United Bank, TD Bank, and a newly public Eastern Bank located in Boston.

In addition, there are a host of Federal and State-chartered banks in the markets in which HIFS does business, many of whom have established branch networks and local personnel.

Other:

HIFS maintains investment in a mutual fund that qualifies as CRA (Community Investment Act) credit. While the bank engages in some honest-to-God CRA and community activity, the mutual fund allows management not to get distracted from its core business.

HIFS has an investment in Founders Bank, a de novo bank based in Washington, DC. This investment is small relative to core operations at HIFS but could blossom into something quite attractive in the future. HIFS's approximately $1m net investment makes it the largest shareholder of Founders Bank.

Moat:

HIFS operates in a commodity industry. Generally, only large national banks with dense branch networks enjoy a true advantage via a lower cost of funds. HIFS differentiates itself by focusing relentlessly on reducing overhead costs and loan losses.

I would characterize HIFS as having a moderate moat. That moat must be earned every day by continually learning and staying up-to-date on the marketplace. A competitor with the drive to understand a market niche like that occupied by HIFS could make inroads (technically nothing is stopping it) but would be difficult.

Key Variables/Metrics:

- *Loan losses:* The quality of the loan book is the most important metric to pay attention to. Actual write-offs tell the best story. Reserving is important but subject to management estimates.

- *Efficiency ratio:* Controlling costs is the second major variable management can control and which has an outsize impact on future returns.

Market/Growth:

The Boston, Mass. MSA contains approximately 5 million people, the tenth-largest in the US. Washington, DC has about 6.2 million placing it sixth.

According to the St. Louis Fed, commercial real estate loans secured by multifamily properties amounted to $416bn as of early 2021.

I hesitate to use bank asset data as it is imperfect and not necessarily representative of the actual market. Case in point is the total of $1.7bn assets across four banks in Washington, DC (including $82m Founders Bank). This reflects the fact that those serving the DC market are based outside of the ten square-mile nations capitol.

Still, a rough analysis of HIFSs primary market is instructive. Massachusetts banks (excluding State Street Bank, which is primarily in the securities business) held $194bn in assets. Mass. State average had about 6% of total assets in multifamily loans or about $12bn, and another 41% in 1-4 family 1st lien loans, or about $80bn. In reality, the niche market in which HIFS looks to operate is likely much smaller, although harder to quantify. Given the entrance into Washington, DC and the similarities of that market compared to Boston, HIFS likely has a clear runway to double its asset size without much trouble. On the plus side, its growing capital base means it will be able to take on larger projects as time goes on.

Valuation:

I'm hesitant to provide an exact valuation for several reasons. First, I could be wrong. Second, each investor has his/her own opportunity costs and return hurdles.

- The bank currently trades at a price/book ratio of 2.0x, which is in-line with its five-year average. (The absence of intangibles means this also equals price/tang. BV.) This appears high even given a historical ROA of around 1.25%, but reflects the bank's ability to reinvest at satisfactory returns. The ability to earn a high ROA in the future will affect the future valuation of HIFS, as banks are generally valued on a price/book or price/tang. book basis, with the ROA holding substantial weight.

- The current market cap of about $600m implies a going-in earnings yield of about 7.5%. Reinvestment at historical ROEs in the 15% range will serve to bring this initial yield up over time.

- I'm generally in favor of Bruce Greenwald's three-bucket approach to assessing value. This framework separates asset values, earnings power value, and growth, and is a distinct (and in many cases better) approach from a DCF model.

    - *Asset value:* It's safe to assume HIFS assets and liabilities are appropriately valued. In this case equity is a good proxy for net asset value, or $293m.
    - *Earnings power value:* I generally demand 10%. If we use the 7-year average of 1.40% ROA applied to the current assets of $2.9bn we arrive at $41m of sustainable earnings. Capitalized at 10% results in a value of $410m.
    - *Growth:* The market is currently placing ~$200m value on HIFS future growth. Said another way, it implies a 3.2% perpetual growth rate using a 10% discount rate.

- Below is a screen of banks ranked by price/book, which indicates HIFS is near the top of both its historical range and that of other banks earning similarly high ROAs.

#	Company Name	On Total Assets Last Year	Market Cap	Price to Book
1	First Financial Bankshares I	1.99%	6.85B	3.49
2	Westamerica Bancorporatic	1.43%	1.75B	2.33
3	Union Bankshares Inc	1.22%	133.13M	2.32
4	Fidelity D and D Bancorp In	1.15%	299.18M	2.19
5	ServisFirst Bancshares Inc	1.67%	3.02B	2.16
6	Commerce Bancshares Inc	1.08%	9.24B	2.08
7	Stock Yards Bancorp Inc	1.77%	1.25B	2.03
8	Bank South Carolina Corp	1.64%	101.57M	2.02
9	Glacier Bancorp Inc	1.54%	6.03B	1.96
10	Lakeland Financial Corp	1.76%	1.94B	1.95
11	City Holding Co	1.78%	1.31B	1.90
12	BancFirst Corp	1.57%	2.35B	1.83
13	Tompkins Financial Corpora	1.22%	1.34B	1.82
14	SVB Fin'l Group	1.03%	26.57B	1.81
15	Community Bank System In	1.48%	4.17B	1.79
16	Washington Trust Bancorp I	1.31%	928.51M	1.75
17	Bank of Marin Bancorp	1.26%	560.39M	1.72
18	Arrow Financial Corporatio	1.18%	547.40M	1.66
19	Farmers and Merchants Ban	1.51%	611.38M	1.65
20	Park National Corp	1.38%	2.22B	1.64

Summary:

HIFS is a very well-managed bank whose advantages come from its relentless focus. Management focuses on the two primary variables it can control, namely, overhead costs and loan losses, while accepting that it is largely a market-taker when it comes to yield and cost of funds.

Significant insider ownership aligns management with shareholders and serves to mitigate the risk of unwelcome surprises. Management is content to operate in a few very well-defined niches.

Continued focus on the fundamentals should keep this bank on our watchlist for a long time.

HIFS Summary Financials

Balance Sheet FYE 12/31/xx ($ millions, rounded)	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Cash & equiv.	$234	$252	$296	$355	$323	$267	$190	$116	$101	$130
Investment portfolio	66	47	38	34	27	41	71	106	103	97
Loans, net	2,495	2,227	2,009	1,834	1,606	1,406	1,239	1,079	950	850
PP&E	15	15	15	14	14	15	15	16	14	11
Other	47	49	50	47	44	40	38	39	38	40
Total assets	**2,857**	**2,590**	**2,409**	**2,285**	**2,015**	**1,769**	**1,552**	**1,356**	**1,206**	**1,127**
Deposits (non int.)	313	238	214	185	148	128	117	93	79	63
Deposits (int. bearing)	1,826	1,583	1,360	1,320	1,218	1,089	972	848	791	724
FHLB advances	408	505	607	579	475	402	330	303	234	247
Other liabilities	17	17	16	13	12	11	12	10	9	10
Equity	293	247	213	186	161	138	122	103	93	82
Total liab. + equity	**$2,857**	**$2,590**	**$2,409**	**$2,285**	**$2,015**	**$1,769**	**$1,552**	**$1,356**	**$1,206**	**$1,127**
Shares outstanding	*2,138*	*2,136*	*2,133*	*2,133*	*2,133*	*2,129*	*2,129*	*2,129*	*2,126*	*2,126*

Income Statement FYE 12/31/xx ($ millions, rounded)	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Interest & div. income	$106	$107	$94	$81	$72	$62	$56	$49	$49	$48
Interest expense	21	40	28	17	13	11	10	11	11	13
Net int. income	**85**	**67**	**66**	**64**	**58**	**51**	**46**	**39**	**38**	**36**
Loan loss provision	2	2	1	2	1	1	1	0	1	1
Gain (loss) on securities)	8	8	-3	0	0	0	0	0	0	0
Other income	1	1	1	1	1	1	8	2	2	2
Operating expenses	22	21	20	20	19	19	20	17	16	16
Pre-tax income	**70**	**54**	**43**	**44**	**40**	**33**	**33**	**23**	**22**	**20**
Taxes	19	15	12	18	16	13	11	9	9	8
Net income	**$51**	**$39**	**$30**	**$26**	**$23**	**$19**	**$22**	**$13**	**$13**	**$12**
Diluted EPS	$ 23.25	$ 17.83	$ 13.90	$ 11.81	$ 10.89	$ 9.02	$ 10.44	$ 6.28	$ 6.25	$ 5.67
Core net income	**$45**	**$33**	**$33**	**$26**	**$23**	**$19**	**$17**	**$13**	**$13**	**$12**
Core diluted EPS	$ 20.43	$ 15.12	$ 14.99	$ 11.79	$ 10.78	$ 9.01	$ 7.76	$ 6.28	$ 6.25	$ 5.67
Notes: 2014 includes $5.7m after-tax gain from gain on life insurance.										

Loan Book Detail	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Total loans, net	$2,495	$2,227	$2,009	$1,834	$1,606	$1,406	$1,239	$1,079	$950	$850
Residential real estate loans	25%	31%	35%	38%	41%	43%	44%	47%	46%	45%
Commercial real estate loans	68%	60%	57%	54%	50%	48%	49%	46%	46%	48%
Construction loans	6%	8%	6%	7%	8%	7%	5%	5%	6%	5%
Home equity loans	1%	1%	2%	2%	2%	2%	2%	2%	3%	3%
Commercial & consumer loans	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Loan allowance	-1%	-1%	-1%	-1%	-1%	-1%	-1%	-1%	-1%	-1%
Net deferred loan orig. costs	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Loans, net	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
% total assets	87%	86%	83%	80%	80%	79%	80%	80%	79%	75%
Non-performing loans/total loans	0.2%	0.3%	0.0%	0.1%	0.1%	0.1%	0.2%	0.6%	0.3%	0.8%
Charge-offs, net % loans	**0.01%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**-0.01%**	**0.00%**	**0.01%**	**0.03%**	**0.06%**

Deposits Detail	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Total deposits	$2,139	$1,821	$1,573	$1,506	$1,366	$1,217	$1,089	$941	$870	$788
Regular	5%	5%	6%	6%	7%	7%	8%	8%	8%	8%
Money market	31%	29%	33%	34%	40%	37%	40%	42%	36%	33%
NOW	0%	0%	0%	2%	3%	3%	3%	3%	4%	4%
Demand	15%	13%	14%	12%	11%	11%	11%	10%	9%	8%
Total non-certificate accounts	**51%**	**47%**	**52%**	**55%**	**60%**	**57%**	**61%**	**64%**	**57%**	**53%**
CDs < $250k	35%	36%	35%	32%	32%	34%	31%	28%	19%	22%
CDs > $250k	14%	17%	12%	12%	8%	9%	7%	9%	24%	26%
Total certificate accounts	**49%**	**53%**	**48%**	**45%**	**40%**	**43%**	**39%**	**36%**	**43%**	**47%**
Total deposits	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Deposits % total assets	75%	70%	65%	66%	68%	69%	70%	69%	72%	70%

Summary Key Ratios & Growth	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Return on average assets	1.88%	1.55%	1.32%	1.21%	1.22%	1.18%	1.52%	1.07%	1.15%	1.14%
Core return on average assets	1.65%	1.32%	1.42%	1.21%	1.21%	1.18%	1.52%	n/a	n/a	n/a
Return on average equity	19.0%	16.8%	15.0%	14.7%	15.6%	14.8%	19.3%	13.5%	15.1%	15.3%
Core return on average equity	16.7%	14.3%	16.1%	14.7%	15.4%	14.8%	19.3%	n/a	n/a	n/a
Net interest margin	3.22%	2.72%	2.90%	3.05%	3.10%	3.17%	3.23%	3.19%	3.38%	3.50%
Efficiency ratio	25.4%	30.3%	29.9%	30.1%	32.2%	36.3%	37.1%	43.2%	41.4%	42.9%
Average equity to average assets	9.9%	9.2%	8.8%	8.2%	7.9%	8.0%	7.9%	7.9%	7.6%	7.4%
Growth:										
Total assets	10.3%	7.5%	5.4%	13.4%	13.9%	13.9%	14.4%	12.5%	7.0%	
Total loans	12.0%	10.8%	9.6%	14.2%	14.2%	13.5%	14.8%	13.6%	11.8%	
Total deposits	17.5%	15.7%	4.5%	10.2%	12.2%	11.7%	15.8%	8.2%	10.5%	
Non-interest-bearing deposits	23.2%	3.6%	-0.4%	-4.7%	21.4%	2.6%	10.0%	27.7%	20.9%	
Equity	18.5%	16.3%	14.2%	15.6%	16.7%	13.6%	17.7%	11.2%	12.8%	

Capital Allocation	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Core net income	$45	$33	$33	$26	$23	$19	$17	$13	$13	$12
Dividends	(4.9)	(4.7)	(4.1)	(3.5)	(3.3)	(3.1)	(4.5)	(2.9)	(2.8)	(2.7)
Sale (purchase) of securities, net	(10.3)	0.0	0.0	(2.8)	17.5	30.1	0.1	(32.7)	(7.0)	(4.7)
Growth capex (pos. # = net decline PPE)	(0.8)	0.4	(0.5)	0.4	0.6	0.1	0.6	(1.7)	(3.6)	(2.6)

Bank Screen: Listed in order of sum of best P/B (lowest) and best ROA (highest)

#	Company Name	% Return On Total Assets Last Year	Last Close Price	Market Cap	Price to Book	P/B Rank	ROA Rank	Sum Ranking
1	California First National Bancorp	2.04%	$17.50	179.97M	0.84	12	3	15
2	Bank OZK	1.81%	$44.29	5.68B	0.92	26	8	34
3	HomeTrust Bancshares Inc	5.58%	$25.61	427.35M	0.94	36	2	38
4	PacWest Bancorp	1.75%	$39.37	4.60B	0.91	25	14	39
5	Northeast Bank	13.80%	$29.27	239.87M	0.96	40	1	41
6	Hilltop Holdings Inc	1.48%	$36.14	2.97B	0.93	31	30	61
7	Pacific Premier Bancorp	1.36%	$43.05	4.06B	0.90	23	50	73
8	Croghan Bancshares Inc	1.43%	$52.51	117.94M	0.97	42	39	81
9	Madison County Financial Inc	1.33%	$31.00	97.40M	0.94	37	57	94
10	Pinnacle Financial Partners Inc	1.44%	$89.13	6.77B	1.00	59	37	96
11	Umpqua Holdings Corporation	1.23%	$18.26	4.02B	0.86	17	79	96
12	Premier Financial Bancorp Inc	1.36%	$17.17	251.94M	1.00	51	50	101
13	United Bancshares Inc	1.21%	$24.21	79.38M	0.86	16	89	105
14	Renasant Corporation	1.25%	$43.30	2.44B	0.94	35	75	110
15	FNB Corporation	1.12%	$12.86	4.13B	0.78	9	112	121
16	First Bancorp New	1.33%	$11.45	2.50B	1.02	67	57	124
17	Taylor Calvin B Bankshares	1.52%	$34.60	96.50M	1.08	100	26	126
18	First Bancshares Inc	1.11%	$35.94	758.87M	0.86	15	117	132
19	Civista Bancshares Inc.	1.47%	$22.35	355.68M	1.08	103	33	136
20	Sandy Spring Bancorp Inc	1.35%	$41.55	1.96B	1.06	84	54	138
21	Hope Bancorp Inc	1.09%	$15.30	1.89B	0.87	20	126	146
22	First Financial Bancorp	1.37%	$25.29	2.46B	1.08	99	49	148
23	Jeffersonville Bancorp	1.27%	$19.00	80.47M	1.06	82	68	150
24	Simmons First National Corp	1.12%	$32.04	3.46B	0.95	38	112	150
25	LCNB Corp	1.15%	$18.50	238.26M	0.99	48	104	152
26	Fentura Financial Inc	1.12%	$22.92	106.56M	0.97	43	112	155
27	Commercial National Financial Cc	1.13%	$18.55	53.07M	0.98	46	110	156
28	SmartFinancial Inc.	1.08%	$22.85	345.19M	0.93	29	127	156
29	SB Finanical Group Inc	1.15%	$19.45	143.27M	1.00	55	104	159
30	First Financial Corporation	1.21%	$46.41	629.27M	1.04	73	89	162

SHALLOW DIVE:

AAON, Inc.

(NASDAQ: AAON; Disclosure: N/A)

Price (3/3/21):	$75
Shares out (diluted):	53.1mil
Market cap:	$3.9bn
Revenues (FYE '20):	$515m
Net income:	$79m
Revenues/avg. capital	$1.60
EBIT margin:	20%
Pre-tax return on capital	32%
10-yr avg. pre-tax ROIC	32%
Insider ownership:	22%

Overview:

AAON, Inc. was founded in 1987 by Norman Asbjornson. AAON is headquartered in Tulsa, Oklahoma, and is in the HVAC industry. Specifically, AAON manufactures a line of commercial and industrial rooftop HVAC units for buildings under ten stories high. In short, it's products heat, cool, filter, control humidity, and move air within and without buildings.

AAON estimates it has a 13% market share of the great than five ton rooftop market and a 2% share of the less than five ton market (note: air conditioning units are measure in tons, which is the amount of heat it takes to melt a ton of ice or approx.. 286k BTU). Half of 2020 sales were from renovation and replacement markets and the other half from new construction. The company primarily does business in the United States.

AAON's sales organization consists of 46 company employees, 63 independent representatives across 125 offices in the US and Canada. AAON also utilizes an international sales organization with 28 distributors.

AAON's stated strategy is to operate within niche markets. It defines these niches first as buildings below ten stories and higher on the quality scale compared to its competitors.

Industry/Competition:

AAON competes in a large industry. The bigger players are Lennox International, Trane, York (Johnson Controls), Carrier, and Daikin.

$ bil	Ticker	Market Cap	TTM Rev.	EBIT %	TTM ROIC	P/E
AAON	**AAON**	**$4**	**$0.5**	**19%**	**24.6%**	**49**
Lennox International	LII	$11	$3.6	13%	n/a	32
Trane Technologies	TT	$39	$12.5	12%	8.5%	41
Johnson Controls	JCI	$43	$22.1	8%	4.3%	56
Carrier Global	CARR	$32	$17.5	11%	13.5%	17
Daikin Industries	DKILF	$60	$22.5	10%	7.1%	42

What I Like About AAON:

There's a lot to like about AAON's underlying business.

- *Basic products:* The need for air conditioning isn't going away, especially in the warmer south. Additionally, the pandemic may create a nice tailwind as building owners upgrade to more advanced filtration systems.

- *Niche market*: The company isn't trying to take the big guys head on. They focus on two main niches: buildings under 10 stories and higher-quality equipment.

- *Conservatively financed*: The company appears allergic to debt, which is always a plus. A recent expansion, including a new plant and major R&D facility, were financed with cash on the balance sheet.

- *Insider Ownership*: Insiders own 22% of the company, which includes Norman Asbjornson at 19% and his son, Scott, at 3%.

Risks/Concerns:

Management transition: Norm brought in Gary Fields several years ago and groomed him to be his successor. At the last board meeting Norm assumed the title executive chairman, while Fields was elevated to CEO. Fields appears a good manager but time will be the ultimate judge.

Competition: Will the larger players enter AAON's niche markets, especially as it gets bigger? What's really keeping them out? Or is AAON small enough compared to the market that it doesn't matter at this point?

Valuation: I'm not entirely sure what I'm missing. AAON appears to be wildly overvalued at 10x book value. Even for a company generating consistent pre-tax returns on capital in the 30% range this is very high. AAON's business appears to be a very good one, but it's one with clear capital requirements to grow.

Conclusion/Final Thoughts:

AAON appears to be a very good business with solid long-term prospects. I'm adding to the Watchlist to follow and study.

Balance Sheet ($mil)	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010
Cash	79	27	2	24	44	30	40	36	9	0	13
Accounts receivable	47	67	54	50	43	50	44	39	44	34	40
Inventories	82	74	78	71	47	38	38	32	33	35	34
Other current assets	12	20	7	8	7	5	9	6	6	15	5
Total current assets	220	188	141	154	141	124	131	114	92	84	92
PP&E, net	223	178	163	142	115	101	92	87	91	94	67
Intangibles & goodwill	3	4	4	0	0	0	0	0	0	0	0
Other	2	2	1	1	1	8	10	15	11	1	1
Total assets	**449**	**371**	**308**	**297**	**257**	**233**	**233**	**215**	**193**	**179**	**160**
ST bank lines & loans	0	0	0	0	0	0	0	0	0	5	0
Accounts payable	12	12	11	11	7	6	11	8	13	14	13
Accruals	47	44	37	39	32	37	31	29	27	20	23
Total current liabilities	59	56	48	50	39	43	43	36	40	39	36
Deferred tax liabilities	28	15	11	8	10	9	14	14	16	18	7
Other	11	10	2	2	2	2	3	1	0	0	0
Long term debt	0	0	0	0	0	0	0	0	0	0	0
Stockholders' equity	**351**	**290**	**247**	**237**	**206**	**179**	**174**	**164**	**138**	**123**	**117**
Total liab. + equity	**449**	**371**	**308**	**297**	**257**	**233**	**233**	**215**	**193**	**179**	**160**

Income Statement ($ mil)	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010
Net sales	515	469	434	405	384	359	356	321	303	266	245
Cost of sales	359	350	330	282	266	250	248	231	233	220	189
Gross profit	156	119	104	123	118	109	108	90	70	46	55
SG&A	60	52	48	49	39	37	41	34	26	22	23
Operating income (EBIT)	102	67	55	74	80	71	68	56	44	22	33
Net income	79	54	42	54	53	46	44	38	27	14	22

Return on Capital	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
Revenues	515	469	434	405	384	359	356	321	303	266
Capital employed (cash-adjusted)	333	309	256	243	193	177	168	159	154	145
Average capital employed	321	282	250	218	185	173	164	156	149	145
Revenues/avg. capital	$ 1.60	$ 1.66	$ 1.74	$ 1.86	$ 2.08	$ 2.08	$ 2.18	$ 2.05	$ 2.03	$ 1.84
EBIT margin	20%	14%	13%	18%	21%	20%	19%	17%	15%	8%
Pre-tax return on capital	31.7%	23.7%	22.2%	34.0%	43.0%	41.3%	41.6%	35.7%	29.6%	15.3%

RUSSELL 3000 BANK PROJECT:

With the help of two interns, I'm currently working on two bank-related projects. One is a simple screen of good ROA banks with a keen interest on high insider ownership.

The second bank-related project is looking for banks that may fall out/off of the Russell 3000 in June when that index is reconstituted. I was alerted to the opportunity thanks to Twitter (see social media has some positive benefits). We'll be digging into the index to see if there are some smaller banks that might get discarded come rebalancing time. Estimates are that in the range of 80 won't make the cut. Even one good name from that list would make the effort worthwhile.

WHAT'S COMING NEXT MONTH:

I won't lock myself into writing about certain companies next month. But I'm strongly leaning toward **Credit Acceptance Corp. (CACC)** It's a business I recently discovered thanks to that first bank screen mentioned above. I almost deleted it as it didn't *look* like a bank. I'm sure glad I took the time to read the annual letter to shareholders as it ranks as one of the best I've read.

I might also feature another bank if something comes out of the Russell 3000 bank project.

If you're starting to sense a theme of banks/financials you're right. Given my background in banking I'll probably spend some time on them in future issues. My intent is *not* make this a bank newsletter but I need to start where I'm strongest.

SUSPECT LIST:

I needed a place to list some companies on my radar that I'm thinking about discussing in future newsletters. These are companies I might have heard were good but can't claim any definitive insight or knowledge, or others on which I've done a bit of digging but can't definitively put on the Watchlist at the moment. I decided while writing this section that the only company that will make the Watchlist without any discussion here (yet) is **Berkshire Hathaway (BRKA, BRKB; Disclosure: Long).** I know Berkshire intimately through my five-years writing a book on the business, and it's a long-time core holding of my family and clients.

To see the latest Watchlist and Suspect List on Google Sheets, head to www.watchlistinvesting.com or click here.

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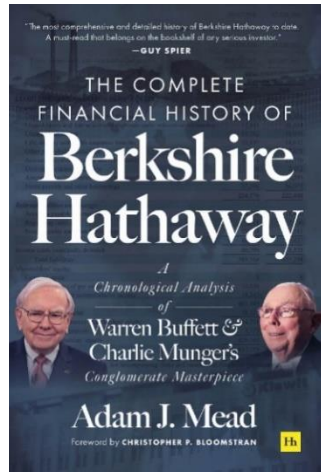
Issue #1 | March 2021

About

After nearly two decades as an individual investor, a decade in commercial credit at various banks, and a few years managing money for friends/family in the background, I decided to go full-time managing money for clients in 2020. Watchlist Investing is an extension—albeit separate and distinct—of what I do day-to-day as a practicing capital allocator. Inverting the margin of safety principle, I hope to add value to readers above and beyond the nominal cost of the newsletter.

My investing style is influenced by my background growing up in a family of business owners. I followed suit selling firewood through high school and founding a welding business in college. Looking at stocks as businesses is natural to me. My investing approach rests on fundamental value investing tenets but it's adapted to suit my style. I'm 100% certain I'm not the best investor or analyst, but I hope to improve over time.



Between 2016 and 2021, I wrote a book on Berkshire Hathaway. *The Complete Financial History of Berkshire Hathaway* was and is my passion project. I hope it brings new shareholders up to speed on the company and provide a fresh look to longtime shareholders, in addition to serving as a resource/reference book. The publication date is April 13, 2021 and can be purchased here. I also created www.theoraclesclassroom.com as an extension of the book, which includes an archive of a lot of BRK material.

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