Silicon Valley Bank, Contagion, and Regional Banks, March 13, 2023

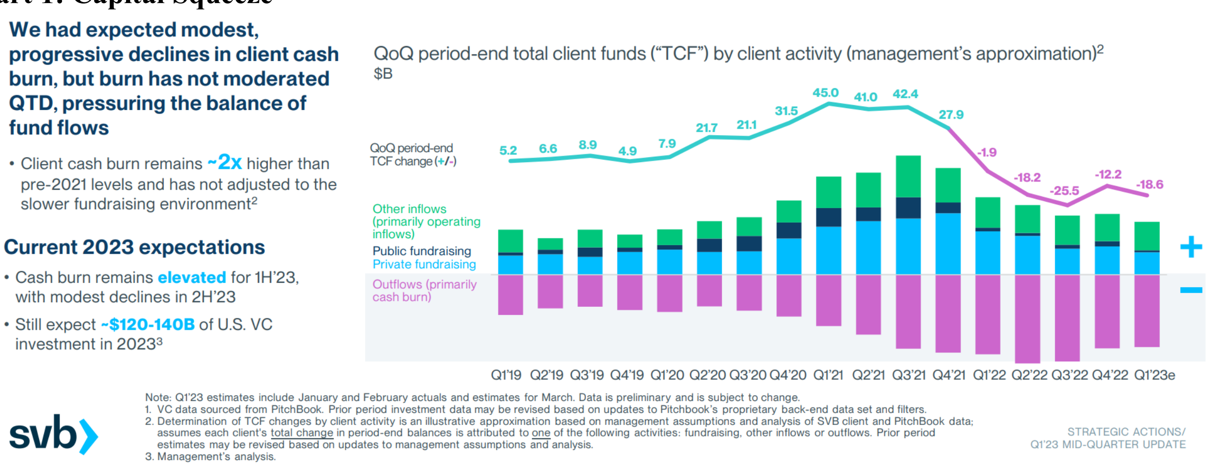
I have discussed the impact of the ‘unknown-unknowns’ events on capital markets. The bank regulators closing Silicon Valley Bank (SIVB) on Friday, March 10, 2023 is one of those ‘unknown-unknowns’ events that the markets could not have anticipated. Several of our clients have contacted us to determine if our investments, on their behalf, have exposure to SIVB. Also, our clients inquired if there are any contagion effects on other regional banks in their portfolios.

First, Decatur did not own SIVB in our clients’ account. In this brief note, I will address the SIVB event that resulted in the bank closure, explain contagion, and discuss the impact on regional banks, with a particular focus on the regional banks that we hold for clients.

SIVB was a medium sized regional bank based in Santa Clara, California with total assets of over $200B, making it one of the top twenty banks by assets in the United States. SIVB was founded in 1983 and focused on the banking and financing needs of start-ups, venture capital firms, and private equity firms in the healthcare, technology and wine industries. In addition, SIVB served the investors, founders and employees of these firms with bank accounts, mortgages, and payroll services.

Chart 1 shows how several events occurred in tandem that led to the bank’s demise. Due to weakening corporate outlooks, firms increased their cash burn rate which resulted in outflows (pink bars) of deposits. The capital market decline resulted in less fundraising on both public (dark blue bars) and private (light blue bars) markets. Plus, the increasing interest rates resulted in losses on SIVB’s fixed income investments resulting in lower operating inflows (green bars) These events resulted in a capital ‘squeeze’ for the bank. In Chart 1, SIVB estimated March outflows and total client funds decline (pink line) significantly exceeded their expectations.

Chart 1: Capital Squeeze



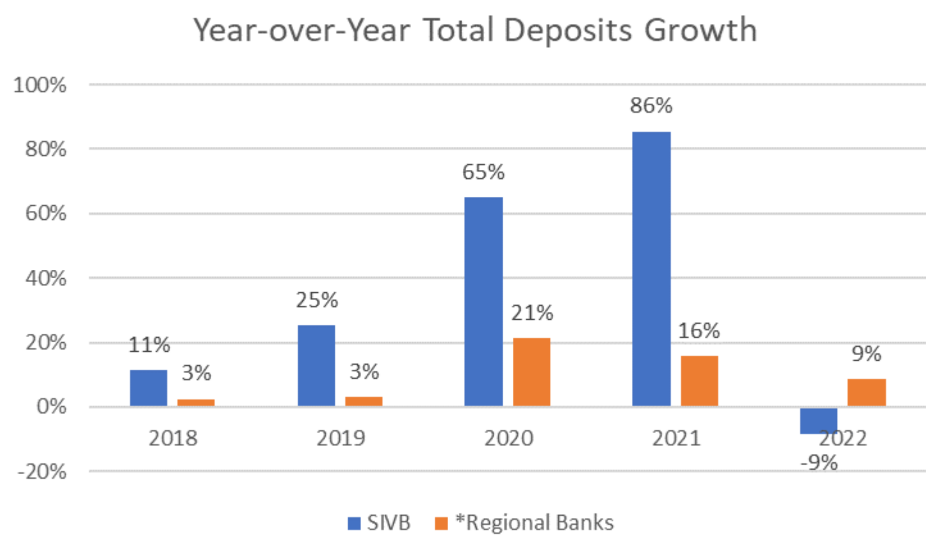
Source: SVB Strategic Actions/Q1-23 Mid Qtr Update March 8, 2023

By Friday, March 10th, SIVB failed to raise sufficient capital to cover the steep deposit outflows, and the regulators closed the bank.

Our clients asked if there will be a contagion effect on other regional banks. The term contagion refers to insolvency risk being transmitted from one financial institution to another. Many may remember that during the Great Financial Crisis (GFC) 2007 -2008, numerous banks became insolvent. The difference between SIVB's closure and the GFC closures is that the latter closures were due to the nationwide housing bubble. SIVB's closure appears to be isolated to client concentration in high risk industries. We have reviewed our regional bank holdings and none of the banks have a similar concentrated risk profile. It is important that the regional banks maintain diversification in deposits and loans. During the GFC, banks with a diversified loan book fared better than banks with a high concentration in housing loans and mortgaged-backed securities investments.

Interestingly, the surge in SIVB bank deposits should have been a warning that deposit outflows could be equally as abrupt. In Chart 2, we compare SIVB year-over-year deposit growth to Decatur's regional bank holdings average growth.

Chart 2: Y-o-Y Total Deposits Growth



Source: Zacks Institutional Services, Decatur Capital Management, Inc.

The surge in deposits appears to be an idiosyncratic issue with SIVB and not systematic to all regional banks.

The closure of Silicon Valley Bank was due to idiosyncratic issues related to a highly concentrated business model and we do not expect the insolvency to spread to other regional banks. In the short term, we do expect that there could be some negative price effect within the banking industry.