

M A I D E N F I N A N C I A L

HINGHAM SAVINGS
ESTABLISHED 1834

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Q3 2024 UPDATE

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Hingham Institution for Savings: Third Quarter Update

Hingham Institution for Saving recently released its third quarter earnings update, and I am pleased to say that the bank's earnings continue to inflect, while its balance sheet maintains a positive trend towards increased resilience.

Most comforting is improvement in the spread between Hingham's interest-earning assets and interest-bearing liabilities, which hit a low of 0.13% in Q1, and has since improved by +162%, to 0.34%. This is thanks to the rate on Hingham's interest-earning assets outpacing the cost of its interest-bearing liabilities by 382 basis points YTD, as lending conditions normalize, and loan repricing and maturation continues. Complimentary is a QoQ, +11.46% increase in net interest margin, which grew from 0.96% to 1.07%, and a +45% rise in core return on average assets, from 0.2% to 0.29%.

HIFS Quarterly Tracker							
Quarter	Q1/2024	QoQ Change	Q2/2024	QoQ Change	Q3/2024	QoQ Change	YTD Change
CROAA	0.20	17.65%	0.20	0.00%	0.29	45.00%	70.59%
CROAE	2.14	17.58%	2.08	-2.80%	2.99	43.75%	64.29%
Spread	0.13	-23.53%	0.25	92.31%	0.34	36.00%	100.00%
NIM	0.85	-4.49%	0.96	12.94%	1.07	11.46%	20.22%
Opex/Assets	0.67	3.08%	0.67	0.00%	0.68	1.49%	4.62%
Efficiency Ratio	77.24	7.91%	68.57	-11.22%	62.19	-9.30%	-13.12%
Equity/Assets	9.54	0.53%	9.59	0.52%	9.64	0.52%	1.58%
IE-Assets	4.43	0.68%	4.56	2.93%	4.62	1.32%	5.00%
IB-Liabilities	4.30	1.65%	4.31	0.23%	4.28	-0.70%	1.18%
Cash	373.25	3.10%	369.14	-1.10%	368.10	-0.28%	1.68%
FHLBB/FRBB	677.8	13.17%	725.9	7.10%	815.50	12.34%	36.17%
Total Immediate Funds	1,051.0	9.38%	1,095.0	4.19%	1,183.6	8.09%	23.17%
Net Loans	3,938.0	0.61%	3,933.0	-0.13%	3,863.0	-1.78%	-1.30%
Imm. Funds % of Loans	26.69%	8.71%	27.84%	4.32%	30.64%	10.05%	24.80%
Retail/Business Deposits	1,893.0	1.72%	1,921.0	1.48%	1,977.0	2.92%	6.23%
Total Deposits	2,392,921	1.83%	2,418,264	1.06%	2,461,132	1.77%	4.73%
Core Diluted EPS	1.01	17.44%	1	-0.99%	1.44	44.00%	67.44%

Although the reported performance is well below Hingham's long run average, the bank has managed to navigate the longest yield curve inversion on record without reporting a net loss. For a bank that holds no interest rate swaps, and finds little company in its degree of liability sensitivity (its loan book is structured as 1/4th fixed-rate and 3/4ths fixed-rate adjustable), Hingham's performance has been exceptional.

And while the bank is miles away from the late sages of its next earnings cycle, investors may take solace in two key developments. One, immediately accessible funds, inclusive of choice HLB-Option advances issued by the Federal Home Loan Bank of Boston, along with unused Federal Reserve borrowing capacity and cash on-hand, now comprise 30.1% of Hingham's loan book value. Two, since the Fed began hiking rates in 2022, not a single commercial loan on Hingham's books has entered a state of non-performance.

In addition, management recently stated that Hingham is changing its loan adjustment interval on fixed-rate adjustable mortgages from 5 years to annually, which will help reduce profitability pressure during periods of rising rates. Reportedly, customers have welcomed the change, but should any issues arise, management's close customer relationships and proven track record of sensible adaptation should see them quickly resolved.

As Hingham approaches year-end, my focus remains on three components: total deposits, immediately accessible funds, and net spread. All three metrics are critical resilience indicators, which have shown consistent improvement YTD. This is a trend I want to see continue as lending conditions normalize.

Why? Because if we see a near-term spike in inflation and the restoration of rate increases, large and rapidly accessible capital has historically proved a structural failsafe for Hingham during unfavorable lending conditions. Recent FHLB policy changes makes liquidity expansion especially salient, as member banks have seen allowable wholesale funding as a percentage of assets decrease from 50% to 40%. While Hingham's FHLB advances have never exceeded 40% of assets on an annual basis, FHLB advances presently comprise 34.4% of Hingham's assets, with 21-26% a more typical share of funds.

Data Revisitation Leads to Heightened Thesis Validation

I want to take the time to publicly thank [Dr. Pureum Kim](#), who is an associate professor of finance at California State University, Fullerton. Dr. Kim graciously invited me to deliver a guest lecture to his students on October 21st, for which his invitation inspired me to revisit my study on regional banks. To my surprise, the review led to me to discover a blind spot in my analysis that undercut the significance of reported findings.

In my original report, I hypothesized that the Great Financial Crisis and the 80s Savings and Loan Crisis were not caused by a lack of intelligence, but by a lack of good behavior. Therefore, banks with owner-operator incentive structures should show increased economic, operational, and loan book performance over non owner-operated banks on a cross-cycle basis.

Analysis of 138 banks in the SPDR S&P Regional Banking Index (KRE) revealed my hypothesis to be generally true, yet I was surprised to find business returns, as measured by return-on-equity (ROE), to be lower than expected.

In my report, I defined banks as "owner-operated" if the head executive owned at least 7 times their total annual calculated compensation in stock (OTC). But, instead of comparing the economic, operational, and loan book performance of >7x OTC to <7x OTC KRE banks, I measured >7x OTC banks to *average* KRE performance metrics, which understated >7x OTC performance.

5-Year Economic Characteristics for >7 OTC Banks				
KRE		>7 OTC		Difference
OTC X	6	OTC X	30.7	411.67%
ROE	10.57%	ROE	10.76%	1.80%
NIM	3.64%	NIM	3.82%	4.95%
NPLs	0.33%	NPLs	0.34%	3.03%
HTM securities	19.30%	HTM securities	13.50%	-30.05%
Equity-tangible assets	8.17%	Equity-tangible assets	8.89%	8.81%
Cash/non-loan assets	21.70%	Cash/non-loan assets	27.60%	27.19%
No derivatives	12.30%	No derivatives	47.10%	282.93%
Efficiency Ratio	57.40%	Efficiency Ratio	51.26%	-10.70%
GFC net charge-offs	1.81%	GFC net charge-offs	1.13%	-37.57%

By segregating >7x OTC banks from <7x OTC banks, a reproduction of the study shows substantial outperformance of >7x OTC banks over <7x OTC banks included in the KRE. Focusing on ROE, my original study showed 5-year average ROE for >7x OTC banks as having a 1.8% edge over the average. This was impressive given higher conservatism is a notable feature of >7x OTC banks, but by segregating the factor from <7x OTC banks, the ROE outperformance spread rises to a whopping 23.73%.

5-Year Average Economic Characteristics of >7x OTC Banks				
KRE <7x OTC (86.2%)		KRE >7x OTC (13.8%)		Difference
OTC x	2.3	OTC x	19.3	739.13%
ROE	8.47%	ROE	10.48%	23.73%
NIM	3.29%	NIM	3.51%	6.69%
HTM Securities (% NLAs)	17.84%	HTM Securities (% NLAs)	13.30%	-25.45%
Equity-Tangible Assets*	8.08%	Equity-Tangible Assets*	8.82%	9.16%
Cash/Non-Loan Assets*	20.50%	Cash/Non-Loan Assets*	26.10%	27.32%
Derivative-Free	8.40%	Derivative-Free	42.10%	401.19%
Efficiency Ratio	58.30%	Efficiency Ratio	51.60%	-11.49%
GFC Net Charge-Offs	1.85%	GFC Net Charge-Offs	1.57%	-15.14%

*Q3 2023

Why is this revision important?

Banking is one of the most commodified industries in America. A potato with a bank charter could take share. Yet, what distinguishes long-tenured, high-performing banks from the average is that high-performing banks tend to be run by owner-operators, with the average bank having little incentive to emulate. Indeed, just 13.8% of banks in the KRE are run by executives who hold >7x OTC.

Why is this the case?

Because there is no shortage of business to go around in regional banking, and the sector is highly fragmented. There are some 4,000 regional banks in the US, and over 600 of them are publicly traded. Among those public, even bank managers who oversee peanut-sized loan books of \$300MM-\$650MM average seven figure annual pay packages. If seven figure

compensation is the norm in regional banking, and business is plentiful, then why strive to be above average?

Beyond managerial apathy, the establishment of an owner-operator incentive structure is *expensive*. Establishment requires either the dilution of shareholders until sufficient executive ownership is had, or an executive must acquire stock on the open market, either voluntarily or involuntarily. Both options are generally unpopular.

The latter phenomenon helps explain why Hingham's model is rarely practiced, despite being one of the best cross-cycle performing banks relative to the KRE. Hingham's insiders own about 30% of the company. The business generates 50%~ more profit over the KRE average for each dollar of equity it produces. Not a single KRE bank is more efficient; Hingham is *the* low-cost producer. And despite supernormal efficiency, Hingham has the highest underwriting standards in the dataset, with unmatched cross-cycle loan book performance (just 0.07% peak net charge-offs in the GFC: a KRE-wide record!).

As mentioned, Hingham's conservatism remains, for none of Hingham's commercial loans have non-performed since the Fed's hiking cycle began. To add a cherry, management has insured 100% of depositors through the FDIC and the MDIF for over 20 years. Drop a bomb, and Hingham will likely survive it.

Courtesy of Hingham's liability sensitivity, from Vancouver to Omaha, I failed to convince one professional money manager of Hingham's merit. This is unfortunate, for the managers I spoke with based their fears not in practical considerations, such as stress testing the quality of Hingham's balance sheet, but in matters of the complex, like predicting inflation.

Sadly, investors often get investing in cyclicals wrong. Just look at the all-stars who piled into Stellantis before its recent drop.

So let me be clear. Capital deployed to cyclicals, be them compounders or otherwise, is best allocated in conditions characterized by uncertainty and subnormal profitability, where the market's focus is on the quality of a company's balance sheet. It is worst practiced in conditions characterized by optimism and supernormal profitability, where the market's focus is on a company's story. Thanks to Peter Lynch, who infected me with his love for cyclicals and financials, you will never find Maiden at a party where either category is the host.

Buy em' when it's raining. Sell em' when it's sunny. Don't get cute.

Despite Hingham's strong performance over the past year (an 80% spread over the S&P 500), the bank remains in the beginning of its earnings cycle. The company is my largest position by far; I have not sold a single share since first buying in 2023; and, I will not sell a single share until my thesis reaches maturity.

In terms of forward returns, a return to late-cycle ROE of 16%, coupled with an exit multiple of 2x tangible book, presents investors with a potential forward CAGR of 17.5%, and >18% on a total return basis from present prices. I suspect that exit conditions will be met within seven years, with the potential for material volatility a key risk for short-term investors.



To conclude, I feel deep gratitude towards to the impressive stewardship that CEO Robert Gaughen and COO Patrick Gaughen have demonstrated in their management of Hingham. Truly, I am in awe of their stalwart resistance to the institutional imperative. If I lived in New England, Hingham would be the last bank that I would want to compete with, and the only bank that I would want to work for. For those of you who live out east, Hingham offers customers impressive assurances, so it might be worth giving the bank a call. I believe they would make your business worthwhile.

As an aside, I may write a report on another standout bank at some point, but I need to be mindful of the behavioral usefulness of reports I author for my audience, especially as I shift Maiden from a contract-based research service to one that is subscription-based. If I should run out of ideas at some point, I might put its analysis to a vote.

Thank you for your continued support.

Signed,
Gwen Hofmeyr