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# Summary

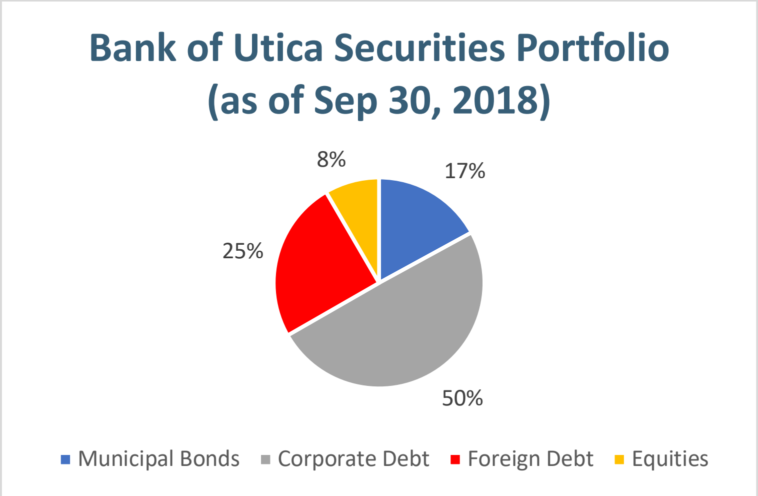

- Bank of Utica is a community bank with a unique structure that gives it a strong advantage over other banks
- The current interest rate environment, with a fairly flat short to mid-term yield curve, is particularly difficult for Bank of Utica. However, the company has still managed a 5-6% ROE in the past few years and a 1%+ ROA.
- Owner-operator management has conservatively bolstered the balance sheet for good reason and adds a further advantage over other banks
- With shares trading at 54% of book value and 10x earnings (LTM), shares are trading below their fair value


All financial data cited in this report came from the FDIC Call Reports.

# A Bank That Doesn't Look Like a Bank

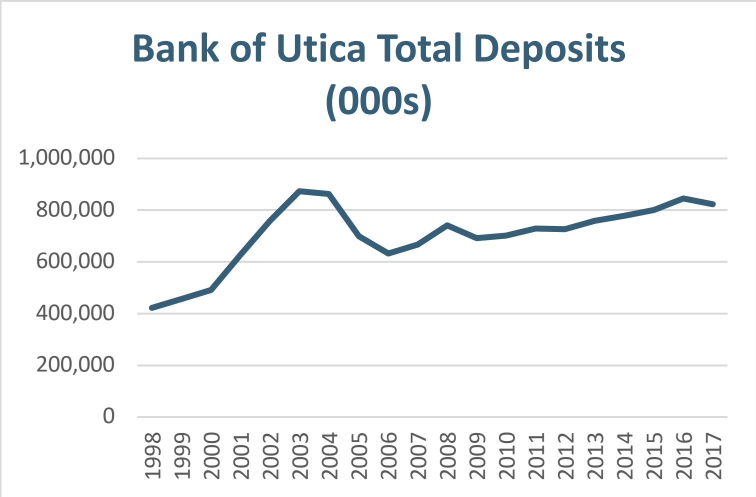
Bank of Utica ($BKUTK), based in Utica, NY, a city of about 60,000 roughly 55 miles east of Syracuse, was founded by John Sinnott in 1927 and has been operated effectively by generations of the Sinnott family since. The bank has a unique structure and a lower-risk business model that generates surprisingly strong returns on capital and is also very difficult for another bank to replicate.

The bank keeps only a small loan book, accounting for just 6.24% of total assets as of Sep 30, 2018. Instead, the majority of assets (88.7%) are invested in a securities portfolio consisting namely of investment-grade corporate (primarily domestic but including foreign), municipal, and government bonds as well as a smaller portion in equities. Not only does the bank operate a more liquid asset base, but there is also little duration risk in the portfolio. As a matter of fact, the average duration of their fixed income investments is likely between 2.5 and 3 years.



The reason Bank of Utica is able to function in this structure of accepting deposits and buying securities is the bank's extreme efficiency. The bank has only one branch and just 41 full-time employees, yet it maintains and grows a deposit base of most recently $821mm and an asset base of $1.06B. That's $20mm in deposits and $26mm in assets per employee. The bank operates with an efficiency ratio in the low 30s on average with a low of 23% in 2011. This efficiency and unique structure have allowed them to achieve an approximate 1.2% ROA in 2017 (after removing a one-time tax benefit). Many banks weren't able to achieve a 1.2% ROA in this rate climate despite having longer-duration, less-liquid assets.

Despite Bank of Utica's impressive structure, the bank has typically earned deposit business by simply paying higher rates than competitors while offering similar services. For example, currently (Nov 17, 2018), the bank is offering a 3-year CD at 3%, a rate that bests most of their competition in the area. The bank is also offering a 4 and 5-year CD, products that aren't even available at their competitors.




The bank has grown deposits at a 2.1% CAGR for the past ten years, but recently slowed to 1.8% for the past three years with a decrease in total deposits in 2017 (all timeframes ending Dec 31, 2017). An observer of interest rates will note that the past ten years and the majority of the past three years have covered decreasing-rate and low-rate environments where BKUTK's ability to pay higher rates on deposits would be a significant advantage.

Conversely, when interest rates are rising and competitors are able to continually offer higher-yielding products, the company's deposit base suffers as shown by the almost 28% decrease from year-end 2003 to 2006. Overall, it is likely the bank has some measure of competitive edge in keeping deposits due to their strong local presence and operational structure, but the stickiness of deposits isn't significant enough to be considered a long-term advantage.

# Owner-Operator Management

The bank is run by President and CEO Tom Sinnott, 3rd generation in the family, with his son, Barry, seemingly in line. Investors can take comfort in the fact that the Sinnott family are significant shareholders and competent owner-operators. The best examples of this are the changes in the securities portfolio over time. For instance, at the end of 2007, equities constituted roughly 5% of the portfolio at $28.9mm. Over the following three years, management decided to double their equity investments as a portion of the portfolio to about 10% and over triple them in absolute size to $95.8mm, taking advantage of depressed share prices.

Tom Sinnott has favored a conservative capital allocation policy with the bank's Tier 1 ratio reaching its lowest point of 13.8% at September 30, 2008. This conservatism has been especially prevalent since the financial crisis with management preferring to fortify the bank's balance sheet instead of being overly generous to shareholders. Mr. Sinnott has taken this course in spite of decreasing net interest margins, a sign of a truly long-term mindset. Equity as a portion of the bank's assets has grown from a low of 11% at the end of 2008 to 21% at the end of 2017. This is not to say the company hasn't been shareholder friendly. The bank has compounded dividends at 6.8% per year over the same time period. However, management has chosen not to initiate a quite-accretive tender offer for the bank's shares despite the fact that they have bounced between 50% and 65% of book for the past several years.

Mr. Sinnott's primary concerns, as he mentions in his 2017 President's Letter, are changes in accounting rules that could affect the bank's capital in times of stress. He is referencing FASB's ASU 2016-01, effective now, and ASU 2016-13, effective in 2020. The first requires that gains or losses in equity securities be booked on the income statement. The second requires that debt securities have an associated allowance for losses, similar to actual loans, with (paraphrasing) increases or decreases in the allowance to reflect the change in the market value of the security. In effect, this does away with HTM debt securities and will have drastic implications for the bank should there be another financial crisis. *(On a side note, this strange new accounting standard would have more dire consequences in a crisis for the owner of a liquid portfolio than the owner of illiquid term loans of similar quality and duration simply due to the availability of a, frequently irrational, quotable market.)*

Management's fears are not unwarranted. Were another financial crisis to occur today with a 35% decrease in equities and a 20% decrease in fixed income (similar to the peak-to-trough performance of the iShares IBoxx Investment Grade Bond ETF, LQD, in 2008), the bank's core capital ratio would decrease from a recent 21.7% to approximately 3.5%. The bank's tier 1 risk-based capital ratio would still most likely be above the requirement for a well-capitalized bank (6%), but it would be closer to that threshold than it's been in the past few decades. Mr. Sinnott will most likely continue to build capital until the bank comfortably exceeds that threshold in a stress-test. Without knowing what Mr. Sinnott's specific target is, we estimate that it would equate to a roughly 22 to 23% equity to assets ratio. Therefore, we don't expect much of a change in the bank's fortress-building in the next year. Past that, it's reasonable to expect increased dividends or possibly a share tender offer.

Inherently, we trust conservative operators, and view this ownership situation as an advantage. We prefer to have conservative owner-operators thinking long-term as opposed to short-term focused management catering to the whims of Wall Street.

The company has 50,000 voting shares likely primarily owned by the Sinnott family and 200,000 non-voting shares. All shares have equal rights to dividends and ownership. Investment in the company implies giving up voting power to the Sinnott family and, given that the voting shares ($BKUT) trade at a premium, the non-voting shares are the stronger investment.

# What It's Worth

In 2017, spreads between short-term rates and investment-grade corporate debt were the lowest they've been in the past decade. Even through this tough rate environment, and through the recent conservative capital allocation and fortifying of the balance sheet, Bank of Utica has generated strong returns. In 2017, the bank was able to generate a 6.2% ROE and 1.2% ROA after removing a one-time profit boost from the Tax Cuts and Jobs Act. Both returns on equity and assets as well as net interest margin and interest income have found a bottom in the past several years and have slowly increased. This should continue absent any events that rapidly increase short-term rates or compress spreads. Over the past ten and twenty years, the bank has compounded book value at 8.1% and 9.3%, respectively.

It is difficult to model the earnings of the bank into the future without making broad predictions about interest rates and the macro economy (things we deliberately avoid.) However, it's reasonably conservative to base a discounted earnings valuation on the premise that the environment will remain fairly difficult for the bank, holding net interest margins at just above 1.8%, an historically low level. Using an average of the past three years' net income (adjusted for one-time events) as an appropriate normalized earnings figure along with low single-digit growth rates to account for light deposit growth and increased yields from the bank's bonds rolling over at higher rates, our estimate of a fair value for the shares is between $565 and $600.

This valuation translates to between 61% and 65% of book value. The case can be made that the bank should trade close to book value given the liquidity of its asset base. However, we prefer to base the valuation off of earnings potential as it's unlikely the bank will ever liquidate or be purchased. Bank of Utica has paid, and never decreased, a semi-annual dividend for over 90 years. The dividend has increased at a compounded 4% for the past three years and 6.8% over the past decade, and at the current market price of $500, the shares have a yield of 2.88%. There is a possibility of a significant increase in the dividend or perhaps a repurchase by tender offer once the bank achieves management's targeted level of capital cushion.

# Risks

Over the past three years, the bank has seen its total interest income increase by about 2.6% per year. This has been outpaced by its interest expense, increasing at 4% per year for the same period, reflecting the higher cost of earning and retaining deposit business. If short-term rates continue to increase at a quicker pace than the change in yield on their securities portfolio, the bank will have a tough time growing net interest income while keeping its leverage down. Along similar lines, if rates rise quickly and the bank sees significant outflows of deposits akin to the 2003 – 2006 period, it's likely that net interest income will shrink.

Should there be another recession, as mentioned above, the bank's capital ratios could be drastically affected. However, on the opposite side of the same coin, if management operates too conservatively in their capital allocation strategy, shareholders may earn a sub-par return.

Lastly, the shares trade over the counter, and building a position of meaningful size will take weeks if not longer. Some investors consider illiquidity a risk. However, given its opportunity to create mispricings and our business-owner mindset, we generally consider illiquidity a positive.

# Disclosures

I am/we are long BKUTK.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

This article does not constitute a recommendation to buy or sell any security nor does it contain every piece of relevant information regarding the topic discussed. Any reader should make his/her own decision regarding their investments after examining all available information.

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