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STONECASTLE FINANCIAL CORP.

StoneCastle Financial Corp. - An Undiscovered Company Delivering High Quality Dividend Yield and Risk-Adjusted Returns



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CEOCFO: Mr. Bhonsle, would you tell us about StoneCastle Financial Corp. and what led you to take over the CEO role last year?

Mr. Bhonsle: About a year ago ArrowMark Partners acquired certain assets of the manager that was managing the assets of StoneCastle Financial Corp. The Company now has an advisory agreement with StoneCastle-ArrowMark Asset Management, which has managed StoneCastle Financial Corp. since the transaction. In connection with the transaction, I became Chairman and CEO of StoneCastle Financial Corp.

The focus of that change in investment manager was to afford shareholders of StoneCastle the opportunity to invest with continuity and expand the invested portfolio across all bank-related assets for regulatory capital. ArrowMark Partners has the balance sheet and depth of personnel to provide scale to StoneCastle.

StoneCastle Financial is a company that is structured as a closed-end investment management fund, that invests in bank related securities both in the community bank and money-center banking space. The company trades on Nasdaq under the symbol BANX. The company's strategy is to make long-term passive, non-control investments in bank issued term loans, senior and subordinated debt, and equity.

The company's focus is on income generation, capital preservation, and providing risk adjusted returns. Today the company is trading around an 8% dividend yield. If you were to look at the portfolio, it is made up of diversified investments across thirty states with Indiana, California and New York being the top three states in terms of exposure.

CEOCFO: What has changed at StoneCastle over the last year and how has the company evolved under your leadership?

Mr. Bhonsle: We have kind of left more of the same intact, so to speak. What I mean by that is other than bringing a big bank strategy together with a small bank strategy that was run by the legacy team, there is a lot of continuity of strategy and objectives. If you look at it from a human capital perspective, Julie Muraco, our investor relations person, Patrick J. Farrell, our chief financial officer, David Lentinello, our controller, and even the founder, Joshua ("Josh") Siegel,

all have continued after the transition. Just to mention, Josh Siegel who is the former CEO of StoneCastle Financial, serves as a board member of the investment manager.

From an investment strategy, today BANX continues to invest in community banking-related securities. What happened after the transition was, we augmented the small bank strategy with the big bank strategy, including money center banks. Today, we are a company that is actively investing in regulatory capital securities issued by money center banks, as well as community banks across the spectrum. This allows StoneCastle flexibility in the primary and secondary markets and allows us to take advantage of the most advantageous investment opportunities with the strongest positioning of providing risk-adjusted returns.

CEOCFO: *Why does that make sense for you and your investors?*

Mr. Bhonsle: From an investment perspective, the company remains focused on the banking strategy and investing in bank-related securities. Also, it is a company that is really focused on income generation, and as yields have compressed in the community banking space, we have been able to grow the earnings of the company on a quarterly basis by augmenting it with the large bank investment strategy or alternative capital securities that yield in the low double-digits, between 10% and 12%. Incremental yield and income generation has made a lot of sense to investors from that perspective. The company's ability to earn incremental returns has expanded, while leaving the risk profile of the fund the same, if not better, because the banks that we invest in are primarily all investment-grade rated banks.

"When we compare ourselves to our peers on a yield basis, we generate a meaningful amount of incremental dividend yield versus our peers". Sanjai Bhonsle

CEOCFO: *Would you tell us about relative value? That is one of the key messages about StoneCastle Financial.*

Mr. Bhonsle: As I said previously in my introductory comments, the dividend yield on BANX for StoneCastle Financial Corp., today is around 8%. When you compare StoneCastle Financial against other vehicles in the marketplace and particularly the financial services, we have over a 500-basis points advantage versus those indices, and the indices I am talking about are the XLF or the Select Financial SPDR Fund, which has under a 2.0% dividend yield today, and then the KBW Banking Index, which has a 2.4 % yield today. You can see that when we compare ourselves to our peers on a yield basis, we generate a meaningful amount of incremental dividend yield versus our peers.

CEOCFO: *Would you speak to StoneCastle's net asset value?*

Mr. Bhonsle: I think the key word there is stable. One of the things that we have started doing here over the past couple quarters is that the company is reporting its Net Asset Value now, on a monthly basis and not only on a quarterly basis. The last reported NAV as of the end of December of 2020 was \$21.44. The NAV, if you look at it over the last two years has been fairly consistent ranging in-between \$21.00 and \$22.00. We did hit a low of \$19.00 during the peak of the pandemic which was around the end of the first quarter. One thing to note that StoneCastle does not get credit for, is that the company's assets primarily are all marked by using broker/dealer quotes and we are pretty happy that it also allows for a lot of transparency to how we go about valuing the portfolio.

CEOCFO: *Would you speak to the company's credit quality? How does your portfolio team manage risk?*

Mr. Bhonsle: The company investments today are with banks primarily rated investment grade. Our overall community banking exposure is related to banks with an average score of BBB. Our money center banks are all rated in the single A to BBB range, so it is a fairly high-quality portfolio. The banks are also extremely well capitalized with tier-one ratios generally exceeding 12%. The portfolio is fairly diversified not only by exposure but also by geography.

In terms of management, we conduct extensive due diligence on all investments prior to purchase, and post-purchase. That is all the maintenance and ongoing monitoring work we do once we own an investment. The investments are

monitored by a highly experienced credit team today. The breadth and depth of the teams focused on StoneCastle Financial were not available to the Company prior to the transaction.

As part of our portfolio management process, we have regularly scheduled meetings to grow our investment portfolio, to discuss macro scenarios, and to discuss the individual investments that we hold. We analyze various scenarios in terms of market conditions and in terms of investments so that we can make a decision whether to sell any particular investment or hold on to it.

CEOCFO: *What might your team look at that less experienced and knowledgeable people might not take into consideration?*

Mr. Bhonsle: ArrowMark Partners today is a fairly large manager that has many different verticals managed within the firm. We cover everything from equities to fixed income, alternative fixed income, and private debt. The firm itself has a lot of institutional knowledge that we all bring to bear when we make decisions across each one of the verticals. From that perspective, getting industry and/or macro views is fairly easy for our analysts because of the resources that are available internally. StoneCastle Financial now has the advantage of this deep bench.

Within that, we have a team that is just focused on the banking space and these are experienced folks with twenty plus years of experience and have looked at and invested in banks within various cycles such as the great financial crisis and the pandemic. These investment analysts are familiar with banking regulations and what is changing there, what is expected to change in terms of regulations and how they are going to impact banks. Having that kind of wherewithal and knowledge is very important to make the right investment decisions for a long-term strategy.

CEOCFO: *In your last management call you spoke about StoneCastle Financial and the community banks in terms of an impact investment. Would you expound on that? Do you see people being more concerned about impact in their investments?*

Mr. Bhonsle: I'm glad you asked this question. To answer the last part of your question, absolutely. ESG (Environmental, Social and Governance), along with impact is a growing discussion among investors and the broader stakeholder community and that is not missed by us. One could argue that it is about time people are considering and discussing ESG and impact going forward. If you were to look at community banks, they have a significant and positive impact when you look at the local markets in terms of community development, financial inclusion, and job creation.

If you just look at the last stimulus package that came out last year, the PPP loans, which were made to businesses that were shut down, or used to continue employment while businesses were required to shut down; if you look at the amount of PPP loans that were made by the banks across the community banking space and money center banks, community banks accounted for a significant portion of the distribution of those PPP loans. Of those PPP loans that the community banks made, a decent amount went to minority-owned and women-owned businesses.

In terms of numbers if you were to look out there, 74% of all the minority-owned businesses got their loans from a community bank. 73% of all the women-owned businesses out there got their loans from a community bank. 64% of all the veteran-owned businesses out there got their loans from a community bank. You can see the impact that community banks have in supporting these businesses. Community banks exponentially serve their local and rural communities and provided PPP loans to 98% of the economically distressed or low-income counties in the US, so that is a meaningful impact. For those investors seeking an impact play on local markets, we believe StoneCastle Financial at nearly an 8% dividend yield, should be under consideration.

CEOCFO: *COVID significantly impacted the credit markets in 2020? How are the credit spreads in the market today and what do you think 2021 will bring?*

Mr. Bhonsle: To give a bit of a background, if you look at the 1st and 2nd Quarter of 2020, there was a significant dislocation in the markets. You saw asset prices plunge and the risk premium increased pretty meaningfully. A lot of that if you think about it, was driven by technical factors; a lot of forced sellers, and people that had too much leverage in their funds that unfortunately had to sell assets to cover the calls on their leverage facilities. There was a lot more

technical and yes, there was a lot more fundamental issues out there too, but it did not warrant the kind of gapping out on asset prices. If you look at Q-1 and Q-2, in the beginning of Q-2 there was a lot of waiting from investors to see where the dust settles and how to value risk going forward. During that time, in the first half of 2020, risk premiums had increased pretty meaningfully, but as the year continued and people got transparency, where there was a lack of transparency before, and then saw what the Fed was able to do, basically flooding the system with a ton of liquidity; a lot of people started to get comfortable with the certainty that the credit market spread would contract meaningfully.

Where we sit today and looking back on 2020, asset prices pretty much rebounded all the way back to pre-pandemic levels, however there is still an increase of risk premium versus pre-pandemic levels. If you looked at community banks, they issued a meaningful amount of sub-debt during that time to shore up the balance sheets and to be opportunistic in the markets if needed. In the latter half of 2020, banks were still able to issue sub-debt at 4% or 5% range and that was probably incrementally about 50 basis points wide to pre-pandemic levels, so that shows you the markets view on community banks and how stable they are and how well capitalized they are.

Going forward in 2021, we are cautiously optimistic in terms of the economy, but we do need our businesses to open up on a sustainable basis, so the vaccine roll-out is very key. There were some early missteps in the roll-out but the states are dealing with the issues that are plaguing them, and they will get it fixed. And as more and more people get the vaccine and there is more certainty in the markets, you will see the economy open up; so, we are cautiously optimistic, but again, the economic recovery is dependent on not having more missteps related to COVID going forward. One of the challenges that I do see with the banks is loan growth as deposits have increased meaningfully at these banks and so loan growth as a metric will be key. If you look at the last couple of quarters, net income for banks has increased nicely.

CEOFCO: *How have the market spreads impacted alternative capital issuances, both primary markets and secondary markets?*

Mr. Bhonsle: The spreads usually do not impact the issuance of capital securities. It is really a balance sheet tool for large banks to manage their capital ratios. In 2020, it was a fairly active year for the issuance of alternative capital securities, fourth quarter was extremely busy, so we expect 2021 to be also a fairly active year in primary issuances of capital securities.

CEOFCO: *What would you like new investors who are considering StoneCastle Financial Corp. to know about the company, and what if anything might someone miss when they are looking at the company?*

Mr. Bhonsle: StoneCastle Financial is a company that is focused on income generation and capital preservation and its investments are primarily in investment grade rated banks. From a risk perspective, fairly low risk in our opinion. When you look at the relative value versus its peers, it generates over a 500 basis points incremental dividend yield, and you are looking at investment grade risk across our portfolio.

I think what might be missed with our potential investors is that we are a fairly large manager that manages assets across different verticals and from a resources perspective the company has access to a lot of resources it can rely on, and that was very much evident during the pandemic when we were able to take advantage of buying relatively cheap alternative capital securities in the secondary market; something that was not available to the company prior to the transition to ArrowMark Partners.

We do sometimes get lumped in with other BDCs, but we are not a BDC. We are a company structured as a closed-end investment management fund, that invests in banking related securities. They are completely different from other private debt type investment funds. Those are two things that I would like to mention to people that are not that familiar with who we are.