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FOURTHOUGHT PRIVATE WEALTH

Silicon Valley Bank Update

On Friday, Silicon Valley Bank (SIVB) was closed by regulators, marking the largest US Bank failure since the Global Financial Crisis in the late 2000s and the second largest in US history. Investors are understandably focused on the risk of financial contagion, or the spread of financial distress from one institution to others, following the FDIC decision to put Silicon Valley Bank into receivership on Friday. This note addresses frequently asked questions regarding last week's development and critical investment considerations from here.

Background Information – Silicon Valley Bank

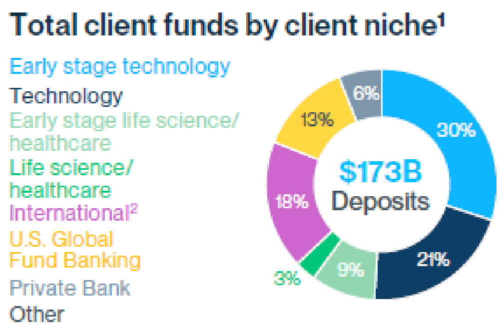
Silicon Valley Bank (SIVB) primarily services customers in the technology and life science industries, venture capital, and private equity firms. The bank strongly focuses on supporting startups and emerging growth companies and provides a range of financial and banking services tailored to the unique needs of these industries.

Silicon Valley Bank had several unique vulnerabilities, such as:

1. High Industry Concentration

SIVB's customer base was dominated by technology start-ups and venture capital firms that fund them. SIVB publicly stated that in 2021 nearly half of all US venture-backed start-ups were customers. Furthermore, in the company's Q4 2022 earnings report (**Exhibit 1**), almost all bank deposits came from Tech or Healthcare companies.

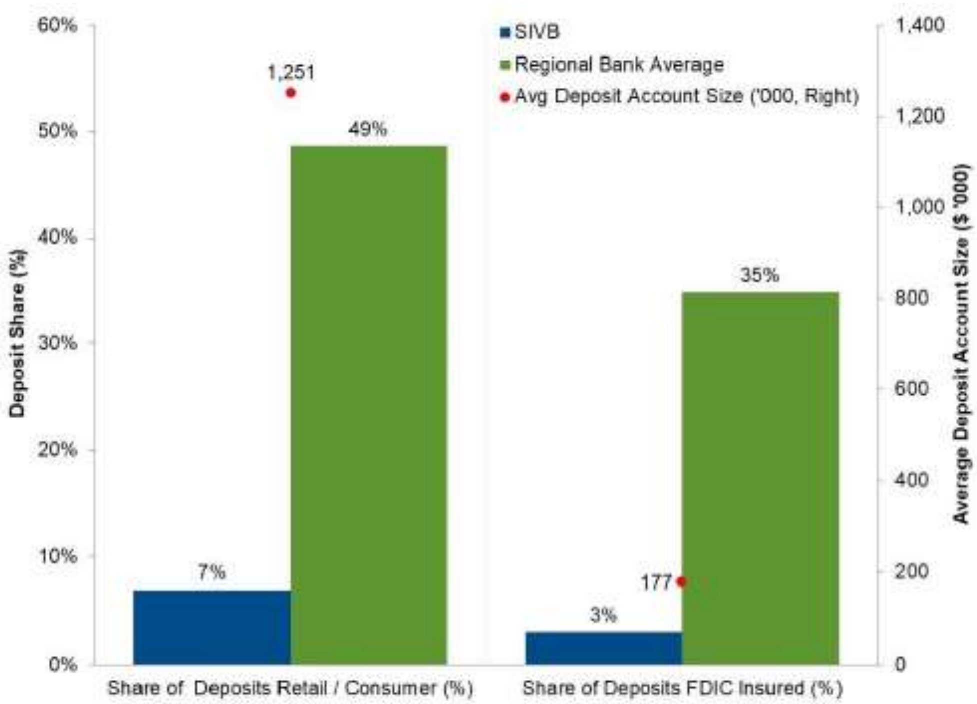
Exhibit 1*



*Source: FactSet Global Research, SVB earnings filings as of Q4, 2022

As the operating environment became more difficult for these firms over the last year, they began to draw down their deposits more quickly than expected. The broader banking industry has a more diversified deposit base with an average account size that falls within the existing FDIC guarantee (**Exhibit 2**).

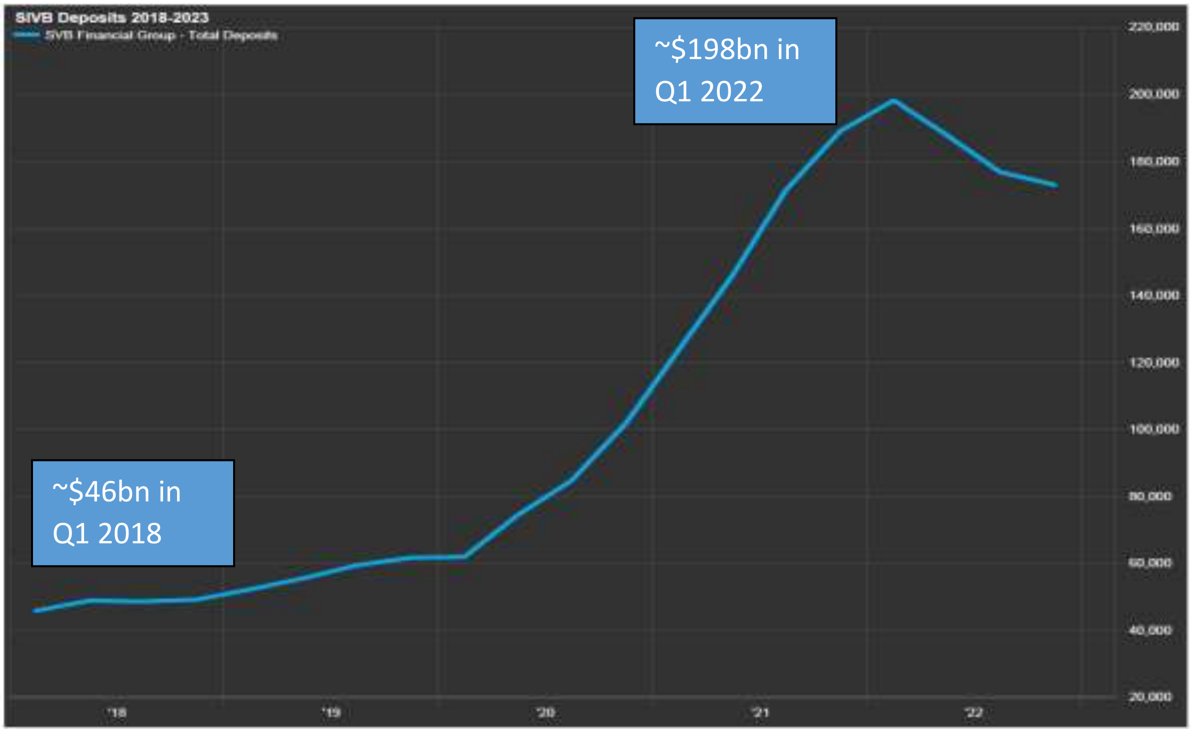
Exhibit 2: Deposit Characteristics of SIVB Relative to Other Large Regional Banks



Source: Investment Strategy Group, Bloomberg, Goldman Sachs Global Investment Research. Regional Bank average is an average of 15 large regional banks.

2. Rapid Growth In Deposits

Coming out of the pandemic, there was a surge in technology fundraising and IPOs as venture capital fund flows were high, rates were near zero, and private equity valuations were at a record high. As seen in **Exhibit 3**, SIVB's deposits grew 330% since the beginning of 2018, going almost vertical in 2020-2021. In contrast, the banking industry's deposits grew a more modest 34% over the same period.



*Source: FactSet Global Research – SVB Financial Group Deposits

3. Rapid Growth In Lower-Yielding Securities

Because SIVB's deposits grew faster than its loan book, the bank deployed the excess funds into securities, namely low-yielding Treasury and agency bonds in 2020 and 2021. The rapid deployment of funds into these securities at lower yields left the bank vulnerable to mark-to-market losses as interest rates rose over the last year.

Silicon Valley Bank had a much higher concentration of securities relative to deposits than the typical US Bank. As of Q4 2022, SIVB invested about 70% of deposits into Available-for-sale (AFS) and Held-to-maturity (HTM) investments versus just 27% for the average bank.

4. A Pause in Private Equity/VC

What impacted SIVB the most was the significant increase in interest rates over the last year, which created a double-edged sword for SIVB and its customers.

On the one hand, the increase in interest rates led to a bear market for equities which was especially felt in growth stocks. Since growth stocks are valued on cash flows well into the future, discounting at a higher rate impacts growth stocks more than defensive stocks, which are typically already mature businesses.

This effect is even more impactful on start-ups and early private growth companies that often rely on public comparable valuations when they IPO or need to raise additional money to stay afloat and are much riskier in nature. Since these private companies did not want to IPO at a much lower valuation, the IPO market virtually shut down as 2022 US IPO proceeds dropped 92.5% from $350bn in 2021 to just $26bn last year – driven by a significant drop in IPO activity. The reduction in IPO and venture capital activity in 2022 dried up new capital flowing into private companies, ultimately leading to a drawdown of deposits at SIVB.

On the other hand, SIVB has to liquidate some of the fixed-income securities they bought in 2020 and 2021 to fulfill client withdrawal requests and federal capital requirements put into place after the financial crisis of 2008. However, since interest rates increased substantially over the last two years, SIVB carried unrealized losses on its securities book. In fact, the unrealized losses on SIVB’s securities essentially exceed its entire tangible book equity, which led to FDIC stepping in on Friday to take over.

Summary

To summarize, several factors led to the abrupt collapse of SIVB. Most of SIVB's clients include tech and venture capital companies. SVB offered relatively higher deposit rates to attract clients than many larger rivals. To help fund these higher rates, SVB bought bonds in prior years when it was cash rich. But that was before the Fed began hiking rates aggressively, and the venture capital market experienced a significant slowdown. The value of most of those bonds SVB purchased has declined substantially (bond values generally decrease as interest rates increase), resulting in looming investment losses.

In short, we believe the forceful policy response announced Friday—together with the idiosyncratic nature of SIVB’s vulnerabilities and the otherwise healthy fundamentals of the broader banking system—lower the risk of contagion. That is particularly true today since the main concern is not credit quality (as it was during the Global Financial Crisis) but rather interest rate risk/mark-to-market losses on otherwise high-quality securities.