PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q1 2020

IN Q1 2020 COVID-19 DRAMATICALLY EFFECTED THE COUNTRY AND FINANCIAL MARKETS

We hope this letter finds you and your family in good health and that you are doing the best you can to deal with the COVID-19 pandemic.

As you know, the pandemic has caused a critical public health emergency and the near shutdown of most non-essential parts of the economy. While we are confident of the country's long-term ability to rebound strongly when the health crisis has passed, the crisis has done significant damage to the economy and financial markets, and most certainly to bank stocks.

Bank stocks in total significantly underperformed the overall stock market and had their worst quarter ever, including the Financial Crisis. This is by far the worst quarterly results in the Partnership's history.

This is a stunning change of circumstances given that the economy and bank stocks were in great shape a mere three months ago. The average bank in the Partnership had a very strong Return on Tangible Common Equity (ROTCE) of approximately 14% in 2019. Bank M&A was running at record levels. Unemployment was 3% and most companies had trouble filling open positions with skilled workers.

As you know, economic activity has been severely impacted during this period and banks are of course at the center of economic activity in every community in the country. While the majority of the banks owned by the Partnership are in places such as Indiana, upstate NY or western PA, which are not currently COVID-19 hotspots, no place in the U.S. is immune from the impact of this crisis.

Despite these challenges, <u>every bank</u> in the country is open for business despite most of their staff working remotely. It is encouraging to see all the effort banks, brokers and other businesses put into business continuity and disaster planning is paying off. Banks are considered an essential business in every state's pandemic planning. Banks are properly servicing their customers, despite many banks closing their lobbies to customer traffic, by relying on video teller ATMs, drive-thrus and mobile banking. [One of the likely results of this will be that banks and bank customers will learn to live with less brick and mortar branches; a significant cost savings in the long run for banks. That's a topic for another day.]

We are doing our best to understand the short and long-term implications of the health crisis on the banking industry and the banks owned by the Partnership. In this letter we share our current thoughts and observations.

Of course, there are many uncertainties in any forecast at any time, no less in a pandemic, where a significant portion of the economy is shut down for an extended period. These are all predictions based on current information.

This letter is long. For those of you who don't want to read the entire letter, here is the summary:

1. Bank stocks have been hit as hard as any sector of the stock market. The volatility in stock prices and the rapidity of the declines is unprecedented.
2. The market has overstated the losses banks will actually incur.
3. Most banks will "come out the other side" of this crisis with their Tangible Book Value per share (TBV) and franchise value intact. Why? No dilutive capital raises are expected due to excess capital today. Earnings for most banks will be sufficient to absorb loan losses (so even if the bank makes no money, the loan losses will not eat into TBV).
4. At current stock prices, it almost doesn't matter what the EPS is in 2020 or even 2021. Merely maintaining TBV when this is all over would allow most bank stocks to ***double*** from current prices.
5. Even if individual banks lose money in 2020 and 2021 and their capital ratios decline a bit, if they do not have to raise more capital (issue more shares), the normalized earnings and long-term franchise value of the bank is

unchanged. That is why today's excess capital is so important.

6. The exact amount of bank loan losses and revenue declines are impossible to predict currently but they would have to exceed the cumulative losses taken in the Financial Crisis to justify where bank stocks are trading. We do not believe losses in this crisis will exceed losses incurred in the Financial Crisis. Banks can handle the loan losses.
7. Banks will be part of the "solution" not part of the "problem" the way they were in 2008-09. This is an economic and health crisis, not a banking crisis.
8. Banks were in great financial conditions going into this crisis which will help them weather the storm.
9. Banks have substantially more capital than in the Financial Crisis. This will enable them to service their customers, absorb credit losses, and pay dividends. Most bank stock repurchases are on hold.
10. Banks will avoid doing dilutive capital raises, thereby allowing existing shareholders (such as the Partnership) to enjoy 100% of the rebound.
11. Bank regulators are incredibly proactive and supportive of banks now, unlike the Financial Crisis.
12. Bank M&A is on hold until likely late 2021 or 2022 when it will come back strongly.
13. Most banks will maintain their current dividends. Dividend yields are currently very attractive.
14. Banks will work with effected customers. Loan accommodations by the banks and direct assistance by the federal government will enable many businesses and individuals to make it to the "other side" of the crisis.
15. The duration of the economic shutdowns will dictate the amount of permanent damage done to the economy. A durable return to normal will only come after COVID-19 testing is ubiquitous, treatments are effective, antibody testing is available and a vaccine is widely available and effective.
16. The federal government has reacted quickly and proactively to provide economic and monetary stimulus, in massive, unprecedented amounts.
17. Interest rates are low and will stay low for several years. Bank net interest margins will be under pressure. Banks will need to find cost savings to offset the revenue declines (after the crisis is over).
18. Unlike non-banks, banks will have no trouble getting the funds needed to service their customers, validating the bank funding business model.
19. Banks will prove how valuable and necessary they are while many non-bank lenders and fintechs will prove how fragile their business models are.
20. The economy, businesses, individuals and banks will get through this after a significant period of disruption.
21. At some point, the stock market will see beyond the near-term crisis and bank stocks will begin to recover. Timing of that is impossible to predict.
22. Every 10-20 years there is a crisis. This one was unexpected and gave little warning. There will be a substantial recovery in bank stocks and the economy, just like there was for years following the S&L Crisis (1989-91) and the Financial Crisis (2007-09).

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Here are some additional thoughts elaborating on the Summary above.

Banks and bank stocks have been hit simultaneously by 4 major, interrelated events:

(1) COVID-19: The virus has caused a major public health crisis leading to economic shutdowns, financial market downturns, credit and money market dislocations, and rising unemployment.

(2) Falling interest rates: The Fed significantly lowered interest rates in response to COVID-19. Banks do better when interest rates are higher.

(3) Dysfunctional credit and money markets: Various parts of the credit and money markets are severely stressed. Liquidity (available credit) for many market participants has not been available. Many fixed income securities have dropped in price despite the Federal Reserve's massive intervention in the credit market.

(4) Lower oil prices: Oil prices cratered in Q1, as the economic downturn from COVID-19 overlapped with a price war between OPEC and Russia. While most banks have no or minimal exposure to oil and gas borrowers, some do.

Below we project how these 4 issues will play out and how banks will be impacted and respond. Of course, the common denominator is the virus and the related public health crisis. Good, or bad, news on that front will have significant impacts on all of the other issues.

(1) COVID-19 will be a critical health crisis for the next 2 months, and a major health crisis for the succeeding 12 months. The virus fades in summer 2020 then comes back in late 2020 and early 2021; treatments and testing get progressively better, and eventually a vaccine will help mitigate it. The economic fallout will be sharp and severe but the recovery will also be robust once closed businesses begin to reopen and unemployed or underemployed individuals go back to work. Massive federal stimulus and programs enable most individuals and businesses to get through the crisis. And not all businesses are currently closed. Many are open and providing essential services.

Banks will work with their customers to help them bridge the gap between now and the reopening of the economy. Bank earnings will be reduced by credit losses, but most banks will come out of this with their earnings power and tangible book value ("TBV") substantially intact.

(2) Low short-term interest rates will be here for at least the next 2 to 3 years.

Banks net interest margins will decline in 2020 and 2021 because banks do better in higher interest rate environments, but they will adapt to low short-term rates. After all, short term rates were at today's levels for most of the post-Financial Crisis period (through 2015) and the banks generated increasing earnings almost every year during that prior period of ultra-low interest rates. Deposit pricing has already come down and many banks thus far have been able to maintain lending rates. Prepayments of higher rate loans will slow dramatically because customers will be unable or unwilling to change banks in the crisis.

(3) Dysfunctional credit and money markets will gradually get better. The massive amounts of money and programs provided by the Fed will ease much, but not all of the pain. Agency, Treasury and investment grade securities will recover first. Non-investment grade and private label securities will recover less quickly. Losses will be incurred by investors who hold those securities. Fortunately, most community banks are not materially impacted by this. It's more of a Wall Street and non-bank problem. The big banks on Wall Street will work their way through this given their high liquidity ratios and reduced risk exposures versus 2008-09. Some non-bank market participants (e.g. mortgage REITs, leveraged funds, high yield bond funds, etc.) will be severely damaged or liquidated.

(4) Oil prices will be depressed until the economy begins to recover, oil producers shut-in production and OPEC/Russia work together to reduce their output. While most banks have no energy industry exposure, those banks with energy loan exposure will incur energy loan losses. Most energy exposed banks will manage through this the same way they did in the last oil downturn in 2015-2016. And most energy industry focused banks have less exposure today than they did in 2015-16. Consumers and businesses that use energy will benefit from lower oil prices.

It is important to note that virtually all of the Partnership's losses are unrealized, due to market price declines, not realized losses because we sold the stock. That comment is not intended to diminish the magnitude of the losses. It's meant to show that we are positioned for potential recovery in those positions.

The banks owned by the Partnership will not fail. Most of these banks have been around for over 100 years and survived all types of crises (e.g. WW1, WW2, the Great Depression, recessions, 9/11, financial crises and other pandemics).

While 1958 is not like 2020, the 1957-1958 flu pandemic is instructive because its comparable in scope to COVID-19. Approximately 115,000 died in the U.S. (over 200,000 today population adjusted). Many of the fatalities were not elderly because most people over 65 appeared to have an immunity from prior exposure. Up to 45% of the population may have been infected. The flu arrived in the U.S. in June 1957 and accelerated in the Fall of 1957. In Q4 1957 the economy went into a recession. Unemployment hit 7.3%. Notably, the recession only lasted for 3 quarters and by mid-to-late 1958 (one+ year after the virus first hit) the economy was back at record levels of production and employment. GDP in 1959 was up +8.4%. And FDIC historical records show that U.S. banks were profitable in 1957, 1958 and 1959. Bank net income in 1958 was +14% over 1957, despite the pandemic and a severe recession. Notably, in the 1957-58 pandemic there were few closures of businesses and schools, which likely raised the toll in human lives but reduced the depth and length of the recession. There was also a vaccine that was available quickly, by the end of 1957. Apparently, it was a mutation of flu against which a previous vaccine was effective (unlike COVID-19 which experts say requires a completely new vaccine to be engineered and produced—likely in 12-18 months). Conclusion: The U.S. economy has demonstrated it can come back strongly from a pandemic.

***Not only will banks survive this crisis, we believe very few banks will be forced to raise capital as so many banks had to during the 2008-09 financial crisis*.**

A bank analyst on CNBC recently said it well when he rightfully pointed out that banks will be "part of the solution" this time around, not "part of the problem" the way the banks were in 2008-09. We agree with him. Coming into this crisis banks were arguably in the strongest condition they have ever been.

Capital ratios are generally 50% greater today vs 2008-09. Most banks have excess capital. The vast majority will not raise capital.

The economy and banks were in great shape a mere month or two ago, which will make the recovery more viable.

Avoiding capital raises is critically important to existing shareholders. If banks do not raise additional capital, existing shareholders such as the Partnership will fully participate in the recovery, without dilution.

Not only will most banks avoid raising capital, the majority should maintain their current dividends. A recent Goldman Sachs research report on the largest banks in the U.S. noted that they should be able to maintain their dividends even if loan loss provisions in 2020 are above the peak taken in the Financial Crisis. Note: Goldman's large cap bank loan loss projections for 2020 do <u>not</u> factor in any mitigating benefit from the impact of the federal programs put in place.

That same report from Goldman Sachs projects that the largest banks will report a net loss in 2020 (-3% ROTCE) as they absorb those projected peak loan loss provisions, followed by a rapid recovery in 2021 and 2022. 2021 and 2022 ROTCE is projected to rebound to 14%, on par with 2019.

And banks have strong liquidity positions to meet their customers' needs ("liquidity" is cash and assets that can be converted to cash quickly and liabilities that can be reliably accessed to generate cash). Liquidity ratios are much stronger today vs. 2008-09.

It is important to note that banks have been able to fund all their liquidity needs with deposits and readily available sources of funds, unlike non-bank lenders, mortgage REITs and fintech lenders who are overly dependent on unstable external funding sources. This crisis has damaged banks, but not because of their funding. Other lenders are being hurt by unstable funding as well as other problems. Banks are more stable because of funding from insured deposits. It will be interesting to see if non-bank lenders survive with their current business models intact. Its times like these when all lenders wish they were banks to have access to stable bank funding.

Banks are likely to get more deposits in the coming months, as nervous investors sell assets and/or flee uninsured money market funds for the safety of FDIC insured bank deposits.

Most banks have strong loan loss reserves. Many had to go to extraordinary lengths to convince their independent auditors that their higher reserves were justified. Additional loan losses will be needed, but not to the level implied by current market pricing.

The FDIC deposit insurance fund's reserve ratio is at the highest levels since the early 1960s. In the Financial Crisis and S&L Crisis, the FDIC fund briefly went negative (causing the FDIC to borrow from the Treasury). This crisis will be shorter lived than the Financial Crisis, and very few, if any, banks will fail due to this crisis. The FDIC will have minimal strain on it, unlike the pressure it felt during the Financial Crisis when many banks failed.

Banks will grow their balance sheets at the fastest pace in years, as they support the economy and work with their customers. Bank regulators and politicians will be supportive. This will support bank profitability.

The vast majority of bank loan customers will remain with their current bank(s). This lack of customer movement will reduce loan prepayments and rate reductions. This is good for banks because in 2019 many banks were lowering their loan pricing and easing terms to compete with other banks, in order to hold onto their customers. Many banks also experienced increased loan payoffs and prepayments as assets and loans moved outside the banking industry due to aggressive terms and structure offered by non-bank participants.

Banks will have pricing power <u>and</u> leverage in the relationship with their customers for the first time since the Financial Crisis. Bank customers will be concerned about the availability of credit, not the price and terms. This should support bank net interest margins, even as overall market interest rates decline. And the customers will be well served by their banks.

Bank regulators and politicians are working proactively with banks. In 2008-09 the banks were under attack by regulators and politicians and many banks were too weak and inwardly focused to significantly help their customers. Today, banks will work with their customers to help the customers get through this crisis.

Loan payments for legitimately impacted customers (consumers and businesses) will be deferred for a period of time during the economic shutdowns. Most banks are allowing eligible borrowers to defer loan payments for 90-180 days. Some, but not all, of these loans will be extended again once the initial extension period expires. While this is not a viable long-term solution for the bank or the borrower, it is appropriate for a limited period of time if it allows the business or consumer to get back to normal. Foreclosure actions will only be taken where absolutely necessary.

In general, banks will continue to accrue and record interest income on these deferred interest payments (the deferred interest will be added to the back end of the loan balance) and will not have to record credit losses on these loans merely because the loan is in deferral. Of course, if the bank does not believe the borrower will be able to repay the loan, even with the accommodation, the bank will stop recording interest income and record a loan loss. Very importantly, the regulators are proactively supporting this patient, accommodative approach.

Bank loan deferrals are only for those legitimately impacted. It's not for every customer that asks and it's not loan forgiveness. There will be fraud and misallocations, but that is acceptable given the urgent needs of effected consumers and businesses.

The Federal Reserve has injected massive amounts of monetary stimulus into financial markets and the economy. The U.S. Treasury has also implemented significant fiscal stimulus and relief programs to help businesses and individuals. As much or more than in the Financial Crisis.

Individuals who lost their job or have reduced income will hopefully get those jobs and income back when the shutdowns are lifted. Don't forget that most businesses were unable to find enough workers to fill all their job openings a mere month ago, when unemployment was ~3%. The federal government has provided enhanced federal unemployment insurance benefits on top of state benefits, and significant assistance to small businesses to maintain their workforce.

Banks will work with these effected individuals to defer payments on all types of credit card, mortgage and car loans. The key is getting everyone back to work as safely and quickly as feasible.

Certain businesses and real estate projects will not survive this crisis and even some that do will have diminished earnings capacity or value. For the most part, banks have senior liens on assets of a company, or first liens on real estate, and should be able to recover some of these losses if they ultimately must foreclose on a loan. Most banks will work extensively with these customers, before pursuing foreclosure, if the borrower has long-term viability.

Elevated credit losses will be incurred by all banks in all parts of the country due to this crisis. The amounts will be material but not as draconian as the market is pricing in. Loan losses is clearly an area we will focus on heavily in the coming months and quarters.

As one brokerage firm analysis stated, "***to illustrate the foundational strength of the bank sector, consider that the regulated banking system today could absorb all of the realized losses incurred during the Financial Crisis and still have higher capital levels than the sector did heading into the Financial Crisis.***" That sums up our view better than we would have said it.

While it is our view that the loan losses in this crisis will be less than the Financial Crisis, and the length of this crisis will be shorter, the ***duration*** of the economic shutdowns due to the virus will dictate how much permanent damage will be done to the economy, businesses and consumers.

Once we get past the public health crisis, the economy will be buoyed by the massive fiscal and monetary stimulus thrown at this crisis. Multiple trillions of dollars are being deployed by the Fed (through more Quantitative Easing or "QE", in which the Fed buys securities in the open market) and the U.S. Treasury (through tax reductions, grant programs, loan deferrals, loan programs, loan guarantees, spending, etc.). The amounts deployed in 2020 will likely exceed the amounts deployed in the entire Financial Crisis. The Fed and Treasury are being very proactive in this crisis, unlike the Financial Crisis when they were reactive.

While we have long term concerns over whether the Fed will ever reduce its balance sheet, or the U.S. Treasury will ever balance its budget, in the near term these measures will be a strong bridge to get past the worst short-term impact of the crisis and significant stimulus for the post-crisis recovery. One step at a time.

Because of the many unknowns, the market quickly shifted from valuing bank stocks on a forward earnings basis to a tangible book value basis.

Bank stocks declined more than the market because they quickly went from trading on an earnings basis (Price to Earnings or PE ratio) to much lower metrics based on tangible book value (TBV). Think of the PE ratio as the "normal times" valuation ratio and TBV as the "crisis or recession" ratio. The gap between the two is large. The market shifted its view of bank stocks from PE ratios to TBV ratios in approximately 30 days. Unprecedented in our over 35 years of experience. Normally this occurs over many months and quarters as an economic slowdown unfolds.

For example, one position in the Partnership is Comerica (Symbol: CMA). It went from trading at $72 at year end to $29 at quarter end, a -59% decline YTD. CMA earned $7.87 in 2019 and has $47 of TBV per share. CMA was trading at a premium to its TBV at year end 2019 (152%) because the market focused more on the PE ratio to value the stock. At the quarter end price of $29 the Price to TBV ratio was 62% and the dividend yield was 9%. While CMAs earnings will clearly decline in 2020 and 2021 vs. 2019, and they might even record net losses, CMAs earnings almost don't matter to the market right now. The market believes that CMA will have significant net losses and that CMA's TBV is at significant risk due to potential credit losses.

Is the market correct? We don't believe so. CMA would have to write off over 7% of its entire loan portfolio to reduce its TBV ($47) to the quarter end market price ($29). To put that in context, in a typical year CMA writes off ~0.30% of its loans. So, losses would have to be 25x greater than normal to reduce TBV to the current market price. **And in the entire <u>four</u> years of the Financial Crisis (2008-2011) CMA's cumulative losses were ~5%, less than what the market is pricing in today for what is likely one to two years of extraordinary loan losses.** We do not believe CMA will write off over 7% of its loans nor do we foresee this crisis lasting as long as the Financial Crisis. CMA should actually grow its TBV by the end of this crisis. Even if we are wrong and there is some diminution of TBV, we do not believe TBV will decline to the current market price. The market discount is simply too great. While CMA is one of the worst hit banks in the past 3 months, it is not an isolated instance. Many bank stocks have significant discounts to TBV built into their market price.

These market discounts often ignore the fact that banks have significant capacity ("lines of defense") to absorb loan losses without destroying TBV.

These Lines of Defense Include:

1. **<u>Loan loss reserves (LLRs)</u>:** Most banks have LLRs that equal about 1.00% of loans. Most banks have loan losses of ~0.30% per year. So, they have 3+ years of "normal" loan losses covered. That will help but will not cover extraordinary loan losses from the pandemic.

2. **<u>Pre-tax, Pre-Loan Loss Provision Earnings ("PTPP")</u>:** Banks generate on average every year 1.50% to 2.00% PTPP (as a % of total assets). So, if loan losses are 1.50% of assets (2% or more of total loans since not all assets are loans), the bank with 1.50% PTPP will absorb all of those losses without losing money and it will preserve its TBV. It lives to fight another day. The bank with 2.00% PTPP still makes money for the year. Either way TBV is intact, or grows a bit, by the end of the year.

3. **<u>Excess Capital and Tax Effect</u>:** Let's say loan losses are greater than LLRs and PTPP can absorb. Now banks are using existing "excess" equity capital to absorb the extra loan losses not covered by the LLRs and PTPP. Most banks have on average 8% to 12% capital. That is well above what is required to run the bank safely and soundly (~6% to 7% is considered adequate). So, let's use a bank with 10% capital at the beginning of the crisis. Let's say that the loan losses for the year are 3% of assets (equivalent to ~4% of loans). LLRs and PTPP would absorb say two-thirds of the loan losses (~2%). The additional 1% is a pre-tax number so the bank would tax effect it, reducing the loss to say 0.75%. That 0.75% net loss would go against the 10% capital, reducing the capital at year end to 9.25%. The bank still has excess capital. It would be painful, but the bank would not need to raise capital. Let's assume the same loss again for one more year. That would reduce capital to 8.5%. At that point, the bank would still not need additional capital. But even that capital level would only be reached if the loan losses over 2 years were approximately 8% of loans (~6% of assets). Those are extraordinary loss levels not seen in the Financial Crisis. In 2008 and 2009 the banking industry had total LLPs of 1.55% and 1.92% of assets, respectively.

In summary, banks have substantial capacity to absorb loan losses, even above the amounts incurred in the Financial Crisis. And because they have excess capital today (50-100% more than they did at the beginning of the Financial Crisis) even extraordinary loan losses are absorbable.

While banks cannot use the discount to TBV that the market has put on many bank stocks, bank shareholders like the Partnership in effect have already absorbed those extraordinary losses. See the example of CMA above. That market discount in many cases is already well above the amounts taken by the 3 lines of defense above. ***We believe that the market discounts in many cases are excessive and will not actually happen at the underlying bank. Markets typically negatively overreact, particularly in times of uncertainty. We think that is the case today.***

In Q1 2020 bank stocks declined significantly more than most other sectors and the overall market. This harsh relative valuation of bank stocks is on top of the significant discount already placed on bank stocks at year end 2019. The overall market at year end 2019, as measured by the S&P 500 index, was trading at 19x earnings while banks were trading at 10-12x. And while banks in the Partnership increased earnings in 2019 by approximately 9%, the overall S&P saw minimal earnings growth.

The Federal Reserve has cut the federal funds rate to a range of 0.00% to 0.25%. The Fed's QE treasury and agency securities purchases have cut 10-year Treasury rates to approximately 0.60%. Other market rates have fallen, but nowhere near as much. We hope the Fed will not, and do not believe it will, pursue negative interest rates such as in Europe and Japan. Negative rates would cause us concern.

Falling interest rates decrease most bank's net interest margins, as we have discussed numerous times before. There are actions banks can take to mitigate lower interest rates, but it is not easy to offset completely. Banks successfully navigated near zero short term interest rates for the entire period between 2009 and 2015. They will do so again.

Most community and regional banks favored by the Partnership have "plain vanilla" securities portfolios, consisting mainly of U.S. agency mortgage-backed, U.S. agency, and state/local municipal securities. Many of these securities have increased in value as rates declined. Most banks have avoided the private label MBS and other securities formerly held before the Financial Crisis. The recent Fed QE and other Fed lending programs have stabilized the MBS and agency markets as well as most municipal markets. There is still dysfunction and turmoil in the corporate bond and non-agency securities market, markets in which most community banks have low or minimal exposure.

Not all banks have large mortgage banking operations. Some do. Banks with large mortgage divisions will benefit as lower interest rates have caused a massive mortgage refinancing boom.

Bank M&A in 2020 was going to be robust. Almost all bank M&A will now be deferred until the crisis passes. One of the Partnership's holdings, Sussex Bank (SBBX) did announce a sale in Q1. It was an attractive deal that we support. In times like this it does not matter what the fundamentals are or what positive actions are taken. Bank M&A will revert to normal beginning in late 2021 or 2022 and will be robust because all the deals that were deferred during the crisis will resurface. We also assume that many bank CEOs and boards, burnt out by this crisis, will seek to monetize their bank's value once fair value returns. And for the future buyers, M&A is still the best way to grow long term.

In the short term, banks will be less efficient as they spend money to deal with the crisis and quickly accommodate customers. In the intermediate and long term, this crisis will cause bankers to find efficiencies and profit improvements by reconfiguring delivery channels, increasing the pricing of loans (banks have always underpriced their loans), reducing the cost of deposits, and reducing overhead. More technology, less staff and less fixed assets. Banks have been evolving and becoming more efficient for the past 40 years. This is a temporary halt.

The next 30-60-90 days will be dominated by the health crisis. We all need to get through that before much progress can be made in bank stocks. During this 30-60-90-day period it is probable that the stock and bond market, and bank stocks, will go through significant continued volatility.

At some point after the health crisis is over, banks will once again trade based on forward looking earnings and the current crisis discounts will begin to abate. We believe that upward revaluation process will begin when more accurate information is available on the virus and the economy, total confirmed cases peak, and investors begin to realize that bank TBVs are more stable than currently projected by the market.

The key for bank stocks to recover to their most recent valuation, and potentially even get a higher valuation in the future, is to prove they can weather a downturn such as this without destroying TBV, cutting their dividends or raising dilutive capital.

For some time, we have wondered why bank stocks have not traded more in line with utility stocks. In many ways they are similar (closely regulated, slow but steady growth and high dividends). Most utility stocks trade for PE ratios twice the level of banks. While it won't be easy, we think banks can show they deserve higher PE multiples in a post-COVID-19 crisis world. That is an issue for another time, but that is the upside potential post-crisis.

With government largesse comes government restrictions and political expectations. Businesses that get direct federal loan assistance (e.g. airlines) will have appropriate restrictions put on their stock repurchases, dividends, and executive compensation. It is unclear how this will impact banks, as the banks are the conduits for getting federal aid out to the economy, not the direct recipients (the way they were in 2008-09).

As a practical matter, there is a short-term regulatory and political expectation that banks will eliminate or significantly reduce their stock buyback programs for the duration of this crisis. You may recall seeing headlines that the largest U.S. banks were suspending their buyback programs. Most banks would have voluntarily suspended their stock buybacks anyway to preserve capital in order to help their customers. Stock buybacks will resume once the crisis has passed and more information is known about the economy.
It is <u>un</u>likely that banks will be forced by regulation or law to suspend their dividends. We expect that regulators will work with banks on an individual basis to evaluate their capacity to pay dividends, as they routinely do. However, if the crisis stretches into 2021 and banks are losing money, regulators will begin pressuring banks to cut their dividends.

We discussed previously the 1958 flu pandemic. In closing, we ask what other prior crises are instructive or comparable? Can we learn anything from those events? An imperfect but close analogy to this crisis is a hurricane. Think of Puerto Rico after Hurricane Maria or New Orleans after Katrina. In both instances there was massive economic damage and massive physical destruction. Banks in both areas suffered losses, but they were minor. And the subsequent upturn due to stimulus and rebuilding spending was very good for the local banks. The banks were part of the solution, and they benefitted from it as well. COVID-19 will have a longer tailed duration than a national hurricane because once the hurricane passes you are safe to go outside. COVID-19 will linger, until such time as testing is ubiquitous (allowing confirmed cases to be quickly isolated—rather than isolating the whole population), effective treatments are identified, an antibody test is widely available (once you know you have immunity you can go out in public) and a vaccine is developed. But unlike a hurricane, this crisis has not destroyed physical infrastructure. It will be there for businesses and individuals once they are able to work and travel again safely. Banks will rebound as that happens.

INVESTMENT STRATEGY IN Q2 AND BEYOND

While there might be changes made that we cannot presently foresee, the current portfolio is likely to remain substantially unchanged in Q2 and beyond. We are sickened by the losses incurred in Q1 2020 but we don't believe it would be wise to sell in any material way in Q2 or beyond given our view that the economy will recover over the course of 2020 and 2021 and banks will perform better than the market has priced into bank stocks. We also believe bank stocks will outperform the overall market over the next few years, beginning at a point which is difficult to predict. The discount on bank stocks is simply too great compared to the discount on the overall market, even after accounting for the risks facing banks. If banks don't do well, that means the economy is not doing well, and therefore the overall stock market won't do well either.

The fact that bank stocks in the Partnership are historically cheap does not guarantee the Partnership will not or cannot incur additional losses in Q2 or beyond, or bank stocks will outperform the overall market. In crises it's hard to get the outcomes right, no less the timing.

Every 10-20 years there is a financial or economic crisis which severely impacts bank stocks. The 2 most comparable to this are 1990-91 (S&L Crisis) and 2007-09 (Financial Crisis). In both instances bank stocks had subsequent multi-year recoveries and upside. This crisis will be no different. Of course, it is impossible to know when the upside recovery begins, except in hindsight. To quote Warren Buffett, "Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons."

There will be a recovery and the banking industry will remain viable and profitable for years to come after this is over. Banks will work their way through this. We will monitor it all as best we can.

For those who are tracking information on COVID-19 closely, the following website from the University of Washington contains predictions on the so-called pandemic curve for all states and the U.S. in total. The COVID-19 federal task force mentioned this data in their briefings. It appears to be a reasonable projection, unlike some of the early predictions that seemed wildly alarmist and unsupportable.

https://covid19.healthdata.org/

FINAL THOUGHTS

We are distressed by the losses taken by the Partnership in Q1. Whether they are unrealized or not, the losses are real and material. We are doing our best to absorb and understand fast-changing events and information for the benefit of the Partnership. Given our confidence in the short and long-term capacity of the U.S. banking system to work though challenging times, we are also confident that bank stocks and the Partnership will enjoy a return to normalcy at some point.

Markets are always forward looking and hard to predict, so the turn in the stock market and in bank stocks may happen before all the health care and economic challenges are met. Timing is of course impossible to predict, except in hindsight. And from what level of stock prices that upturn begins is also impossible to know.

We are trying not to get distracted and whipsawed by the unprecedented day to day volatility in the financial markets. Long-term volatility is ultimately background noise. Fundamentals matter in the long term.

We look forward to everyone getting back to their normal lives, after doing their part to get through this health and economic crisis. We are awed by and deeply appreciative of everyone who is exposing themselves to this virus directly in order to help others, from the medical professionals in the ER to the cashier at the local Walmart and Walgreens.

We wish everyone the best and hope you and your family remain healthy. Thank you for your support.

Please feel free to contact us at any time with questions or comments.

Best regards,

Rich, John, Curt and Martin

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