PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q3 2020

Q3 2020 AND YTD RESULTS ARE NOT REFLECTIVE OF THE FUNDAMENTAL PROGRESS MADE BY BANKS

Despite significant improvements in bank earnings and fundamentals during the past 90-120 days, bank stocks and the Partnership generated negative returns in Q3.

Q3 and YTD results for both the Partnership and bank stocks remain significantly less than the overall market.

We will talk about bank fundamentals in a bit, but certain aspects of the overall stock market are worthy of comment first.

The overall stock market, as reflected in the results of the S&P 500 index, has lately been driven by what appears to be a speculative bubble in certain large cap tech stocks (think Facebook, Apple, Google, Microsoft) and other high-flying stocks (think Amazon, Netflix, Tesla, Peloton, Spotify, Moderna), reminiscent of the internet stock bubble of 1998-2000. No one can predict how it will end, but after up to 40 years each of observing stock markets, we do not believe it will end well for many of the stocks caught up in this speculative mania, even well-run companies that deserve premium valuations.

For example, Apple (AAPL) is a world-class company that has helped transform the way we live. It makes money and deserves to trade at a premium. The question is how much of a premium. AAPL stock has doubled in value in the past two years. What drove that?

Did their net income double? No, it went down.

EPS doubled? No. It did go up a bit (+9% in 2 years) but only because massive stock buybacks helped grow EPS even though net income went down. And given the current valuation, future stock buybacks will destroy shareholder value, not increase it.

Apple (AAPL)

Year Ending	Stock Price	Net Income (in $ bils)	EPS	PE Ratio
9/30/18	$56	59.5	$2.98	18.8x
9/30/19	$57	55.3	$2.97	19.1x
9/30/20	$116	56.9	$3.25	35.7x
% chg. (2018 to 2020)	107%	-4%	+9%	

And we did not pick Apple to highlight our point because it was an overvalued outlier. Among the stocks caught up in this mania, Apple is actually relatively cheap. Netflix trades for 84x earnings. Amazon trades for 120x earnings. Spotify loses money. Tesla has a larger market cap than Toyota, GM and Ford ***combined*** despite selling 1/65th of the number of cars those 3 did in 2019. And it's not as if every other car manufacturer in the world isn't making electric vehicles. Peloton stock has gone up 357% in the past year, has a $26 billion market cap (14x revenue), and is unprofitable. Gyms will not stay closed forever and once you own a Peloton bike you are not going to replace it every year, and the monthly subscription fee does not justify its valuation either.

Very few of these high-flying stocks distribute dividends or other payouts to shareholders (such as stock buybacks). In fact, most repeatedly and materially dilute shareholders by granting large numbers of free shares to employees because that is the culture of growth companies.

Meanwhile, bank stocks are trading as if: (1) they are losing money; (2) Tangible Book Values per share are going down; (3) pandemic induced credit losses will lead to the need for dilutive capital raises; (4) dividends will be eliminated or at least reduced; (5) M&A will never happen again; and (6) banks cannot make money due to low interest rates.

In the Q1 and Q2 letters we laid out our thesis on all of those market concerns and debunked each of them. And the past 90-120 days of bank earnings and related disclosures has ***strongly*** reinforced our views. Here is an update of each of the market's concerns based upon actual results:

Banks will lose money in the pandemic – FALSE

We track data on over 350 publicly traded banks (as well as the entire banking industry which includes 5,000+ banks and thrifts, most of which are privately held). In a normal quarter or year, 95% to 98% of all banks make money. For instance, in 2019 96.4% of all banks (public and private combined) made money.

Q1 2020: 87% of all publicly traded banks made money.

Recall that in Q1 2020 many banks had to absorb a material expense from adopting a new accounting standard called CECL, which required an extraordinary change in the way loan loss reserves were established, on top of reacting to the pandemic.

Q2 2020: 93% of all publicly traded banks made money.

Banks accomplished this despite record breaking negative -32% GDP, soaring unemployment and near total shutdowns in many parts of the country.

Q3 2020: We are highly confident 90%++ of all publicly traded banks will make money and their EPS will be up over Q2 EPS.

Why? In part because loan loss provisions should be lower than Q2.

Q4 2020: Results will be positive, on par with Q3.

Full Year 2020: We predict ~94% of all banks (public and private combined) will make money for the year, in line or a few % less than a 'normal' year.

To be sure, most publicly traded banks did report lower EPS in Q1 and Q2 2020 versus 'normal' EPS levels, but the declines were even less than most analysts predicted and the vast majority of banks certainly did not lose money.

In Q1 2020, median EPS was down -35% versus Q4. In Q2 2020, median EPS was up +13% versus Q1 2020. Combined, the first half of 2020 EPS was down approximately -25% versus the comparable period of 2019. But the important point is that banks are making money throughout this unprecedented economic contraction and pandemic.

And don't forget that the pandemic will not last forever, and those EPS declines are not permanent.

Tangible book values ("TBV") per share will go down – FALSE

Bank stocks are trading as if banks will be forced to raise common equity capital, leading to permanent dilution in TBV per share and shareholder value.

This has not happened to date, and we predict it will not happen. *In fact, median TBV's per share <u>went up</u> in Q1 and Q2.* Median TBV per share grew approximately +1% (unannualized) in Q1 2020 and +2.5% (unannualized) in Q2 2020. And that TBV growth was after covering loan loss provisions and paying dividends.

Pandemic induced credit losses will lead to dilutive capital raises – FALSE

As we predicted in the Q1 and Q2 letters, banks will **<u>not</u>** need to raise common equity capital because they came into the pandemic with excess capital and earnings power which would cover loan losses without destroying capital.

Everything that has occurred to date convinces us that our view is correct. No capital raises and no dilution for bank shareholders such as the Partnership.

In fact, the opposite is happening. Many banks are accreting capital by buying back common stock at prices significantly below TBV, creating higher EPS and TBV per share!

Dividends will be eliminated or at least cut – FALSE

A few banks cut their dividends so far in 2020, but the vast majority (more than 95%) maintained or increased their dividends. Why? For the reasons noted above. Banks are making money, have excess capital and are covering their loan losses with earnings.

M&A will never happen again – FALSE

Bank stocks are trading as if M&A will never happen again. The reality is that M&A has continued even during the pandemic, albeit at a much reduced level. While the pandemic and economy will dictate when M&A will return to normal, we are 100% convinced it will happen. It's a matter of when, not if. And when M&A does pick up again, it will last for several years at levels well above normal.

Long term bank consolidation is one of the primary reasons we set up the Partnership years ago. We look forward to several great years of strong performance as bank stocks recover and then M&A kicks in again.

Banks will struggle to make money due to low interest rates – FALSE

The rapid cuts in interest rates by the Fed is a headwind for bank earnings, but the market is missing the point that bank net income and EPS is also driven by net interest income **in $s**, not solely by net interest margins **in % terms**.

Net interest income (in $ terms) can grow even if net interest margins decline (in % terms), as long as the balance sheet (loans and deposits) can grow by a greater amount, as shown in the equation below:

Rate (%) x Volume ($) = Net Interest Income ($)

And that is exactly what has happened in 2020 to date. Despite massive rapid declines in open market interest rates caused by the Fed, declines in the 'Rate' (net interest margins in % terms) were more than offset by growth in 'Volume' (balance sheet growth). Net interest income in $s still grew for most banks. That is what counts.

Publicly traded banks enjoyed median net interest income growth of over +2.5% in Q2 (unannualized), despite a large decline in the net interest margin from a median of 3.58% in Q4 2019 to 3.29% in Q2 2019.

Bank balance sheets have grown tremendously in the past 12 months, most of it during the pandemic. From June 30, 2019 to June 30, 2020, total banking industry assets grew 16% and deposits grew over 20%!! Those are unbelievable growth rates for a mature industry that has over $21 trillion (trillion with a 'T') in assets as of June 30, 2020.

And don't forget that banks successfully navigated ultra-low interest rates for over 7 years from 2009 to 2016.

RECAP OF FUNDAMENTALS

To recap, banks have remained profitable despite the unprecedented pandemic and GDP contraction. Banks will remain profitable for the entirety of 2020 despite recording the vast majority of the loan loss provisions needed to get them through the entire pandemic! 2021 will see more improvements.

To illustrate this point, we wanted to share with you the financial performance of Horizon Bancorp, Inc. (HBNC). HBNC is based in Michigan City, Indiana and is a typical Midwest based bank with $5.7 billion of assets.

Horizon Bancorp (HBNC)
Dollars in millions, except per share amounts

	Q2 YoY Change	Q2 2020	Q1 2020	Q2 2019
EPS	(11%)	$0.33	$0.26	$0.37
ROTCE[1]	(18%)	13.01%	10.13%	15.87%
Stock Price	(35%)	$10.69	$9.86	$16.34
Div. Yield	53%	4.49%	4.87%	2.94%
Provision for Loan Loss	684%	$7.0	$8.6	$0.9
Net Interest Income	3.6%	$43.0	$40.9	$41.5
Net Interest Margin	(7.7%)	3.36%	3.47%	3.64%

(1) Return on Tangible Common Equity

As you can see, the second quarter 2020 year-over-year EPS was only down -11%, despite a large increase in the loan loss provision. Yet the stock is down 35%!! Additionally, HBNC most likely saw the peak of loan loss provisioning in Q1 2020. And notice how the net interest margin (in % terms) declined materially yet net interest income in $s increased from Q2 2019 to Q2 2020. HBNC is but one example of how the market is and has been too pessimistic. Even the bank analyst community has been too dire. For example, the Wall Street analysts' consensus estimate of HBNC's Q2 2020 earnings were $0.22 per share, a miss of 50%, with one major firm at $0.18, a miss of 83%!

A recent Stephens Inc. survey of bank CEOs and CFOs reinforces our view that the worst will be behind us in 2020. 20% of the bankers surveyed believed their bank's loan loss reserves already peaked in Q2, while 60% believe the loan loss reserve will peak in Q3 or Q4 2020. *Only 19% believe the peak reserve will occur in 2021*. For the record, we vote for a peak in reserves in Q4, but even if the peak is in 2021, a substantial portion of the cost of that peak reserving has already been expensed or will be by the end of 2020. In fact, from a bank earnings standpoint we believe the worst is already behind us as of the end of Q2.

Another positive data point buttressing our view that the worst is behind us is the dramatic decrease seen in the past month or two in the level of loan deferrals and forbearances. As you may recall, in Q2 many banks proactively gave their borrowers leniency on their loan payments so borrowers could sort out the impact of the pandemic. Some banks gave deferral on the full payment (principal and interest), some on principal only. Most deferral terms were 90 days while some were 180 days. At this point most 90-day deferral plans and many 180-day deferral plans have expired in the past 60-90 days, without being extended.

As part of their normal Q2 earnings reports, and in subsequent intra-quarter reports, the vast majority of banks have disclosed very favorable data on the level of loan deferrals reverting to normal payment schedules.

Most banks have enjoyed significant decreases in deferrals since the peak levels of April-June, with reductions of 50% or more in loans remaining on deferral. Some are reporting over 90% improvement. Very few borrowers are coming back for a 'round 2' request for continued deferral, as most 'round 1' deferral borrowers are back on full payment schedules. Even those on 'round 2' deferrals are generally making some payments. Of course, the status of the pandemic and economic lockdowns will dictate future progress, but we are very pleased with the data. It is even better than we thought. And don't forget that these are payment deferrals, not forgiveness. The banks will eventually collect these amounts, typically over the life of the loan.

Eventually, the market will reward bank stocks for their fundamental resiliency, positive trends in loan deferrals, high dividend yields and low valuations.

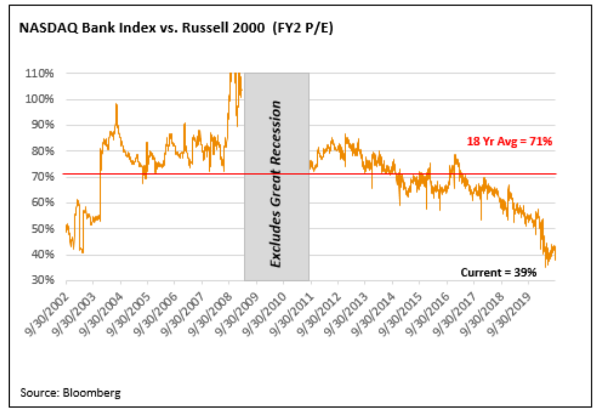
We have always believed that fundamentals matter in the long run and future returns are in large part driven by the starting price/valuation. Given that current fundamentals are rapidly improving and valuations of bank stocks are so low, there is almost by definition a large recovery rally coming at some point.

Most stocks in the Partnership would be up 40% to 90% if they merely went back to pre-pandemic levels. And that would merely get back to valuations which were low to start with. As we described in the Q4 2019 and earlier letters, bank stocks were historically cheap before the pandemic. There is even more upside potential after the recovery rally occurs when investors realize how resilient banks were during the pandemic.

And then M&A is going to kick in, turbocharging returns and lasting for three to five years.
The following chart shows graphically how cheap bank stocks are compared to, in this instance, other small-cap and mid-cap stocks as represented by the Russell 2000 index (and btw, small-cap and mid-cap stocks are cheap relative to large-cap stocks so banks are doubly discounted).

Bank stocks are as relatively cheap as they were coming out of the internet bubble in the late 1990s and early 2000s. Long term PL Capital investors will remember that PL Capital's funds and bank stocks had a great run from 2000-2003 after the internet bubble burst. It's not unreasonable to think that will happen again.

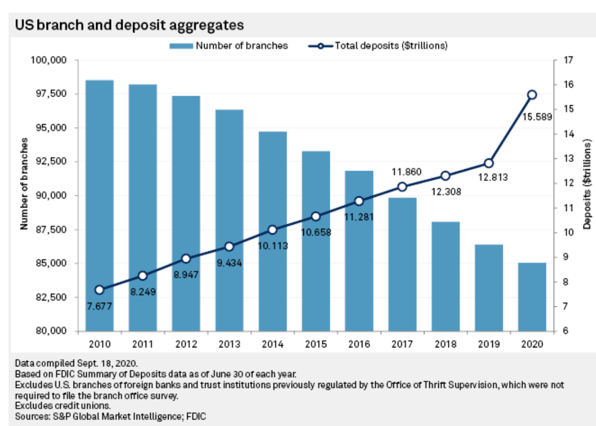
Relative Price to Earnings
(Banks versus Small and Mid-Cap Stocks)



While we wait for valuations in bank stocks to recover, the Partnership is collecting attractive dividend income. At quarter end, the median yield in the Partnership was approximately 4.6% (based on then current market values), an attractive return when 10-year treasuries yield 0.7% and the S&P 500 yields 1.7%.

Meanwhile, bankers aren't sitting around waiting for a complete economic rebound. Many are aggressively cutting costs and becoming more efficient now, in large part by continuing to shrink the number of branches they have and increasing their digital footprints. Branch counts have been dropping rapidly for years, as noted in the following chart.

Total U.S. Banking Industry Branches and Deposits



The numbers are hard to read, but the chart shows that since 2010 total branches have shrunk from ~100,000 to ~85,000 while deposits doubled from $7.7 trillion in 2010 to over $15.5 trillion in 2020.

The reduction in branches has clearly not hurt deposit growth, as shown above, or loan growth, as previously noted in this letter. Banking isn't as sexy as tech but banks are profitable, growing and becoming more efficient. Those trends will accelerate coming out of the pandemic.

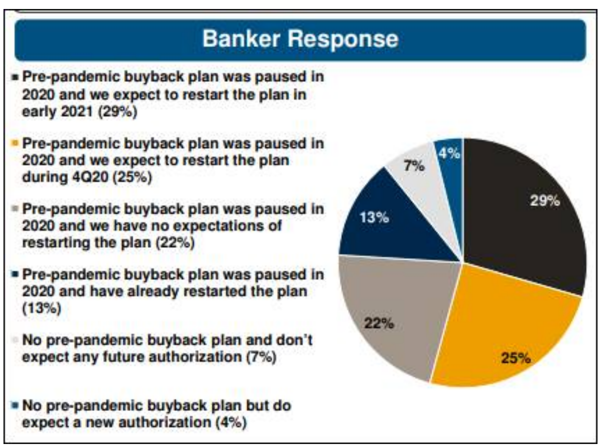
BANK INSIDERS AND BANKS ARE BUYING THEIR OWN STOCKS

In this letter we discussed how we believe the stocks of many high-flying companies, mostly in technology, are overvalued, over-hyped and over-owned, while banks (and other financial companies) are undervalued, under-owned and ignored.

Apparently, we aren't the only ones who believe banks are undervalued and tech is overvalued. The people that would know the most, insiders at these companies, agree with us. Recent data from 3,000 public companies show that insiders at financial companies (mostly banks) were the largest buyers of their own stocks of any industry (as a % of their industry), while tech insiders were the lowest buyers of any industry, at a ratio of 5x1 (30% for banks vs 6% for tech).

Bankers are also expecting to restart their company stock buyback plans paused by the pandemic. As noted in the chart below from a recent Stephens Inc. survey of bank CEOs and CFOs, 13% of banks already restarted their stock buybacks and 54% plan to do so in either Q4 or early 2021. Only 22% do not have current plans to restart their buybacks. We assume the majority of that 22% will restart their buybacks after the pandemic is in the rear-view mirror.

Which Statement Best Describes Your Bank's View on Stock Repurchase Activity?
Stephens Bank Forum Survey - September 2020



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,

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