PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q4 2019

THE EVENTS WHICH SHAPED BANKING AND THE PARTNERSHIP IN 2019

The economy did not boom or bust in 2019. Economic activity was robust enough to drive loan and deposit growth at most banks, and to reduce credit costs. It was a strong year for most banks.

Most banks, and the industry as a whole, had record profits due to balance sheet growth, positive operating leverage (revenues growing faster than expenses) and low credit costs.

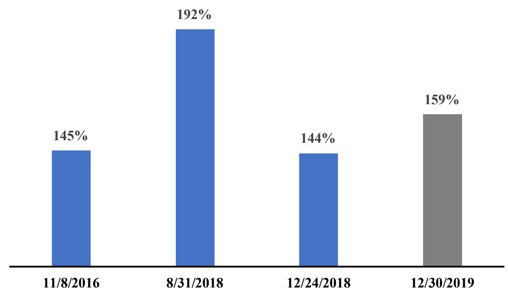
Stock buybacks were robust due to excess capital generation. This boosted EPS at many banks.

The 2018 declines in bank stocks and the flattening yield curve in 2019 were cited by economists as harbingers of a recession in 2019. It did not happen.

Despite a sharp flattening of the yield curve and drop in interest rates during the first 9 months of 2019, the banking industry was able to sustain a healthy net interest margin (NIM). The industry average NIM only dropped 10 basis points over the past year. And despite that drop in the NIM, net interest income in $'s still went up (due to balance sheet growth outweighing the NIM).

The improvement in bank stock prices was due to two factors. One, increased earnings. Two, increased valuation metrics, as noted in the Price to Tangible Book Value chart below, which shows that valuations improved 10% in 2019 (from 144% at year-end 2018 to 159% at year-end 2019). Note that valuations today are still well below the mid-2018 levels, the most recent peak in bank stock prices.

FIGURE 1: PRICE TO TANGIBLE BOOK VALUE
(All Banks)



Source: Janney Research (FIG Group); SNL Financial

In contrast, the S&P 500 index returns were almost all from higher valuation metrics, not earnings growth. The S&P 500 index coming into 2019 had a PE ratio of less than 15x trailing EPS and ended the year closer to 20x. The S&P 500 cannot have valuation increases every year like that. It's not sustainable.

Bank PEs remained well below the S&P 500 index in 2019. Most banks are still trading at approximately 11x 2020 projected earnings, versus 19x for the S&P 500 index. This relative ratio of ~60% (11/19) is well below historical averages of 80%++.

While bank *earnings* in 2019 were not tied to the yield curve as much as pundits claimed, bank *stocks* were held hostage by the yield curve. Flattening curves correlated closely with bank stock declines all year. This is the reality of short-term bank stock price action.

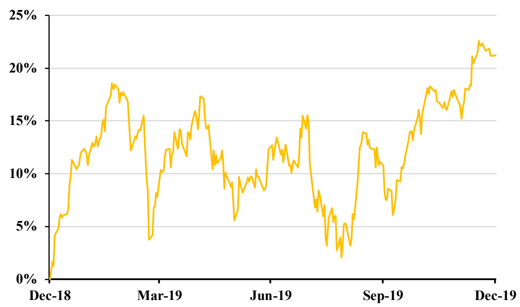
Bank M&A set records once again. While the final stats are not out yet, there were at least 271 mergers announced in 2019, up from 258 in 2018. As a % of banks in the U.S., 2019 appears to be a record at ~5%. Total bank M&A deal value was $59 billion in 2019, up from $30 billion in 2018, driven in part by the very large merger of BB&T and SunTrust, as well as overall deal volume.

Bank M&A valuations were lower in 2019 than 2018, a function of lower bank stock valuations in 2019 vs. the majority of 2018 (most of the decline in 2018 was in Q4).

The market came into the year 2019 forecasting multiple Fed interest rate <u>increases</u>. In actuality, there were 3 Federal Funds interest rate <u>cuts</u>, to the current level of 1.50% to 1.75%.

Even though bank stocks went up nicely for the full year, it was not in a straight line. There were numerous periods of sharp declines and volatility, as noted in the graph below of the NASDAQ Bank Index:

FIGURE 2: NASDAQ Bank Index – Price Change (%)
(12/31/18 – 12/31/19)



Source: SNL Financial

A REVIEW OF OUR 2019 PREDICTIONS and OUR 2020 PREDICTIONS

"It's tough to make predictions, especially about the future."— **Yogi Berra**

In every year end letter, we review our prior year predictions and humbly make predictions for the coming year, which the famous Yogi Berra did not think was a smart idea.

A REVIEW OF OUR <u>2019</u> PREDICTIONS

#1: *The banking industry earns record profits in 2019, driven by stable NIMs, stable credit quality, increased efficiencies and industry consolidation.*

TRUE. The banking industry did earn record profits in 2019, due to all of the factors cited. While NIMs did decline by 10 bps, that is a stable outcome given the volatility of the yield curve during the year.

#2*: NIMs are stable. +/- 5 basis points change versus current levels. Rising deposit costs are a headwind. Net interest income (in total $s) continues to rise to new record levels due to balance sheet growth and lending.*

TRUE and FALSE: We are taking a mulligan on the +/- 5 bps! While NIMs did decline by 10 bps, that is a stable outcome given the volatility of the yield curve during the year. And net interest income in $'s was up for the year despite higher deposit costs.

#3: *The Fed reduces Quantitative Easing (QE) significantly without significantly impacting interest rates or financial market liquidity, for the reasons previously noted regarding excess reserves.*

FALSE: The Fed did reduce QE in early to mid-2019, but not as much as we predicted. In mid-2019 the Fed got nervous and pulled back from raising rates and shrinking their balance sheet. By year end, the Fed's balance sheet was larger than at the beginning of the year. Interest rates did not rise significantly. Rates in fact fell in 2019.

#4: *Bank M&A slows in 2019 vs 2018 due to the decline in stock prices in late 2018. M&A picks up in the back half of 2019. Despite the slowdown in M&A, over 4% of the industry merges in 2019.*

TRUE and FALSE: The number of deals did not fall as predicted. It rose, from 258 in 2018 to 271 in 2019. As predicted, M&A did pick up in the second half of 2019 as bank stock prices recovered. Over 4% of the industry merged.

#5: *GDP remains strong in 2019, but off the levels seen in 2018. GDP is 2.50% to 3.00%. Unemployment stays at or below 4% for most of the year but does not go down much more than the current level of 3.7%.*

TRUE and FALSE: While GDP did slow from 2018, as predicted, it did not grow at 2.50% to 3.00%. When the year is completed it will likely be in the 2.30% range. Unemployment ended the year at 3.6% and was below 4% all year.

#6*: Bank stocks and the Partnership have a great year, driven by the market waking up to the attractiveness of bank fundamentals and valuations.*

TRUE: Bank stocks and the Partnership had a great year.

#7: *Even if investors don't buy bank stocks, the banks themselves will. Stock buybacks will be material for as long as bank stocks stay depressed.*

TRUE: While good data on stock buybacks is difficult to find, it appears that stock buybacks were at record levels in 2019. The regulators were much more generous in their approvals of buybacks than in prior years, acknowledging the fact that most banks have strong balance sheets and excess capital.

***#8:** Bank stocks outperform the general market indexes, reversing the underperformance in 2018.*

FALSE: We are surprised that bank stocks did not outperform the general market indexes. Even though bank stocks did great in 2019, the overall market, as measured by the S&P 500, did better, despite the S&P 500 having less earnings growth than banks, trading at historically elevated valuation levels vs. banks, and the underperformance of bank stocks in 2018.

***#9:** Stock market volatility remains high, due to the algo/quant trading and angst over everything.*

TRUE: See the chart of the Nasdaq Bank stock index above in this letter for the bouts of volatility in the market. The monthly returns for the Partnership also reflect the high volatility, with 3 months of large declines (-9% in March, -6% in May, and -7% in August), and 9 months of increases averaging over +5%. That is the highest monthly volatility the Partnership has experienced since the Financial Crisis in 2008-2009. We believe this reflects the impact of quant/algo trading and angst among market participants, as predicted.

***#10:** Long term interest rates (i.e. 10-year treasury) rise to approximately 3.25% by year end 2019. The current level is ~2.70%. The Fed raises the Fed Funds rate one time in 2019 then pauses.*

FALSE. By a MILE!!: Not only did rates not rise, they fell sharply. The 10-year treasury yield ended 2019 below 2%, after dipping below 1.5% in September 2019.

FIGURE 4: US Ten Year Treasury Yield (%)
(12/31/18 – 12/31/19)

Source: SNL Financial

2020 PREDICTIONS

If Yogi Berra spoke Latin, he would say *Caveat Emptor!*

Many of our 2020 predictions sound similar to 2019s. That is not a surprise. The banking industry does not change much from year to year. Which is a good thing!

#1: The banking industry has record profits in 2020, although the % improvement lags behind the increase seen in 2019.

#2 Net interest margins stabilize at +/- 7 bps from the year earlier. Net interest income in $'s once again hits a new record on balance sheet growth.

#3: Bank M&A in absolute numbers is lower than 2019 but remains robust at over 4% of the industry.

#4: The economy continues to grow at over 2%, with growth steady vs. 2019 at approximately 2.3%. Unemployment remains between 3.5% and 4.0%.

#5: The presidential election dominates every political and market news cycle. Every zig and zag in the market will be ascribed to some political shift in the wind. Consensus is that a Trump win would be good for the stock market and bank stocks, a Warren or Sanders win would be bad for the market and bank stocks, and a Biden win would be neutral (unless the Democrats take the House and Senate too).

#6: Despite more volatility, bank stocks have a good year, up over 10%, on improved EPS, some valuation improvements, and continued stock buy backs and dividend increases as a result of excess capital generation.

#7: Bank stocks outperform the S&P 500 index.

#8: Volatility continues, exacerbated by the Presidential election and Fed indecision.

#9: The Fed does not raise, or cut, the federal funds rate. Year end 2020 long term interest rates are in line with current rates. Inflation picks up a bit, keeping the Fed in check, but is not strong enough to cause rate increases.

#10: The Fed relaxes the rules on how much an investor can own in any one bank without becoming a bank holding company (currently it is 10%). This will create opportunities for PL Capital and the Partnership.

WE ARE GRATEFUL FOR YOUR SUPPORT—25 YEARS!!

There would be no Partnership or PL Capital without each of you, our partners, many of whom have been with us for a lengthy period of time. As PL Capital enters its 25th year, we are grateful for your willingness to entrust us with some of your hard-earned capital. Thank you!

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

We wish you and your family a Happy, Healthy and Prosperous New Year!

Best regards,

Rich, John, Curt and Martin

Richard Lashley
(908) 347-7874
RLashley@plcapitalllc.com

John Wm. Palmer
(239) 777-0187
(630) 848-1342 (fax)
JPalmer@plcapitalllc.com

Curtis J. Thompson
(312) 560-2675
(630) 848-1342 (fax)
CThompson@plcapitalllc.com

Martin Alwin
(630) 742-7060
MAlwin@plcapitalllc.com

January 10, 2020