PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q4 2021

QUARTERLY AND YEARLY RESULTS

2021 was a strong year for the Partnership and almost all bank stocks, continuing the recovery which began in October 2020 after the Covid vaccines proved efficacious. The overall stock market, as measured by the S&P 500 index was also very strong. However, much of the gain came from a small number of mega-cap stocks which have dominated the stock market for the past several years. Think of names such as Apple, Microsoft, Tesla, Facebook, and Google. Small cap stocks were less robust. For example, the Russell 2000 small cap index increased 14.8% in 2021, approximately half of the S&P 500 index gain.

The Partnership's strong performance reflected strong fundamentals generated by the banks in the portfolio. Despite the pandemic, supply shortages, inflation, and political uncertainty, almost all banks had a strong year.

BANKS HAVE PERFORMED EXTREMELY WELL DESPITE THE PANDEMIC

The Covid pandemic has disrupted society and the economy in so many ways. At the onset of the pandemic, no one could predict with certainty how severe those impacts would be. However, as you may recall from our quarterly letters issued in 2020, PL Capital was confident that the banking system would persevere through the pandemic without banks needing to sell assets, raise capital or cut dividends.

So how have banks done since the pandemic began almost two years ago? Was our confidence misplaced?

The short answer is that banks have done extremely well despite the pandemic and our confidence was not misplaced.

Year to date through September 30, 2021, the banking industry has made more money than in any comparable period in history. Full year 2021 will certainly be the most profitable year ***ever***. In Q2 2021 the banking industry recorded its most profitable quarter ever, when it made $76.8 billion. Total assets grew 10% in the twelve months ended September 30, 2021, to $23.25 trillion. Total industry deposits, loans and equity are all at record levels. [1]

(1) FDIC Quarterly Banking Profile

The individual banks in the Partnership have also done well since the pandemic began. For example, we found the following highlights when we compared the fundamentals of the Partnership's 36 current bank holdings as they were pre-pandemic (12-31-19) and as of today (either 9-30-21 or 12-31-21, whichever data is the latest available):

- None raised common equity capital or sold material amounts of assets.
- Only 1 bank has a lower Tangible Book Value per share (TBV) today vs. 12-31-19 while 35 banks increased their TBV per share.
- Only 1 bank decreased its dividend; 19 increased their dividend and 16 maintained their dividend. One of the 19 paid two large special dividends that almost equaled our entire cost basis!
- 29 banks are projected to have higher EPS in 2021 than they did in 2019 while 7 are projected to have lower EPS; none are projected to lose money in 2021.

Despite this strong fundamental performance by the banking industry and the banks held by the Partnership since the pandemic began, and the large increase in bank stock prices since October 2020, valuations of the banks held by the Partnership are still very attractive, as noted below:

- The median current PE on 2021 full year estimates is 10.0x, below the 11.3x from 2019.
- The median current Price to TBV % is essentially unchanged vs. 12-31-19 (145% vs. 146%).
- 7 of the Partnership's top 10 holdings have lower Price to TBV ratios currently than at 12-31-19.
- The median current dividend yield increased to 2.76% at 12-31-21 vs. 2.51% at 12-31-19.

To recap, despite the vast majority of the banks in the Partnership having higher TBV, EPS and dividends today than pre-pandemic, most of their valuation metrics are still at or below pre-pandemic levels.

And don't forget that bank stocks were cheap pre-pandemic relative to the broad market so they are especially cheap today.

At 12-31-19 bank stocks on average traded at 10 - 11x PE ratios while the overall S&P 500 index traded at 19.8x, an approximate 53% relative PE ratio.

At 12-31-21 bank stocks still generally traded at 10 - 11x while the S&P 500 index PE was 23x, an approximate 45% relative PE ratio.

So on a relative % PE basis, bank stocks are even cheaper today than the attractive level seen in 2019.
For perspective, small and midcap banks favored by the Partnership historically traded at 75% or more of the S&P 500 PE multiple in prior periods. If banks traded at their historically normal 75% of the S&P PE, bank stocks would appreciate by 67% above current levels!!

And bank stocks are not just cheap relative to the overall market, they are cheap in absolute terms with PEs of 10 – 11x.

Because of our confidence in the banking system, we generally kept the Partnership fully invested in 2020 and 2021 and in some cases increased our exposure to certain banks. While this fully invested position was particularly painful during the sharp downdraft in bank stocks and the Partnership in Q1 2020, in hindsight it was the right decision. If we had tried to exit then later repurchase those positions, the Partnership likely would have still incurred most of the Q1 2020 losses but then missed a substantial portion of the rebound.

Those of you who have been invested with PL Capital for an extended period know we typically try to avoid market timing. If the fundamentals and valuations are attractive, we tend to stay fully invested.

We are more likely to sell when bank stock prices are rising but valuations are at the upper end of historical ranges, rather than when the market is going down but valuations are attractive. That was clearly not the case in 2020, 2021, or today. Bank stocks were and are a long way from being overvalued.

A REVIEW OF OUR 2021 PREDICTIONS

As you know, in every year end letter we review our prior year end predictions and make new ones for the upcoming year. While no one can accurately predict the economy or financial markets on a consistent basis, it is fun to try!

Our 2021 predictions from the Q4 2020 letter follow. The predictions are in *italics* and the actual results follow. Overall, we did very well with our 2021 prognostications.

#1. *Bank M&A ramps up over the course of 2021, setting the stage for a multi-year M&A boom. Many of the deals that would have happened in 2020 are merely delayed until 2021 and 2022. M&A premiums (to the current stock price) will be lower than historic norms, but the quality of the deals and fair pricing will lead to strong post-deal announcement stock price performance for buyers, benefitting both sellers and buyers. The market's acceptance of M&A for both the buyer and seller will signal a sustainable M&A boom.*

TRUE: M&A activity was more robust than even we expected (210 deals in 2021 vs 117 in 2020). M&A premiums (i.e., takeover price above the market price) were below historical averages. While some acquiror's stock prices declined on deal announcement, the quality of the M&A was strong (high EPS accretion and low TBV earnback periods). The stock market and analysts generally deemed most M&A deals attractive for both the buyer and seller. The only negative in the bank M&A market was that the banking regulators have been very slow to approve larger deals, in large part due to the new presidential administration and the concomitant changes in the leadership of the banking agencies.

#2. *Interest rates increase gradually but remain historically low. The 10-year treasury yield, recently at 0.92%, gradually increases and peaks close to 1.50%, a level at which the Fed decides to engage in yield suppression by increasing purchases of longer-term treasuries. The Fed keeps the Fed Funds target at its current level of 0.00% to 0.25%. The yield curve as measured by the spread between 2-year and 10-year treasury bonds was recently at +80 basis points (0.80%). This increases to +130 basis points at some point during 2021. The steeper yield curve is supportive of bank net interest margins (see #4 below) and bank stocks.*

TRUE: Interest rates did increase in 2021 but remained historically low. The 10-year treasury yield opened 2021 at 0.81%, peaked at 1.75% in early 2021 then closed the year at 1.51%. The Fed was active in buying long-term and short-term treasuries in 2021. The Fed did keep fed funds at 0.00% to 0.25% throughout 2021.

FALSE: The yield curve did not steepen as we expected. The 2-year / 10-year treasury yield spread remained essentially flat at year end 2021 vs. year end 2020.

#3. *History has shown that the optimal time to own bank stocks is in the years after the yield curve flattens or inverts (which occurred in 2020), as well as when "real" (inflation adjusted) interest rates are low. Both* *of those favorable conditions occur in 2021, even with the Fed's interventions.*

TRUE: Real interest rates (i.e., interest rates minus inflation) were negative in 2021, in large part due to higher-than-expected inflation.

FALSE: As noted in #2 above, the yield curve did not steepen.

These mixed signals were on balance still favorable for bank stocks.

#4. *Bank net interest margins (in % terms) bottom out in early 2021 then begin to rise, and net interest income in $ terms increases due to balance sheet growth.*

TRUE: Bank net interest margins (NIM) bottomed out in Q2 2021 then improved over the course of 2021. Net interest income in total $s did not increase YTD through September 30, 2021 despite strong balance sheet growth, as the drop in NIM in early 2021 offset the growth. Net interest income in $s did increase on a linked quarterly basis in Q3 2021 vs Q2 2021 so by year end the total yearly net interest income may yet show an increase vs. 2020.

#5. *Bank stock prices continue to recover, improving by 15% to 25% over year end 2020 levels. Unlike 2020, when bank stock rallies were "sold", in 2021 bank stock dips will be "bought" because most investors are underweighted in bank stocks.*

TRUE: We were right about the direction of bank stocks (up!), but fortunately too pessimistic about the magnitude. While bank stocks did not go up every month of 2021, banks were generally one of the more favored industry sectors because most investors were underweight bank stocks coming into 2021 and analysts were too pessimistic about banking fundamentals.

#6. *Bank stocks outperform the overall stock market as measured by the S&P 500.*

TRUE: Bank stocks outperformed the overall stock market as noted in the table on page 1.

#7. *Many banks return excess capital to shareholders through increased dividends and stock buybacks. Very few raise common equity capital.*

TRUE: Very few banks raised common equity capital (and those that did raised capital for offensive reasons, not because they had to). Most banks returned excess capital to shareholders in the form of increased dividends and/or buybacks.

#8. *The economy recovers and grows +3.5% in 2021. Unemployment rates drop rapidly in the second half of 2021 due to the success of the vaccine program and relaxed economic restrictions. The recovery from the pandemic induced deep recession should be stronger but supply chain issues, higher inflation, government deficits, lingering pandemic impacts, and structural changes in the labor force reduce the expected rebound.*

TRUE: In 2021 the economic recovery has been strong and unemployment has dropped rapidly, driven by the success of vaccines and the re-opening of the economy. Despite the strong economy and job market, the overall recovery has been tempered by all of the headwinds noted in our prediction, particularly supply chain issues and labor shortages.

#9. *Banks close branches and engage in other cost cutting moves.*

TRUE: Banks closed branches throughout 2021 and kept headcount and other costs contained. They also upgraded technology, which is both a cost savings (productivity) and a cost increase.

#10. *Aggregate banking industry loan losses remain well below Financial Crisis levels. Some losses are incurred on loans to various borrowers impacted by the pandemic. Some of these losses will be material to an individual bank's quarterly results but will not impact overall banking industry improvement.*

TRUE: Not only were credit losses well below the Financial Crisis era levels but below even historical norms. This was driven by the government stimulus programs, especially the PPP forgivable loan program, and a rebounding economy. Asset valuations increased for most asset classes, improving loan collateral values. Some banks did incur material but very sporadic losses on certain loans impacted by the pandemic.

#11. *Investors will assign higher valuation multiples to banks, an appropriate reward for proving their resilience in the pandemic.*

FALSE: Unfortunately, investors did not reward bank stocks with higher valuation multiples despite the banking industry's incredible resiliency during the pandemic. While the lack of valuation improvement hampered results in 2021, we remain optimistic that someday investors will assign higher valuation multiples to bank stocks.

2022 PREDICTIONS

#1. Bank stocks have another strong year, continuing the momentum and strong fundamentals enjoyed at year end 2021. Bank stocks rise by more than 15%. Most of the price increase is driven by improved PE ratios, as 2022 EPS for most banks will be flat vs. 2021. Recall that 2021's profits had one-time gains from the PPP program and unusually low credit costs. These will not be repeated in 2022, so even though "core" EPS will grow, total EPS will be flat. Given that 2021 earnings were at historically record levels, we are okay with a flat EPS year in 2022.

#2. For the past few years bank stock prices, on at least a short-term basis, have been highly correlated with interest rates and the yield curve, sometimes to nonsensical extremes (e.g., bank stocks go up or down 3% in a day simply because the 10-year treasury yield went down or up by 0.05%). This volatility continues in 2022. Despite this volatility in short term prices, over the course of the year interest rates rise and the yield curve steepens, driving bank stock prices higher.

#3. The aggregate number of bank M&A deals dips in 2022 vs 2021 but is still robust, consistent with the trend started in 2021 and the long-term consolidation of the industry. M&A by large banks (say banks greater than $100 billion in assets) is hampered by the hostility of the Biden administration towards large banks and brokers. Community banks favored by the Partnership still enjoy favored status with the vast majority of national, state, and local politicians and regulators so their M&A ambitions are not impacted.

#4. Deposit costs remain anchored at very low rates despite increasing open market interest rates. This so-called "low deposit beta" in industry parlance, helps drive net interest margins and net interest income in total $'s higher in 2022 vs. 2021.

#5. The Fed raises the fed funds rate 3 times in 2022, and the 10-year treasury ends the year close to 2.25%. A slowing economy and some financial market volatility in the back half of the year keeps the Fed from being more aggressive. Real (inflation adjusted) interest rates remain very negative due to continued high inflation. The interest rate backdrop is positive for bank stocks.

#6. Fintech stocks, the darlings of private investors and public markets, struggle to hold their elevated valuations when investors realize that few will be sufficiently profitable to justify current valuations and some will face regulatory challenges.

#7. Despite higher interest rates, real estate markets and pricing remain robust, particularly single-family housing. Aggregate mortgage lending volumes decrease in 2022 vs. the strong levels of 2021 but purchases of homes drives stronger than expected mortgage banking profits. Refinance mortgage volumes decrease materially in 2022 vs. 2021 due to higher interest rates.

#8. Inflation remains high but starts to moderate towards the end of 2022. Labor costs go up by the highest % amount since the early 1980s.

#9. Republicans win control of the House and the Senate in the mid-term 2022 elections. Gridlock prevails in Congress so President Biden and government agencies use executive orders and regulatory authority to advance their agenda. Banks face headwinds from banking industry regulators appointed by President Biden who are not friendly to the banking industry. Despite the political noise, the banking industry will not fundamentally change in its mission or profitability.

#10. PL Capital engages in more shareholder activism in 2022. The pandemic did not favor activism. This will change in 2022 and beyond as some banks fall behind their peers despite having attractive franchises, leading to more activism.

2021 INCOME TAXES

While the Partnership did realize some short and long term capital gains for tax purposes in 2021, we were mindful to not realize excessive amounts. However, at some points in 2022 and beyond some of the large capital gains the Partnership has enjoyed will be realized for tax purposes.

We will work closely with KPMG to get the 2021 K-1s issued as expeditiously as possible. However, we were informed last week by KPMG that they are incurring significant labor shortages as a result of the pandemic and people making lifestyle changes. This is true for almost all professional services firms today. Consequently, our audit results and K-1s will be delayed. KPMG is hopeful to have them to us by April 15th but not much sooner. Unfortunately, this is outside of our control. You may wish to advise your tax preparers.

We wish you and your family a happy, healthy and prosperous New Year! Especially the healthy part!

Please feel free to contact us at any time.

Best regards,

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Note on Sources: Unless stated otherwise, data provided by S&P Global Market Intelligence.