PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q3 2022

EXECUTIVE SUMMARY

In an attempt to stop inflation from becoming embedded in the economy long term, the Fed continued to raise interest rates in Q3. The Fed's actions and increasingly harsh rhetoric negatively impacted almost every sector of the stock market in Q3, although bank stocks performed better than most other sectors because higher interest rates are generally good for bank earnings.

Bank stocks remain significantly undervalued. The median bank stock in the PL Capital portfolio trades at only 8.4x 2022 earnings and has a 3.3% dividend yield.

Q3 and Q4 bank earnings should be strong, buoyed by higher interest rates, while higher rates and other economic issues may negatively impact earnings for many other sectors.

2023 bank earnings should be better than 2022's but will depend partly on whether the US enters a recession in 2023.

In our view, the Fed should stop raising rates because inflation is likely to decline regardless of further rate increases, and if they raise rates too far and too fast, the economy will suffer needlessly.

The Partnership remains almost fully invested due to the undervaluation of bank stocks.

THE FEDERAL RESERVE IS MAKING A MISTAKE BY RAISING RATES TOO FAR AND TOO FAST

In the Q2 letter, we discussed in detail why we believe the Fed is making a mistake by raising interest rates too far and too fast after keeping rates too low for too long in the face of rising inflation in 2021 and early 2022.

This policy error accelerated in Q3 when the Fed increased rates by 0.75% at both their July and September meetings. This increased the Fed Funds rate to 3.25% at the end of September. Additionally, they forecasted further rate increases in the coming months.

Because there is a long lag between changes in interest rates and the impact on the economy, the better approach would be to leave rates at the current rate of 3.25% and let the impact filter through the economy and financial markets. Then, if inflation remains stubbornly high in 2023, the Fed can continue to raise rates.

Unfortunately, the Fed seems determined to make up for their prior policy mistake by being overly restrictive in this rate cycle.

Until the path the Fed is taking and what their policy changes mean for earnings and the economy are clear, stock and bond markets will remain volatile.

BANK EARNINGS SHOULD BE STRONG IN Q3 DUE TO HIGHER INTEREST RATES

As discussed in prior letters, higher interest rates are generally good for banks and bank earnings. When interest rates rise, banks typically enjoy ***both*** higher net interest margins in % terms ***and*** higher net interest income in $ terms. This is a powerful tailwind for bank earnings.

This positive impact was already evident in Q2 bank industry aggregate earnings. For example, in Q2, the FDIC reported that banks enjoyed the largest increase in net interest margin (% terms, year over year) since 2010. ***And net interest income (in $ terms) set an all-time record high in Q2.*** These very positive trends should continue in Q3 and Q4.

Banks benefit from higher interest rates because income from their assets (loans and securities) typically grows faster than the increased cost of their funding (deposits and borrowed funds). Bankers refer to this as being "asset sensitive" which simply means that assets reprice more than liabilities.

Bank liabilities (primarily deposits) reprice slower than assets because banks enjoy the benefit of having no-cost and low-cost deposits that do not increase in cost as rapidly as open market interest rates.

Bankers refer to this as having a low "deposit beta," a mathematical term for how much deposit costs rise relative to open market interest rates. For example, a deposit beta of 30% means that deposit costs will increase by 0.30% for every 1.00% move in interest rates. Most banks typically have deposit betas over the entire interest rate hiking cycle (which may last many quarters or even years) of 15% to 35%.

Of course, some banks have more volatile deposit bases, and their betas will be higher. And most banks will lose some deposits due to customers leaving to seek higher rates on their money.

While higher interest rates are generally good for banks, it is not risk-free. The market value of banks' securities portfolios decreases when rates rise, which results in lower reported tangible capital ratios (the accounting is complicated, but generally, fluctuations in securities portfolio valuations run through the balance sheet and affect GAAP capital, but not earnings). It is important to note that market value fluctuations of banks' securities portfolios (both positive and negative) are excluded when calculating regulatory capital[1].

At some point, some banks may feel stress from lower tangible capital ratios, which may cause them to slow balance sheet growth. However, we do not believe capital raises will be needed due to this issue, partly because earnings will remain strong, and most banks have excess GAAP and regulatory capital.

The other stress point for banks will be if the economy goes into recession. Recession typically increases bank credit costs from bad loans. Right now, banks have excess loan loss reserves and strong loan portfolios, but we are watching for signs of economic deterioration and credit distress.

Fortunately, we believe the market has already partially factored increases in credit costs into 2023 earnings estimates. Moreover, the market has factored higher credit costs into the low PE ratios banks currently trade. In other words, the market is further discounting consensus earnings that already incorporate increased provisioning expenses in the future. So even if credit costs rise in 2023 and bank earnings estimates decrease, bank stocks may not decline (i.e., PE ratios may increase from their current 8x to 10x or more without bank stocks declining).

BANK STOCK VALUATIONS ARE TOO LOW

While low valuations on bank stocks seem to be a perpetual problem, please remember that bank stocks have historically traded at higher multiples in absolute terms and relative terms to the overall market.

For example, even though the overall stock market has declined in 2022, the PE ratio on the S&P 500 index is still approximately 16.1x. Many bank stocks the Partnership owns are trading at 8-9x PE ratios, approximately 50% of the overall market, which is too low. In prior years, bank stocks often traded at 70-90% of the overall stock market multiple. Moving to a 75% relative PE level would result in bank stocks appreciating approximately 45%, assuming no declines in the broad market.

Using data compiled from *Janney Research (FIG Group)*, Exhibit 1 below shows at the time of this writing, the NASDAQ Bank Index traded at 9.5x forward EPS versus 16.1x for the S&P 500, or a relative PE of 59%.

Exhibit 1: Price to Next Twelve Months EPS Estimates

	2016	2017	2018	2019	2020	2021	10/6/22
S&P 500:	15.9x	16.7x	16.8x	16.9x	22.1x	21.8x	16.1x
NASDAQ Bank Index:	12.9x	14.5x	14.4x	11.7x	12.0x	14.3x	9.5x
Relative PE:	**81%**	**87%**	**86%**	**69%**	**54%**	**66%**	**59%**
Long Term Median:		**69%**					

The current 8-9x PE ratios of many bank stocks the Partnership owns is also simply too low on an absolute basis given that banks are generating strong returns on tangible capital. For example, in Q2, the median bank in the PL Capital portfolio generated a 15% return on tangible capital.

We hope to see bank stocks improve in valuation as they demonstrate earnings resiliency in the second half of 2022 while many other industry sectors and companies suffer uncertain earnings trajectories. At least we can hope!

1 As an aside, note the mark to market accounting rules are one-sided for banks. The available for sale securities portfolio is generally marked to market each quarter, but loan, held to maturity securities portfolios and liabilities, including deposits are not. Undoubtedly, access to cheap funds at rates much lower than prevailing market interest rates (i.e. core deposits) is extremely valuable, but the accounting rules do not capture this positive fair value mark in a rising rate environment.

Please feel free to contact us at any time.

Best regards,

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