PL Capital Advisors, LLC

QUARTERLY REPORT TO THE PARTNERS Q2 2023

THE HIGH-PROFILE BANK FAILURES IN MARCH AND FIRST REPUBLIC'S FAILURE IN MAY PRESSURED QUARTERLY RESULTS

Bank stocks and the Partnership declined in Q2 and both were well behind the S&P 500 index. The worst of the Partnership's quarterly decline occurred in April and May following the high-profile failures of a few banks. Since early May no banks have failed and bank stocks appear to have bottomed. June was a positive month for the Partnership.

Below is a recap of the recent high-profile bank failures:

- March 8th – California headquartered **Silvergate Bank**, a specialty bank focused solely on the crypto industry announced it would voluntarily liquidate itself.
- March 10th – California headquartered **Silicon Valley Bank ("SVB")**, a venture capital industry focused bank, was closed by regulators.
- March 12th – New York headquartered **Signature Bank**, a high growth commercial bank with a small cryptocurrency focus, was closed by regulators.
- May 1st – California headquartered **First Republic Bank ("First Republic"),** a bank focused on high-net worth individuals, was closed by regulators. First Republic was given sufficient time to raise additional capital, but their balance sheet problems were simply too large.

We discussed these failures at length in the Q1 letter and have more on First Republic below.

FIRST REPUBLIC BANK

We wrote in the Q1 2023 letter that First Republic Bank, a $230 billion in assets financial institution headquartered in San Francisco, California, was at risk of failing.

As expected, it was closed by regulators, on May 1, 2023. Like SVB, First Republic grew its deposits at an unprecedented and risky growth rate. From 2019 to 2022, deposits grew 95% (for context, most banks grow their deposits 3 to 10% per year). It invested those deposits primarily in long-term jumbo mortgages for high-net-worth clients, often at fixed interest rates less than 3.0%. First Republic held those mortgages on its own balance sheet, apparently with no hedges against interest rate risk. This was fine when interest rates were low, but when the Fed started raising rates the mismatch in their balance sheet began to crimp their net interest margin and profits.

Even with the interest rate risk in their balance sheet, it is unlikely First Republic would have failed but for the failure of SVB. In many ways First Republic and SVB were very similar. So, when SVB failed, a crisis of confidence ensued, and First Republic suffered

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an old-fashioned deposit run with massive deposit withdrawals. We recall seeing pictures of depositors lined up outside First Republic branches as early as March 12th, the Saturday after SVB failed.

Most banks fail slowly, due to losses and a lack of capital. Banks generally do not fail quickly due to short-term deposit withdrawals and liquidity problems, but in this case the withdrawals were so large and came so suddenly that First Republic had to be closed by regulators. The bulk of First Republic was purchased by JP Morgan and no depositors lost any money.

Each of the three high profile recently failed banks had unique features that made them more susceptible to interest rate risk and deposit runs. Since the failure of First Republic in early May, no other banks have seen the level of deposit outflows which impacted First Republic and SVB, and the industry has stabilized. At worst, a few small banks overly exposed to long-term fixed rate assets may fail, but 99%+ of banks will not fail.

HAVE WE SEEN THE BOTTOM?

Contagion fears of additional bank failures, increased levels of short selling of bank stocks, and hyper media focus drove bank stock volumes to an all-time high in May. Average daily volume of the widely followed S&P Regional Banking ETF (KRE) more than quadrupled since March 8th, to 32 million shares a day versus 7 million shares a day prior. On May 4th, three days after the failure of First Republic Bank, volume in the KRE reached an unprecedented 118 million shares on media reports that two other regional banks were in distress, with both purportedly seeking a potential partner and/or outside capital. One of the banks immediately refuted the story. We believe short sellers planted that negative story, and others, to cause further declines in bank stocks, and of course the media is always looking for the most negative news to report.

Fortunately, heavy volumes, negative headlines and short selling frenzies often mark a bottom in stock prices. We believe that is the case for bank stocks. While bank stocks continue to be very volatile, it appears the worst is behind us. Specifically, we believe May 4th was the bottom in bank stocks, as measured by the KRE. Since that time no other banks, large or small, have failed. And we believe no other large banks ($50 billion in assets or over) will fail.
Now that the high-profile bank failures appear to be behind us, the proper focus is on where bank earnings are heading and what valuations bank stocks should garner.

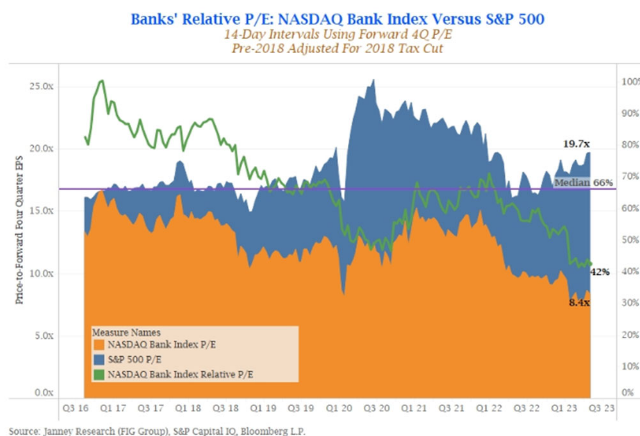
The bad news is that many banks will report lower earnings in 2023 than the record earnings many of them reported in 2021 and/or 2022. The good news is that bank stocks appear to have discounted all or more of the likely earnings declines.

Bank stocks were already cheap at the beginning of the year, with most banks trading at 8-9x estimated earnings. On top of those low valuations, banks have declined 20-30% year to date in 2023. Even with some earnings declines, bank stock prices appear to have bottomed out at low price-to-tangible book ratios and historically low earnings multiples, as further discussed below.

BANK STOCKS ARE SIGNIFICANTLY UNDERVALUED

As shown in the following chart, bank stock PE multiples are at historic lows relative to the S&P 500. The Nasdaq bank index is valued at 8.4x EPS versus the S&P 500 valued at 19.7x, a relative PE of 42% versus a median of 66%.

Exhibit 1: Bank Relative P/E Ratio Versus S&P 500



Source: Janney Research (FIG Group)

Bank management teams apparently agree with us, as demonstrated by the amount of insider buying since March. According to data from Raymond James' bank focused research team, since March 10th thru May 15th (date of the report), their coverage universe experienced 2.3 million shares purchased by insiders (highest since Q4 2019) while only ~335,000 shares were sold (lowest in the data set going back to Q1 2005).

On June 30th, the median bank owned by the Partnership traded at 7.4x earnings versus ~ 20x for the S&P 500 index, a relative PE of 37%, an extremely low level.

In our view, current bank stock PE multiples have already more than factored in declines in earnings.

Furthermore, the market is overlooking significant future increases in tangible book values per share as unrealized losses in bond portfolios decline. These unrealized losses, which were a headwind to tangible book value per share in 2022 as the Fed raised rates, will diminish over time as securities mature and pay down. The recovery of unrealized losses on bank's bond portfolios, together with bank earnings, will significantly increase future tangible book values per share, which should support bank stock prices.

Investors in the Partnership know our strategy is to generally remain fully invested if the Partnership holds attractively valued bank stocks, using shareholder activism to benefit from the long-term consolidation of the industry and collecting attractive dividend yields while we wait for M&A. We also generally hold limited short positions. Given that strategy, the Partnership periodically suffers from industry drawdowns driven by macro events such as the recent banking turmoil. We are not pleased with the Partnership's performance but are extremely enthusiastic about the current upside potential in bank stocks, given low valuations, high dividend yields, projected growth in tangible book value per share, and future earnings potential. Bank stocks are simply too cheap and investor capital will flow back to the sector at some point. Recall how bank stocks rallied over 100% off the Covid lows.

REGULATORY CHANGES

It seems, every time there is a crisis in the banking industry, politicians and regulators take it upon themselves to increase bank regulations, which in turn force banks to spend more money on compliance and maintain higher minimum capital levels. The new regulations and standards arising from the recent banking turmoil have yet to be officially proposed but will likely require higher minimum regulatory capital levels and the elimination of the Accumulated Other Comprehensive Income (AOCI) Opt-Out Election. The AOCI election allows all but the nation's four largest banks (JPM, BAC, WFC, and C), to exclude from regulatory capital calculations unrealized losses (and gains) arising from fluctuations in prices of their securities portfolios. Given the increased rate environment, almost all banks have mark-to-market losses in their bond portfolios. Those unrealized losses are already included in GAAP capital and tangible book value per share, but as previously mentioned are excluded from regulatory capital.

We expect only those institutions with greater than $100 billion in assets will be required to include AOCI in regulatory capital, and the

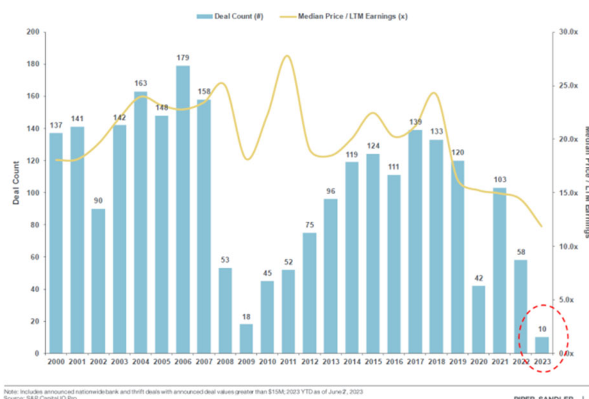
rule will be phased in over several years giving banks time to adjust. The bulk of unrealized losses in bank securities portfolios may already be gone by the time the full phase-in takes effect. Banks smaller than $100 billion in assets will likely be allowed to continue to exclude AOCI from regulatory capital.

We also believe minimum regulatory capital ratios will be higher in the future, by explicit regulation and/or implicit supervision, but any changes will also be phased in over several years.

The Partnership generally invests in banks with less than $100 billion in assets, so the Partnership's exposure to extraordinary regulatory changes is minimal.

BANK M&A IS ON HOLD BUT WILL RECOVER RAPIDLY IN THE NEXT FEW YEARS

Exhibit 2: Historical Bank M&A Activity



Source: Piper Sandler & Co.

Higher interest rates and lower bank stock prices have reduced M&A to a very low level. However, this merely delays the inevitable long-term consolidation of the industry. Once this period of turmoil passes, banks will continue to engage in M&A. In many ways, the turmoil will accelerate M&A in future years. This will be good for the Partnership and the banking industry.

While regulators have sent mixed signals in recent years about M&A, we believe the recent turmoil has made it more likely that regulators will approve appropriately structured M&A deals for all but the largest banks. And as shown by the rapid regulatory approval JP Morgan received when it acquired First Republic, even large banks can get regulatory approval in the right circumstances.

Q1 2023 FUNDAMENTAL RESULTS WERE SO MUCH BETTR THAN THE NEGATIVE HEADLINES SUGGEST

If you picked up the paper or turned on the TV over the past few months, you would think the banking industry was losing money. Quite the opposite is occurring. The first quarter of 2023 was the most profitable in the history of the banking industry! Yes, the first quarter of 2023, despite the high-profile failures and the decline in bank stock prices, was the most profitable quarter in the history of the banking industry. And for the 300+ publicly traded banks we regularly track, only 4 banks lost money in Q1 2023, one of which was because of a non-cash goodwill impairment charge.

As measured by the FDIC's Quarterly Banking Profile, the entire industry made approximately $80 billion in Q1 2023. The only other quarter that comes close is Q1 2022, when the industry made $77 billion. However, on an adjusted basis Q1 2023's net income was much greater than Q1 2022, because Q1 2022 included $14 billion in negative loan loss provisions (a positive effect on earnings) as it reversed out reserves previously established for potential COVID losses. In Q1 2023, the industry provided for approximately $21 billion of loan loss reserves (negative effect on earnings), a $35 billion (pretax) difference. Despite that negative $35 billion swing, the industry still made more money in Q1 2023 than the previous record quarter of Q1 2022!
To add more context, net interest income, the primary source of bank earnings, was $176 billion in Q1 2023, a near all-time record only surpassed by Q4 2022 at $180 billion.

Not all banks enjoyed record earnings in Q1 2023 of course. Generally, the larger banks did better than smaller banks during Q1 2023. But overall, the actual quarterly industry results were fine, and nothing like the doom and gloom seen in the media headlines.

There has also been a lot of concern that banks would have to cut or eliminate their dividends and/or raise capital. We disagree. We foresee very few banks cutting their dividends or raising capital. If anything, more banks will raise their dividends than cut and more banks will buy back stock than raise capital. In a recent survey of bank CFOs done after the bank failures of March and May, 57% of the CFOs cited plans to buy back stock in coming quarters.

Additional recent evidence of our view is the positive results from the Federal Reserve's annual "stress test" on the nation's largest banks. All 23 banks subject to the test passed. None need to cut their dividends or raise capital as a result of the stress test. In fact, several of those institutions raised their dividend immediately after the results were announced.

INTEREST RATES

We believe the Federal Reserve is nearing the end of its rate increases. There will likely be one or two more 25 basis point increases before the rate hiking cycle ends. While higher rates are a mistake by the Fed, as we discussed at length in other quarterly letters, it is also a sign the economy continues to be strong, a positive for the banking industry. A pause in interest rate hikes will allow banks to reprice their loan and securities portfolios upward, mitigating some of the current pressure on deposit costs and margins, and increasing the industry's profitability in the future.

CONCERNS OVER CREDIT LOSSES ARE OVERBLOWN

The news and financial media have produced numerous scary headlines about credit losses at banks and other lenders. Despite the headlines, bank credit metrics, as measured by loan losses, nonperforming assets, delinquent loans, and risk ratings, continue to remain very healthy. The long-awaited recession has yet to arrive. Real estate prices have certainly cooled from record highs seen in recent years, but prices are not collapsing the way they did in the Financial Crisis. Housing inventories for sale remain low.

In a recent survey of bank CFOs on what area was their biggest concern, only 7% cited credit costs, in fourth place behind funding costs, liquidity and increased regulation.

While we do not foresee large credit losses on the horizon, we do expect a normalization in bank credit costs in 2023 and 2024 from the abnormally low levels enjoyed by banks today. Most bank's Wall Street earnings estimates already incorporate an increase in future credit expenses.

There have also been concerns expressed about the impact of Covid 'work from home' policies on office buildings, particularly larger central business district office buildings. Fortunately, the loans on those large office buildings are typically not held by the types of community banks the Partnership favors.

Most banks owned by the Partnership have less than 5% of their loans secured by office buildings. Many of those office properties are owner occupied (more of a business loan than a property loan), for health care use (which requires physical presence), suburban (better than urban), or mixed use (retail, office, residential mixed). Furthermore, many community bank office loans are secured by multiple properties and are guaranteed by the borrowers. Average loan-to-values are generally 55% or less so even if there are some property level valuation declines the banks should not lose money. Based on our own experience serving on bank boards and after discussions with many bank management teams across our portfolio, and with other industry participants, we are not overly

concerned about office property exposures of the banks owned by the Partnership.

Regulators will also support banks as they work with their borrowers and customers. For example, on June 29th regulators issued a final *'Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts*.' This regulatory policy encourages banks to work with commercial real estate (CRE) borrowers on loan accommodations and modifications where appropriate. Specifically, the regulatory agencies state that banks which make accommodations for CRE borrowers will not be subject to regulatory criticism even if those accommodative arrangements result in modified loans that result in adverse loan classification. This is an extremely positive development as it encourages banks to be proactive when dealing with troubled borrowers, to the benefit of both the lender and the borrower.

NOTABLE PARTNERSHIP'S ACTIVITY

- On July 6th, Malvern Bancorp, Inc. (MLVF) a top ten position of the Partnership, announced receipt of regulatory approvals for its pending acquisition by New Jersey based First Bank (FRBA). Merger consideration will be $7.80 per share in cash and 0.7733 shares of FRBA stock, equating to $19.64 at the time of deal announcement and $16.25 based on FRBA's current stock price. PL Capital purchased approximately ~9.9% of MLVF between June and August of 2020. We like FRBA and are likely to hold the stock portion of the merger consideration.

We have seen bank stock prices diverge from the underlying fundamentals several times over the years, and each time has turned out to be an outstanding buying opportunity!

Bank stocks are simply too cheap. While timing is hard to predict, at some point investors and the market will realize bank stocks should be bought, not sold!!

We look forward to reporting back to you in Q3.

Please feel free to contact us at any time.

Best regards,

Rich, John, Curt, and Martin

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

John Wm. Palmer
(239) 777-0187
JPalmer@plcapitalllc.com

Curtis J. Thompson
(312) 560-2675
CThompson@plcapitalllc.com

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

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