Bank Performance Newsletter – Q1 2020
Rosenthal Income Strategies Fund LP ("Fund 3")

<u>Prologue – the Coronavirus Edition – (Part 2)</u>: Since our last *Bank Performance Newsletter* sent in February, the world has changed a great deal. Our *Q1 General Newsletter*, distributed to you on April 16th, was one of the most thorough and comprehensive letters we have ever sent and highlighted many of the impacts Covid-19 is having on the banking industry. We won't repeat all that here. But, if you missed it, the following is a link to that vital letter: *1st Quarter 2020 General Newsletter.*

Per our recurring pattern of communications with you, this letter presents key earnings and balance sheet metrics for our banks from the 1st Quarter. As you'll read, core results (pre-provision earnings) were fine. As expected, banks took meaningfully differing approaches to provisioning expenses given Covid-19 and its estimated impact on loan quality: thus, our focus on pre-provision earnings this quarter. Moreover, not surprisingly (given historic events and the lightning-fast pace of change) much of this data is 'yesterday's news' – or, somewhat less relevant than it might ordinarily be. Specifically, since the end of Q1 the first installment of Paycheck Protection Program loans ("PPP Loans") issued by many of our community banks under the CARES Act ($350 billion) has concluded, and the second segment of that program ($310 billion) is underway. This historic funding for small businesses is a boon for both the borrowers (and their employees) whose businesses are being helped – but also for our banks who've underwritten these **<u>government guaranteed loans</u>** (against which no capital allocations are required as part of the all-important "risk-based" capital calculation). While the interest rates on these PPP loans is low and will therefore slightly impact net interest margins, they will still <u>boost</u> *net interest income.* <u>More importantly</u>, the FEE income generated from this activity will be unprecedented! Origination fees being paid to lenders by the SBA for PPP loans vary from 1 - 5% depending on the size of the loan. In discussions with our banks, it appears that most of them are averaging between 2 - 2.5% fees on PPP loans. As an example, a bank who has facilitated $500 million in PPP loans is likely to receive fees around $11 million! We anticipate that most of this windfall will be used to boost the allowance for loan loss account. In essence, the government has helped banks fund a very meaningful part of potential loan losses banks may ultimately incur. This is an incredibly positive development for banks and, we believe, is not quite fully understood, or appreciated by investors. Plus, the number and quality of new client relationships many of our community banks are getting from this initiative is invaluable and should lead to future cross-selling opportunities – driving various revenue streams higher over time.

Next, as you might imagine, we are scrutinizing important new metrics. Specifically, we are monitoring so-called "at risk" loans extended by banks to borrowers in industries most affected by the coronavirus, i.e. hospitality, restaurants, and energy related concerns. In addition, we are pouring over data about the amount of deferred loan payments offered to clients by our banks. Banks are not being *penalized* (from a regulatory accounting standpoint) for deferring loan payments and, importantly, deferred payments don't *automatically* result in an *actual* loan loss. Nonetheless, it is a new yard stick which we are following closely.

Finally, before getting to the main part of our letter, we want to reiterate and highlight various reasons for our optimism over the long-run: 1) the Fed and Congress have signaled that they will go 'all out' to protect both consumers, businesses, and by extension, the banks, 2) bank's balance sheets were robustly fortified <u>prior</u> to the onset of the pandemic – positioning the industry to be able to assist clients under duress, 3) earnings at our banks, even in light of likely increases in loan loss expenses, should be sufficient to maintain dividends and continue to build tangible book value for the foreseeable future, 4) unlike 2008, there are no exotic or "proprietary" financial instruments in banks which might 'blow up' and cause a 'bank-specific' crisis, and, 5) valuations are simply too low; banks have been more heavily discounted than other market segments based on lingering memories from the Great Recession and current uncertainty. In our judgment, banks will bounce back more than other sectors once the virus is in check and the economy resumes more normal activity. We are not alone in our beliefs. The Global Investment Committee of Morgan Stanley is advising clients to "overweight" financials. With that said, please read on! The following update gives more evidence regarding the strength of our banks.

<u>1st Quarter 2020 Headlines</u>

- **Year-Over-Year Pre-Provision EPS for Banks in Fund 3 up a modest 3% (very acceptable in light of increased costs of adapting to Covid-19 operating environment)**
- **Key <u>Operating</u> Takeaways from Q1:**
    - **Wtd. Avg. Net Interest Margin down 10 Basis Points vs. Q4 '19. (Very good, given low rates)**
    - **Superior Overall Loan Quality (For Now) with Wtd. Avg. Non-Performing Assets/Loans at 0.58% up from 0.56% last year but well Below the 1% Level Considered Good/Normal. This will change meaningfully in Q2!**
    - **Wtd. Avg. Tangible Capital Remains Very Strong at 10.0% compared to 10.2% at 12/31/19**
    - **Current Dividend Yield for Fund 3 is 3.6%**
- **Detailed Portfolio Rebalancing Update Provided Below**

<u>Bank Performance Recap:</u> The headlines above and the chart on page 3 speak for themselves. Furthermore, repeating a key point in the Prologue, much of this info is rather a moot point. Things have changed very rapidly. What everyone should expect to see next quarter will be an increase in non-performing loans, a slight decline in margin, and relatively steady capital ratios. Again as noted above, we anticipate earnings will continue to support the dividends being paid by our banks and a continued increase in book value. But still, the biggest unknown will be earnings – on any basis – bottom line or pre-provision. Banks which participated in the PPP loan program will enjoy huge increases in fee income. We anticipate most of that bonanza will be earmarked for provision for loan loss expenses. We remain confident that our best-in-class banks will weather the economic slowdown and remain profitable. The additional commentary in the Table below provides a further recap of "performance" and we urge you to review that info.

<u>Portfolio Rebalancing Update:</u> We constantly strive for transparency. But we do not intend to overload or bore you with too much information either. Given all that is occurring in these uncertain times, we've added the following detailed table to keep you abreast of our actions and the logic behind them. **[Note: the *Culture* of any organization we buy is of utmost importance. All companies on this list have passed our rigorous screening criteria from a cultural perspective.]**

<u>Changes to Portfolio – YTD 2020</u>

Bank	**Action**	**Reasons for Change**
Q	Partial Sale	Sold 2,500 shares in a rebalancing exercise repositioning this company in line with our target allocation. This position remains a strong long-term position in the portfolio. Internal rating: B. External rating: Hold.
J	Buy	Bought 4,000 shares expanding our current position. This company has been exciting to follow as both earnings and dividends per share have grown rapidly over the past few years. This is a growth story with stout dividend (7.65% in the current price environment) provides our portfolio with the best of both worlds. Internal rating: A. External rating: Buy.
NA	Full Sale	We sold our entire position in this company following 1Q20 results that fell short of our expectations. Internal rating: B. External rating: Hold.
NA	Full Sale	We sold our entire position in this company in 1Q20 in anticipation of negative economic impact due to the company's exposure in restaurant/hospitality lending. Internal rating: C. External rating: Buy.

Refreshing portfolios thoughtfully and deliberately is part of our ongoing work on your behalf. We take great joy in doing it.

Finally, we are currently holding roughly 14% of our Fund in cash. Of course, cash does not provide an increase in value when stocks are declining – but nor does it decrease in value. We view cash as a neutral or passive hedge. We will utilize cash to strategically add to positions as conditions warrant.

We hope all this information is helpful to you. As always, if you have any questions or comments, we welcome your call to us at 574-243-6501. Or, shoot us an email to: john@rosenthalpartners.net or adam@rosenthalpartners.net

With warmest personal regards,

John Adam

Fund 3 Q1 2020 Recap

Ticker	Quarterly Record Pre-Prov. EPS?	Total Assets ($bils)	Pre-Provision EPS (1) 1Q '20	% Change from 4Q '19	% Change from 1Q '19	Tangible CE / Tangible Assets 1Q '20	Tangible CE / Tangible Assets 4Q '19	Net Interest Margin 1Q '20	Net Interest Margin 4Q '19	NPAs + Loans 90+ Days PD / Assets 1Q '20	NPAs + Loans 90+ Days PD / Assets 4Q '19	Reserves / Total Loans 1Q '20	Reserves / Total Loans 4Q '19	Beta vs. S&P 500	Beta vs. SNL Bank
A		$6.5	$0.78	-4%	1%	10.0%	10.6%	4.31%	4.43%	0.38%	0.37%	1.32%	0.71%	0.93	0.76
B		$5.8	$1.68	160%	5%	8.1%	8.1%	4.75%	4.97%	0.76%	0.53%	1.80%	0.78%	1.15	1.40
C		$3.9	$4.67	1%	3%	14.9%	14.4%	3.76%	3.78%	0.78%	0.73%	0.97%	0.96%	0.67	0.47
D		$3.8	$0.70	-2%	8%	7.6%	7.1%	3.38%	3.47%	1.08%	0.77%	0.77%	0.69%	1.19	0.92
E		$3.1	$32.47	NM	0%	11.4%	12.3%	3.12%	3.27%	0.40%	0.63%	1.08%	1.28%	-0.01	0.01
F		$2.9	$1.68	-3%	10%	9.3%	8.9%	3.37%	3.22%	0.20%	0.20%	0.89%	0.82%	0.78	0.59
G		$2.5	$0.73	3%	4%	9.6%	9.6%	3.51%	3.63%	0.20%	0.18%	0.76%	0.72%	1.11	0.92
H		$2.2	$0.78	4%	-5%	9.3%	9.8%	3.28%	3.71%	0.57%	0.54%	0.98%	1.09%	1.38	0.97
I	Yes	$1.8	$0.54	9%	16%	9.7%	10.0%	3.18%	3.31%	1.13%	0.52%	1.36%	1.19%	1.07	0.79
J		$1.8	$0.61	-12%	-16%	10.9%	11.3%	4.75%	4.89%	0.53%	0.69%	1.12%	0.98%	1.25	0.89
K		$1.7	$0.50	-28%	-22%	10.8%	11.7%	4.35%	4.56%	1.42%	1.30%	1.80%	1.72%	1.17	0.91
L		$1.2	$0.70	2%	-10%	10.1%	9.9%	3.16%	3.17%	1.29%	1.34%	1.26%	1.20%	0.15	0.09
M		$1.2	$0.18	-2%	-9%	10.5%	10.2%	4.08%	4.25%	0.46%	0.47%	1.38%	1.29%	1.15	1.24
N		$1.1	$0.43	-16%	7%	9.2%	9.6%	3.40%	3.59%	0.60%	0.61%	1.27%	1.13%	0.15	0.11
O		$1.1	$0.77	6%	4%	10.5%	10.6%	3.45%	3.45%	0.45%	0.50%	1.34%	1.29%	1.08	0.69
P		$0.9	$0.65	-19%	-9%	11.1%	11.0%	3.83%	3.92%	0.52%	0.57%	0.80%	0.77%	0.15	0.13
Q		$0.9	$0.55	20%	-12%	12.1%	11.9%	3.21%	3.27%	0.03%	0.02%	1.09%	0.95%	0.65	0.42
R		$0.8	$0.95	-7%	-5%	10.3%	9.9%	3.65%	3.76%	0.68%	0.70%	1.28%	1.27%	0.11	0.04
S	Yes	$0.7	$0.41	14%	77%	NA	9.0%	3.87%	3.74%	NA	0.42%	1.21%	1.16%	0.44	0.37
T		$0.7	$0.50	-13%	22%	9.8%	9.7%	4.49%	4.52%	0.42%	0.82%	0.93%	0.92%	0.00	0.03
U	Yes	$0.6	$0.71	4%	42%	9.5%	7.0%	3.96%	3.78%	0.01%	0.01%	1.64%	1.31%	0.12	0.10
Wtg. Avg.		**$1.9**		**2%**	**3%**	**10.0%**	**10.2%**	**3.65%**	**3.75%**	**0.58%**	**0.56%**	**1.19%**	**1.08%**	**0.67**	**0.52**

Note: For certain performance metrics, if data was not reported, consolidated and/or bank regulatory data for the most recent quarter available may have been used.
(1) Pre-Provision EPS = Pre-provision net revenue per share assuming a 21% federal marginal tax rate and based on average diluted shares outstanding. Pre-Provision Net Revenue = Net Interest Income + Noninterest Income - Noninterest Expense

Legend: Our color coded legend above gives an overview of GREAT, GOOD and BELOW PAR – but oftentimes does not tell the whole story. We do NOT adjust earnings for one-time events such as acquisition costs. So, a "red" in one quarter may end up being a bit misleading. Furthermore, given the lines of business for certain of our banks, there is some seasonality to income; which makes quarterly comparisons difficult. Green is outstanding and represents banks which have posted EPS increases of more than 5%, whose net interest margin is up and whose non-performing loans are down. Yellow is good and represents banks which have posted EPS gains within a range, up or down, of 4.9%. Red represents banks which have posted EPS declines of greater than 5%, had a decrease in their net interest margin or an increase in non-performing loans.

Finally, as always, past performance may not be indicative of future results. Therefore, no current or prospective client should assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the advisor), will be profitable or equal to past performance levels.