JOHN W. ROSENTHAL CAPITAL MANAGEMENT, INC.

2nd Quarter 2021 General Newsletter

Please Save the Date: 2021 Annual Investor Meeting To Be Held Monday October 25th, 8:00 a.m. – See Page 3 for Details

Prologue: In our recent *1st Quarter General Newsletter*, we wrote, "Worth noting, our forecast is for more [stock price] gains this year. But we do *not* anticipate the stupendous percentage increases of the past two quarters". Thus, not surprisingly, results this quarter have generally been more subdued. (See table below.) Nonetheless, halfway through the year, most folks would consider these YTD increases an awesome outcome for a *full-year*.

We expect solid 2nd half performance from our banks with strong bottom-line profits and EPS growth – which we assume will translate into further stock price appreciation later this year. So far this July, volatility remains high as overall market sentiment seems to be in flux and bank stock prices remain "range bound" at recent levels. More news is summarized below; please read on.

Headlines:

- **Just *"Holding"* the Substantial % Gains from the Past 2 Quarters Affirms the Strength of Our Banks**
- **Eight of our Portfolio Companies Acquired So Far this Year – Enhancing Overall Gains; M&A Activity Strong**
- **Fees from Payroll Protection Program ("PPP Loans") and Residential Mortgage Loans Continue to Boost Bank Earnings and Capital**
- **The Yield Curve Flattened Modestly in Q2. But still, the Spread between the 10 and 2 yr. UST has Increased from 0.51% (as of 7/1/2020) to 1.23% (as of 7/1/2021). This Historically Steep Yield Curve Will Benefit our "Asset Sensitive" Banks. However, the recent Slight Flattening, has Impacted All Bank Stock Prices**
- **Asset Quality Remains VERY Strong; Loan Deferrals Shrink and Charge-offs are Much Lower than Expected**
- **Fed Permits Reinstatement of Stock Buyback Programs and Dividend Restrictions Removed as of June 30**

Summary Data Tables (Results): The table below presents our performance this quarter – by month, QTD and YTD. We also included the results from Q1 '21 and Q4 '20 at the bottom of the table to highlight the incredible results which have occurred in our portfolios in the last 9 months. As to be expected, in some periods we outperformed our benchmarks or broader market indices; and in others we did not. Generally, we have done well against our benchmarks.

Q2 2021 Results

2021	Fund 1	Fund 2	Fund 3	^BANK[3]	KRE[3]	KBE[3]	Russell 2000[2]
April[1]	2.3%	4.3%	3.5%	3.0%	2.6%	2.9%	2.1%
May[1]	2.2%	3.5%	2.2%	2.8%	3.4%	2.5%	0.1%
June[1]	-4.8%	-4.8%	-3.8%	-6.1%	-6.8%	-6.2%	1.8%
Q2 '21	-0.5%	2.7%	1.7%	-0.6%	-1.2%	-1.1%	4.1%
YTD '21	20.1%	22.0%	23.2%	27.1%	26.8%	23.5%	17.0%
Q1 '21	21.7%	19.0%	21.2%	27.8%	28.3%	24.8%	12.4%
Q 4 '20	37.4%	42.0%	32.0%	41.5%	45.6%	42.0%	31.0%

1. Average monthly net rate of return after fees/expenses
2. Russell 2000 is a small-cap stock market index and "BANK" is the Nasdaq Small Cap Bank Index
3. BANK is the Nasdaq Small Cap Bank Index, KRE and KBE are regional bank stock ETF's

Random Musings – Tidbits, Mission, Philosophy and Approach: The normal flow of our letter would be to expound on each of the headlines above in separate sections. But, for the most part, the bullet points speak for themselves. So, while we will supplement some of those main themes at various spots in this letter, we are *breaking our pattern* and choosing to share some "Random Musings" rather than repeat in greater detail that which is sufficient as a headline.

First, we must emphasize again, *bank earnings* have been, are, and, we believe, will remain ***stellar!*** Earnings releases from banks which have already reported 2nd quarter results bear this out. Bank *stock prices* in the 2nd quarter started strong but fizzled a bit in June. Yet, on the heels of the whopping double-digit gains of the previous two quarters (and the continuing gains in the first two months of this quarter), simply *holding* gains during the quarter seems quite reasonable. (Things can't go up 20+% *every* quarter.) But interest from "generalists" in the banking space seems to have waned and there appears to be less urgency for them to add to positions in the financial services sector. Plus, we are now in the midst of the summer doldrums and trading volume is lighter. "Growth" (especially loan growth in the banking sector) remains a key focus and some market participants seem to have less conviction about the timing and magnitude of future economic expansion and increased borrowing. And, worth noting, several of our banks were removed from the Russell 3000 when the index raised the cutoff for market capitalization on June 25.

M&A remains in focus and we have more to share about that in a bit. Investors are clearly focused on takeout candidates given the weaker performance of buyers after deals are announced. Many of our banks are very attractive takeover targets.

Interest rates (especially the 10 yr. UST) have recently come down somewhat. As explained many times before, that is a double-edged sword for banks: putting some pressure on net interest margins but facilitating increased home mortgage loan origination fees. Simply put, there is always something. Good and bad. Which leads us to the main "musing" upon which we wish to reflect: ***the importance of long-term perspective.***

You know this in your heart and head but it bears highlighting from time-to-time. We are long-term, conservative, value oriented investors. Our overriding goal is to preserve and expand your wealth through carefully selecting healthy, well-managed, conservative yet innovative, growth oriented, client-focused, and geographically attractively located community banks. We fervently believe in the concept of "compounding value" by being consistently invested over time in stable banking businesses. We certainly focus on near-term results. But our highest priority is on ***long-term outcomes***.

We ardently believe that excellent long-term gains can be achieved over various economic cycles without having to "time" the market. We acknowledge that risks exist, challenges persist, and unknowns are inevitable. But through it all, *winners* will be the ones who "stick to their knitting" and avoid disastrous/outsized catastrophes. Given the highly regulated nature of banks, outright failures, or huge losses (while not impossible) occur FAR less than they do in other businesses/industries. To a large degree, the "service" nature of a bank also protects them against product obsolescence, changing fashion trends, or fads. Banks are not "meme" stocks!

The 5 pillars of our investment philosophy and approach are time-tested, proven, and driven by common sense. We exist to *create, protect, and preserve* your wealth – not to *gamble with your* wealth. Said another way, we are NOT speculators. We are fundamentalists! It is our core belief that through diversification within our own niche portfolios, we will avoid getting "tripped up".

Time is the best friend for the kind of investing we do! Investor's moods will swing; pandemics (or other black swan events) will occur; rates will move around; new technology will be invented; policies will change; multiples (P/E and P/B) ascribed to investments by investors will fluctuate – (but our banks will consistently grow tangible book value which will ultimately drive-up stock price); and the world will be very different in the future than it is today. But we believe our wonderful community banks will always be there to facilitate commerce. The way they do that will inevitably evolve – and as we have all re-learned very pointedly these past 18 months, "necessity" *is and will remain* the mother of invention.

From time-to-time we get a little friendly teasing from you all about our consistently optimistic or bullish views about our banks. That optimism is not simply rooted in our careful analysis of the banks in which we ultimately choose to invest; but partly due to this "larger view" of long-term "value" investing. This is the "game" we are playing! No bitcoin, no recapitalizations, no fads, no hoping for an occasional "grand slam" to cover frequent failures, no silly stuff. You've placed your trust in us to use this approach with a portion of your assets. We thank you for that trust and confidence!

M&A Activity Strong: It should be no surprise when we tell you bank M&A activity was severely depressed in 2020 when economic uncertainty created by the pandemic pushed many buyers to the sidelines. That sentiment has clearly shifted in 2021 and bank deals have surged with 60 such announcements made in 2Q21 according to a Raymond James Industry Brief from July 2, 2021. So, with this M&A resurgence, I'm sure you're wondering what these deals look like, why the sudden surge, and how do we try to capitalize on these transactions? Let's take a closer look at each of those issues below.

The structure of the deals announced, and price multiples have clearly changed in recent months for a variety of reasons. Even though the stock currency of acquiring institutions has generally gotten stronger, several large transactions have been structured as all cash deals. One such deal realized in *our* portfolio was Eastern Bankshares' acquisition of Century Bancorp. One could speculate the threatened changes to tax law may be influencing the final terms. In addition, pricing multiples have generally marched higher for the third consecutive quarter as bank stocks have outperformed the S&P 500 this year, and we believe pricing multiples will continue upward as the year progresses.

While it's difficult to generalize why M&A has surged, there's plenty of themes and speculation to review. First is the idea that many merger conversations were initiated in 2020 but tabled until this year due to COVID – boosting activity in 2021. Second, the uncertainty of future tax law changes may be pushing boards and management teams to take advantage of "more favorable" tax ramifications for a sale in 2021. Third, is the notion that mergers give institutions more scale to become efficient and invest in technology to meet growing customer demands. Finally, it could just be that bank boards, once on the fence about a sale, do not want to weather another storm like 2020 and have decided to "cash out" while valuations are high. In reality, a bank's decision to merge/sell is some combination of all the factors above and more. That is why analyzing the potential "take-out" prospect of a financial institution remains integrated into our bank evaluation methodology.

So, given all the deal activity, how do we work to capitalize on mergers? As noted above, 8 of our banks have been acquired so far this year (each at a premium). We continue to invest in banks with sound metrics, solid management, and are in great markets. It is our belief with greater regulatory scrutiny and higher valuations across the board, these banks at the "top of the heap" will prove to be "worth the squeeze" i.e. able to command a premium acquisition price, as acquirers look to prudently deploy capital over time.

Asset Sensitive Banks and How they will Drive Outperformance: An "Asset Sensitive Bank" is one who's loans and investments (assets) reprice faster/sooner than their deposits/other borrowed money (liabilities). Talk of the Fed tapering their bond buying programs and ultimately raising the target Fed Funds rates is front and center as inflation has recently increased. As rates increase in the future, asset sensitive banks will experience a faster/greater increase in net interest income than banks with a neutral asset/liability mix or a liability sensitive balance sheet.

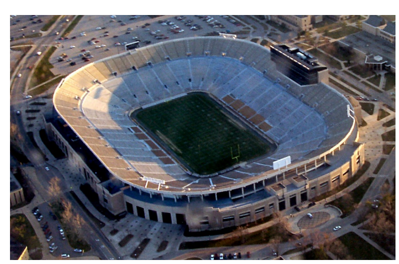
As you may recall, we have always placed a very high priority on owning stock of community banks with significant non-interest-bearing deposit franchises. Non-interest-bearing deposits don't reprice higher as rates rise. Banks with high proportions of demand deposits are therefore asset sensitive. Consequently, given the likelihood of the Fed tapering and ultimately raising rates, when they finally do go up, the majority of banks in our portfolio are more likely to benefit in the near term than the industry as a whole. Some of our largest holdings are the most highly asset sensitive banks in the country, including: Meta Financial, Merchants Bancorp, SVB Financial Group and Wintrust Financial Corp. Each of these banks are projected to have more than a 10% increase in net interest income with a 100 bp increase in interest rates. Meta, who has a business model and balance sheet with an enormous proportion of non-interest-bearing deposits could have an increase in NII of 40% or more. This is just another example of "data" that causes our bullishness.

Please Save the Date: 2021 Annual Investor Meeting To Be Held Monday October 25th, 8:00 a.m.:
We were not able to gather last year for the *10th Anniversary Celebration of our Annual Investor Meeting & Banking Industry Update*. Even though it's been a long, hard wait – *celebrate we shall* – in style and by having some fun!

10th Anniversary Celebration of our Annual Investor Meeting & Banking Industry Update
Monday, October 25, 2021 – 8:00 a.m. (Breakfast to Be Served)
Your Guests are Welcome to Join Us
Dahnke Family Ballroom – Notre Dame Stadium
Stadium Tour at the Conclusion of the Meeting
(Formal Invitations to Follow)

Agenda: The purpose and intention behind our gathering is to share our perspectives about money, investments, and equity markets; provide useful information on the "state of the banking industry" and specific details on our banks; showcase what we do as an investment management company; and *most importantly*, make up for lost time during which we were not able to see each other. We've desperately missed being with folks. I hope you agree that this program will be valuable, relevant, and worthwhile.

We've chosen to refresh our format and approach to this gathering. First off, as noted above, we've decided to move the time and location of our Gala. The size of the Dahnke Family Ballroom is quite large and the AV equipment is state-of-the-art – so we will spread out and provide some level of *social-distancing* for you. With the pandemic waning, but not necessarily fully behind us, we will forgo having a CEO from one of the banks in our portfolio as a guest presenter. While this feature of the meeting has been an informative and entertaining hallmark of past meetings, the truth is – this part of our program has drastically curtailed the type of robust Q&A session we wish to provide our guests. It's one thing for us to share *our* perspectives; it's another thing altogether for us to address questions or comments that are on *your* mind! So, more than any other function we've ever hosted, this will be an interactive session with hearty audience participation.



Stadium Tour: Maybe most interestingly, at the conclusion of our gathering, staff from the University of Notre Dame will provide you with a comprehensive tour of Notre Dame Stadium. A behind-the-scenes look at this football shrine should be great fun. (It may not be lost on you that the timing of our event is set to follow Notre Dame's victory over Southern Cal two days earlier!) Beyond this special tour, we have some other fun goodies to share with you at our party.

Virtual Attendance Alternative: If you are unable to attend in person, we will utilize the technology that has become commonplace during the pandemic and live-stream our function. (Unfortunately, you'll miss the stadium tour afterwards if you participate by Zoom.) Details regarding virtual attendance will be provided in the formal invitation to follow. We would consider it a tremendous honor and great personal favor if you are able to join us.

<u>Closing:</u> We've recapped results, highlighted current banking industry trends, and let you know about our upcoming annual meeting. But it was a particular delight for us to take this opportunity to emphasize our long-term investment philosophy and approach. Sharing the "big-picture" of how we think about what we do is an important thing to review from time-to-time. In fact, it is so relevant, we plan to delve even deeper into this at our 2021 Annual Investor Meeting and Banking Industry Update. We have vast experience and expertise in the banking industry! Couple that with our unwavering and conservative investing principles, and we have absolute faith and confidence in the long-term future of our Funds.

As we genuinely invite and encourage you to do in every letter, you may reach us with comments or questions by replying to this email or by calling the office at 574-243-6502, John's cell at 574-276-1128, or Adam's cell at 440-667-5974.

With warmest personal regards,

John Adam

<u>As has become our custom, the Appendices with various charts which we normally include have been added to our website and we invite you to peruse them there. The website is www.rosenthalpartners.net and the password/login to the Investor ONLY section of the site is: banksrus</u>

Additional Investment Form

I wish to *increase* my investment by:__________________________________

(Fill in any dollar amount ≥ $10,000)

Fund 1 Fund 2 Fund 3

(Circle the one(s) that you wish to increase your investment)

Name:____

Email:____

Best Phone #:____

I understand you will forward additional paperwork for me to execute which will indicate that I continue to accept *all* the terms and conditions of the Limited Partnership Agreement.

Please return this form using any of the following options:

Scan and email to: john@rosenthalpartners.net
or

Fax to: 574-243-4377
or

Mail to:
John W. Rosenthal Capital Management, Inc.
4220 Edison Lakes Parkway
Ste. 310
Mishawaka, Indiana 46545

THERE IS NO NEED TO SEND CASH NOW
We will Invoice You at the Proper Time

Questions Please Call 574-243-6501