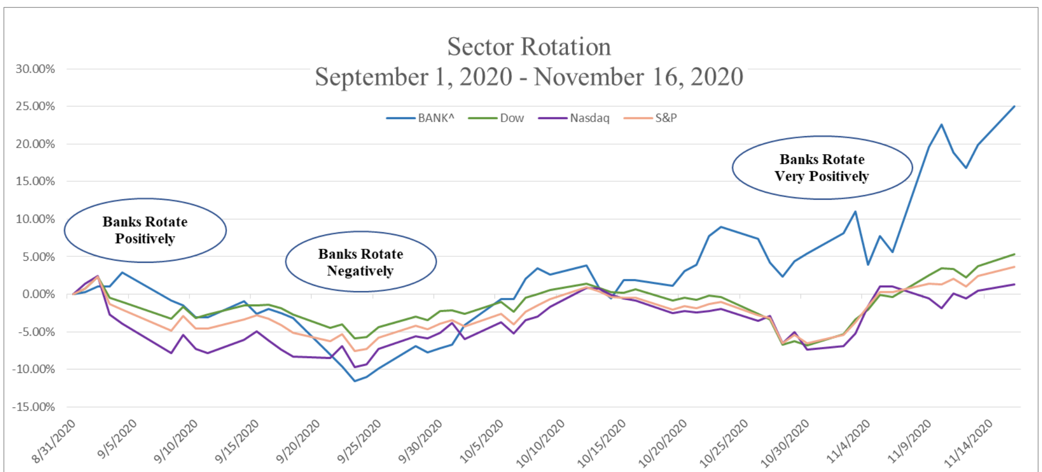
BANK PERFORMANCE NEWSLETTER – Q3 2020
RPCA FINANCIAL VENTURES QP & LP ("FUND 1")

Prologue: *October was a great month for all 3 of our Funds and they each produced double-digit percentage gains. (That's just the gain for October – not an annualized rate.) Additionally, at this writing, we've seen a further increase in November alone of approximately 16%! Woo hoo!* In our last letter we wrote, "In all candor, we are *very frustrated and exceedingly disappointed* with the stock price performance (not earnings) of banks in Q3 and believe the declines are unwarranted and unjustified." Given the rousing rebound of bank stock prices so far in Q4, it appears our views may have been correct and general investors have finally come to the same conclusion – causing bank stocks to surge significantly!

As demonstrated by the blue line in the graph below (which we've updated from the *3rd Quarter 2020 "General Newsletter"* sent last month) these positive results for bank stocks in Q4 are in stark contrast to broader market performance. October was the worst month for major market indices (not banks) since March. "Small cap value" stocks have regained favor vs. "large cap growth" stocks – and banks are finally getting some attention and recognition for being significantly undervalued. This positive *sector rotation* into banks is a function of various factors described below. But before we review them, it's important to remember that markets love clarity and struggle with uncertainty. Given recent events, uncertainty may have diminished – but hasn't vanished. Volatility will remain.



Bank earnings for Q3 have significantly exceeded analyst's estimates due to lower provision expenses and much higher fee income on home mortgage loan originations and Payroll Protection Program ("PPP") loans. Over the last several weeks, long term interest rates have risen, and the yield curve has steepened meaningfully. This too has facilitated the run-up in bank stock prices. In spite of this recent bounce, valuations remain well below historic levels and we believe there is more "room to run". While we are getting closer, the question remains: how long will it take for bank stocks to rebound fully? While we are not exactly sure *when* a complete recovery from the declines suffered during the "Black Swan" event called Covid will occur, we are VERY confident our stocks will eventually eclipse their previous highs – and continue to grow! We remain long-term value investors – not market timers!

3rd Quarter 2020 Headlines

- **Bank Earnings/Operating Performance Exceeds Analysts Expectations!**
- **Year-Over-Year EPS for Banks in Fund 1 Increased a Solid 4% while Linked-Quarter EPS Pop 36%!**
- **Tangible Book Value for Our Banks Continues to Grow, Creating Long-Term Shareholder Value**
- **Other Key Operating Takeaways from Q3:**
  - **Strong Revenues Enable Reserve Building to Continue in Pandemic Environment**
  - **Near Record Mortgage Loan Fees Contribute to Big Non-Interest Income Increases**
  - **SBA Loan Origination Fees Grow Due to Government Guaranteed PPP Loans**
  - **As Anticipated, Wtd. Avg. NIM Declined 40 BP's vs. Q4 '19 Primarily due to Low Rate (1%) PPP Loans**
  - **Loan Quality Remains Very Good with Wtd. Avg. Non-Performing Assets/Assets at 0.54% – Still far Below the 1% Level Considered Normal. More Commentary on Loan Quality Below**
  - **Dividend Yield[(1)] for Fund 1 is 3.15%**

(1) Using the "cost basis" vs. "current market price"

- **Detailed Portfolio Rebalancing Update Provided Below**

<u>Analysts Expectations Exceeded:</u> Overall, bank earnings have again surprised to the upside and caused many upward revisions to EPS forecasts and target stock prices. Industry wide, a whopping 88% of banks which have reported have *beaten* consensus forecasts (despite continued reserve builds) on strong mortgage banking results and good expense management. Also, we note that PPP Loans, while adding some noise to certain metrics we track (i.e. net interest margin, loan growth, reserves/loans, etc.), have resulted in meaningful additional interest and fee income and contributed to EPS beats.

Despite certain pressures, industry-wide, median *total* revenue growth was 3.9% (linked quarter) on top of 4.2% growth in Q2 as extraordinarily strong mortgage banking revenues have driven median *fee* income growth up 13.1% on the heels of being up 7.7% in the 2nd Quarter. And due to strong expense management, median efficiency ratios have declined to 57%, compared to 58% in Q2. (Lower is better!) As expected, fee income as a percentage of total revenue has leapt to 26% this quarter compared to 23% in Q4 '19!

<u>Linked-quarter EPS Results Shine, Tangible Book Value Grows:</u> Due to moderating provision expenses industry-wide this quarter, YOY *<u>pre-provision</u>* earnings increased a more modest 12%; but linked quarter (regular) EPS sprung up by 36%. Importantly, net income less dividends paid to shareholders have generally resulted in increased tangible book values for our banks. This is very meaningful. Ultimately, stock prices are partially determined based on a multiple of book value and earnings. Currently, those multiples have been depressed compared to historical standards. We believe that as P/B and P/E ratios continue to return to more customary levels, the increase in book value being generated by our banks will translate into much higher stock prices.

<u>Reserves for Possible Loan Losses Continue to Increase:</u> As highlighted in the Performance Recap Chart, Reserves/Total Loans have increased from 0.92% at the end of 2019 to 1.39% at the end of the 3rd quarter. This is despite an abnormally large increase in Total Loans, as PPP Loans exploded banks' loan portfolios. The point is: excluding the huge amount of fully guaranteed PPP Loans, this important ratio would be much higher! These heightened reserve levels serve to protect banks earnings should non-performing loans and any potential resulting charge-offs increase in the future.

<u>Interest Income Up Even though Margins Contract:</u> Net interest margins have long been a key metric in analyzing banks. However, it is <u>not</u> the only determinant of *net interest income*. Loan spreads, i.e. the difference between the yields on earning assets and the cost of liabilities (deposits and other borrowings) is only part of the equation to determine net interest income. The actual *<u>volume</u>* of loans is another key factor governing net interest income growth. This quarter, the low-priced PPP Loans (1% rate) definitely hurt margins – but the massive volume of these loans generally contributed to an overall increase in net interest income. The 6 bp median decline in industry-wide bank margins, as well as the 40 basis point decrease from the community banks in our portfolio which have done proportionately far more PPP loans than big banks, is therefore likely overstated due to the lower yielding (1.0%) PPP loans. As PPP Loans are forgiven, margins will rebound. Even so, we must acknowledge that the excess liquidity from all the Fed stimulus and the impact of Fed rate cuts have been a drag on *core* margins this year. Once again, we bring up the all-important notion that it's not only the actual level of rates, but the shape of the yield curve that ultimately drives net interest margins. Happily, the yield curve has steepened meaningfully with the 10/2 spread on UST's now hovering around 70 basis points. We are NOT unduly concerned about the new level of margins at our banks; but rather, we're pleased with the higher revenue from the PPP Loans – which have a zero risk-based capital weighting due to the 100% government guarantee.

<u>Loan Quality Holding Up:</u> The traditional measure of loan quality is Non-Performing Assets to Total Assets. Again, noise due to PPP Loans makes this bellwether less indicative of overall loan quality than usual. It is, however, still relevant. As noted in the headlines, NPA/Total Assets increased very modestly from 0.50% at the end of 2019 to 0.54% in the Q3, which is very much in a historically acceptable range. Emphasizing once again, strong revenue growth and good expense management have driven earnings generally above consensus expectations and allowed banks to build reserves to even higher levels than we saw in Q1 and Q2. While visibility into the next several quarters and beyond remains murky due to uncertainty presented by the disease, consensus earnings estimates are more positive this quarter compared to the significant forecast reductions in Q1. To date 2020 and 2021 consensus EPS expectations are up at (not by) an unprecedented 79% and 80% respectively for the banks which have reported 3rd quarter results. Since the market is both backward AND forward looking, this too has caused bank stock prices to rally so far this quarter.

In spite of good loan quality outcomes so far, NPA's are likely to continue to rise due to the lingering effects of the pandemic. We are staying in close touch with our banks and monitoring how borrowers who accepted temporary payment deferrals for certain loan payments begin to repay their loans now that the initial deferral period is over. We are very encouraged that median loan deferrals at banks in the Raymond James coverage universe are down to 2.8% at present compared to approximately 15% at June 30, 2020. We are also closely watching bank portfolios that have somewhat higher overall exposures to so-called "at-risk industries"; namely, entertainment, lodging, restaurants, and energy. Banks with higher concentrations in non-owner occupied commercial real-estate – especially retail and office building loans – are also receiving our special attention. That said, we reiterate our confidence in the long-standing conservative loan underwriting practices of our banks which have generated substantially better-than-peer outcomes throughout various credit cycles.

Now, let's switch gears…

Portfolio Rebalancing Update: We constantly strive for transparency. But we don't 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 the actions we've taken 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.]**

Changes to Portfolio – 3rd Quarter 2020

Bank	Action	Reasons for Change
H	Buy	Added 11,000 shares to bolster our position in this growth name. This company is well positioned to weather the downturn given its defensive characteristics, where it maintains limited exposure to at-risk market segments. Long term prospects are supported by solid core operating results in 3Q2020, where trends are favorable. Internal rating: A. External rating: Outperform.
P	Buy	Bought 54,000 shares to reestablish our position in this long time favorite. After trimming the position prior to the COVID pullback, we are excited to reacquire this name with tremendous upside as banks regain footing and work back to pre-pandemic levels. Given the company's national fee-based franchises we continue to view the risk/reward dynamic very favorably. Internal rating: A. External rating: Strong Buy.
S	Buy	Bought 32,000 shares adding to our existing position. The company is defensively positioned for the near-term, and offensively positioned as we rally towards recovery. Of note, despite throttling back its organic growth engine, it has had significant success with new business customer acquisition which should translate into organic growth as the economy recovers. Internal rating: A. External rating: Outperform.
Q	Buy	Bought 100,000 shares to begin our position in this name. Entering this position while the company traded below book value allows us to take advantage of the bank's strong asset quality. We are behind management as they have aggressively addressed the potential issues arising from the COVID pandemic. Internal rating: A. External rating: Strong Buy.
Y	Buy	Bought 70,000 shares to expand our position in this company. With a price target 15% above its current price per share (as of 11/16/2020), we are excited about this value buy. This company is well positioned with attractive growth prospects, excellent credit metrics, and healthy capital levels currently trading at a discounted price to tangible book value multiple relative to peers. Internal rating: A. External rating: Strong Buy.
R	Buy	Bought 202,000 shares to initiate our position in this name. Entering this position while the company traded below book value allows us to take advantage of the bank's strong asset quality. We view risk-reward positively given its proactive risk mitigation efforts, positive impacts from its interest rate hedging strategy, and solid profitability projections which compare favorably vs. peers despite its discounted valuation. Internal rating: A. External rating: Strong Buy.
NA	Full Sale	Sold entire position in this company. The sale was prompted by our forecast of below average loan growth which would imply a reduction in fee income. Internal rating: B. External rating: Market Perform.
NA	Full Sale	We sold our entire position in this company in 3Q20 in anticipation of the company's flattening growth curve and economic pressures specific to the operating footprint of this banking institution. Internal rating: C. External rating: Neutral.
NA	Full Sale	Sold entire position in this company following the completion of a merger and capitalizing on increase stock price that resulted. Internal rating: B. External rating: Market Perform.
NA	Full Sale	Sold entire position in this company due to concerns of earnings below forecast and smaller than expected reserve builds. Internal rating: B. External rating: Outperform.
T	Buy	Bought 14,000 shares to expand our position in this company. The strong reserves outplay its mild exposure to retail, and we have identified this company to have low loan to value on exposure in these potentially troubled areas. Our bullishness is a result of the company's peer-best deposit growth that will continue to drive record pretax pre-provision income in the coming quarters. Internal rating: A. External rating: Strong Buy.
Z	Buy	Bought 45,000 shares to initiate our position in this name. This name provides an attractive deposit base, ability to rationalize expenses, de-risked balance sheet, and heightened capital levels. Internal rating: A. External rating: Strong Buy.
C	Full Sale	Sold entire position in this company. The sale was prompted by a tax planning review and an opportunity to realize a capital loss in a name we believed would be slower to recover based on the market conditions of the company's operating footprint. This also gave us deployable capital to attribute to growth names in our portfolio. Internal rating: A. External rating: Strong Buy.

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

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,

Fund 1 Q3 2020 Recap

Ticker	Quarterly Record Pre-Prov. EPS?	Total Assets ($bils)	Pre-Provision EPS (1)	% Change from		Earnings Per Share	% Change from		Tg. CE / Tg. Assets		Net Interest Margin		Non Int. Inc. / Revenue		NPAs+90 PD/		Reserves / Total Loans		Beta vs. S&P 500	Beta vs. SNL Bank
			3Q '20	2Q '20	3Q '19	3Q '20	2Q '20	3Q '19	3Q '20	4Q '19	3Q '20	4Q '19	3Q '20	4Q '19	3Q '20	4Q '19	3Q '20	4Q '19		
A		$3.2	$0.63	5%	-9%	$0.60	9%	2%	10.5%	12.8%	3.55%	4.74%	19%	12%	0.33%	1.38%	2.40%	1.85%	1.23	0.99
B	Yes	$2.9	$1.12	45%	103%	$0.99	52%	106%	9.8%	10.4%	3.19%	3.47%	67%	62%	0.22%	0.37%	1.44%	1.35%	0.44	0.33
C		$13.4	$1.18	17%	52%	$0.88	17%	33%	8.4%	8.4%	3.84%	3.87%	22%	16%	1.33%	0.49%	1.19%	0.58%	1.35	1.39
D		$9.6	$1.06	-3%	-9%	$0.63	0%	-37%	9.2%	9.9%	3.43%	3.81%	31%	32%	1.00%	0.58%	1.59%	0.96%	1.16	1.02
E	Yes	$6.2	$0.44	14%	4%	$0.40	14%	11%	9.0%	8.5%	3.38%	3.10%	33%	37%	1.14%	1.14%	0.36%	0.34%	1.31	1.09
F		$3.0	$0.64	-8%	-8%	$0.55	0%	-20%	11.0%	11.3%	3.52%	3.91%	7%	9%	0.46%	0.42%	1.05%	0.90%	1.04	0.85
G		$0.5	$0.31	17%	-15%	$0.30	15%	-17%	10.3%	11.5%	3.25%	4.13%	19%	11%	1.26%	0.50%	1.25%	1.43%	0.28	0.21
H		$14.6	$1.32	-1%	13%	$1.03	54%	-10%	8.8%	9.8%	3.74%	4.24%	19%	14%	0.29%	0.37%	1.62%	1.06%	1.27	1.07
I		$5.0	$0.82	4%	-3%	$0.66	-12%	-19%	8.5%	8.1%	3.05%	3.39%	38%	39%	0.34%	0.30%	1.53%	0.61%	1.12	0.94
J	Yes	$2.8	$0.36	5%	22%	$0.25	-4%	-7%	9.5%	10.7%	3.30%	3.68%	5%	5%	0.04%	0.03%	1.40%	1.18%	NA	NA
K	Yes	$10.1	$1.53	2%	21%	$1.28	42%	20%	11.2%	12.2%	3.10%	3.54%	17%	8%	0.73%	0.73%	1.38%	0.97%	1.05	0.93
L	Yes	$4.0	$0.46	3%	6%	$0.45	0%	2%	9.9%	9.5%	2.65%	2.56%	10%	10%	0.09%	0.05%	1.08%	0.92%	0.99	0.82
M		$4.9	$0.64	-1%	6%	$0.55	2%	12%	10.0%	10.3%	3.51%	4.04%	25%	21%	0.48%	0.32%	1.44%	0.53%	0.93	0.76
N		$5.6	$0.91	0%	8%	$0.89	16%	7%	11.4%	12.0%	3.07%	3.32%	24%	22%	0.35%	0.50%	1.32%	1.24%	0.94	0.77
O	Yes	$2.4	$1.04	24%	89%	$0.67	91%	20%	6.0%	10.2%	2.82%	3.60%	34%	22%	0.86%	1.29%	1.12%	1.02%	NA	NA
P		$6.1	$0.54	-23%	-5%	$0.38	-28%	-28%	8.6%	8.1%	3.79%	4.97%	39%	40%	0.62%	0.53%	1.60%	0.78%	1.19	1.36
Q		$19.8	$0.80	19%	13%	$0.70	NM	1%	9.0%	10.2%	3.56%	4.37%	13%	5%	0.19%	0.10%	2.10%	0.41%	1.30	1.11
R		$145.2	$0.55	4%	15%	$0.52	NM	33%	7.8%	8.3%	3.15%	3.42%	38%	38%	0.95%	0.96%	2.54%	1.04%	1.38	1.17
S		$8.3	$0.50	-13%	-9%	$0.42	-11%	-14%	10.7%	11.1%	3.42%	3.87%	21%	18%	0.76%	0.71%	1.59%	0.67%	1.25	1.05
T	Yes	$63.8	$3.82	3%	25%	$2.62	19%	-4%	7.8%	9.3%	2.57%	2.74%	5%	2%	0.46%	0.35%	1.04%	0.63%	1.10	1.00
U		$4.4	$0.73	-7%	0%	$0.64	8%	-16%	9.5%	10.6%	3.28%	3.74%	28%	28%	0.32%	0.34%	1.44%	0.94%	1.04	0.85
V		$96.9	$5.36	0%	-6%	$8.47	92%	64%	7.5%	8.4%	2.54%	3.29%	40%	35%	0.12%	0.19%	1.34%	0.92%	1.48	1.11
W	Yes	$7.8	$1.63	16%	14%	$1.63	13%	22%	8.0%	8.5%	3.28%	3.47%	24%	25%	0.39%	0.47%	0.97%	0.81%	0.97	0.81
X	Yes	$2.8	$0.67	8%	44%	$0.49	2%	7%	7.8%	8.6%	3.22%	2.98%	13%	11%	0.64%	0.02%	1.13%	0.89%	0.99	0.80
Y		$43.7	$2.03	-12%	3%	$1.67	391%	-1%	6.9%	8.0%	2.58%	3.22%	40%	30%	0.52%	0.52%	0.98%	0.58%	1.31	1.17
Z		$78.4	$1.23	-5%	0%	$1.01	197%	-14%	7.9%	8.5%	3.07%	3.49%	22%	21%	0.74%	0.49%	1.56%	1.01%	1.01	0.96
Wtg. Avg.		**$20.6**		**3%**	**12%**		**36%**	**4%**	**9.2%**	**9.9%**	**3.22%**	**3.62%**	**26%**	**23%**	**0.54%**	**0.50%**	**1.39%**	**0.92%**	**1.03**	**0.88**

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.