



White Paper

Bank Stocks Poised for Multi-Year Bull Run

August 2020

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Executive Summary

In this white paper, we discuss major market cycles for bank stocks which have not traded as cheaply since the *Great Financial Crisis (GFC)* that ended in July of 2009, due to their cyclical business models tied to ebbs and flows of the economy. We furthermore conclude, that after a sharp move down in reaction to the *COVID-19* pandemic, banks may have begun a large, multi-year bull market move, particularly as peak loan losses (a buy signal) may have already taken place.

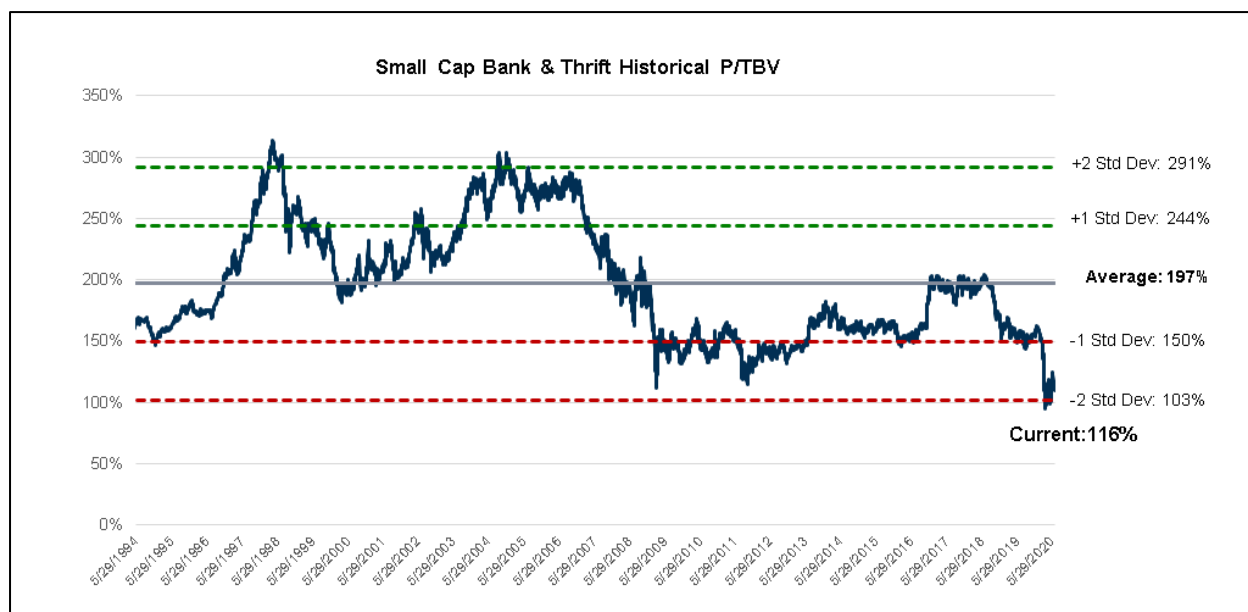
This conclusion is based on our examination of bank stocks in relation to the end of each major recession in recent decades. In each case, recessions triggered sharp downturns in bank stocks that typically cut valuations in half. Subsequently, these stocks began a powerful multi-year bull market five months before the end of each recession and generated a median return of 353%.

The amount of fiscal and monetary stimulus supplied in response to *COVID-19* is unprecedented and on a scale that is many times larger than what was provided in the *GFC*. The efforts to backstop the economy also serve as backstops to the banking industry. Banks are being utilized as an important part of the fiscal solution in this recession, as they earn millions of dollars in fees by making government grants to small businesses via the government's *Small Business Association* lending program. These fees help offset cyclical loan losses, while loan losses should be further mitigated by monetary and fiscal support.

Furthermore, bank regulators have given banks flexibility to give their borrowers leeway in making timely loan payments, recognizing that loan workouts can significantly reduce economic damage caused by lower economic activity during the pandemic.

In summary, we believe the large investable universe of bank stocks and historically low valuations create a compelling investment opportunity in the banking sector, with an attractive ratio of risk versus reward for long-term investors. Consolidation and operating leverage, the two major structural trends for small- and mid-cap banks, remain intact, albeit halted during this pandemic.

Bank Valuations at Cyclical Lows



Data Sources: S&P Global and FJ Capital Research.

The chart above displays the *Price-to-Tangible Book Value (P/TBV)* ratio of U.S. Small Cap Banks and Thrifts based on data supplied by *S&P Global* for U.S. banks with market caps of \$250 million to \$1 billion. This index covers a significant amount of the public bank universe, and excludes the largest and smallest public banks, which tend to have more complicated business models and lower liquidity, respectively. Accordingly, this index serves as a solid proxy for community banks in the U.S. and demonstrates that they are trading at cyclical lows not seen since the depths of the *GFC* a decade ago. We note the index did not remain at low valuations for long, and instead moved up sharply as the bottom in economic growth trends neared. Before we discuss bank valuation trends across historical economic cycles, a short primer on bank valuations is in order.

Bank valuations tend to be measured by both *Price-to-Earnings (P/E)* ratios and *P/TBV* ratios. The *P/E* ratio is a commonly used valuation metric across industries and is thus useful to compare one bank to another, as well as to companies across different industries. A shortfall of *P/E* ratios for banks, however, is that they do not adequately incorporate differences in capital levels (measured by *Tangible Common Equity to Tangible Assets*, or *TCE/TA*). *P/E* ratios also fail to capture significant decreases in bank profitability, which is very relevant in recessionary periods.

In contrast, *P/TBV* captures both differences in financial leverage and profitability. For banks, profitability is best measured by *Return on Tangible Common Equity (ROATCE)*, and our proprietary research shows a 70% correlation with bank valuations. Hence, *P/TBV* is a more meaningful metric than *P/E* in times of economic stress when bank *ROATCEs* are also stressed. As such, while *P/E* ratios show that banks trade at a discount to their historical medians, they fail to show the significantly decreased earnings for banks in a recessionary period. *P/TBV*, however, better illustrates vast differences in price levels, because they are compared to *TBV*, which is much more stable than *EPS*.

Historical Bank Stock Bear and Bull Markets

The table below demonstrates that bank stocks begin large, multi-year bull markets four to five months ahead of the end of each bear market. Given that the consensus view is that the current recession caused by *COVID-19* will end by the end of 2020, we believe the current bank stock bear market will end very soon if it has not already done so. Indeed, *Moody's* said on a recent conference call that the recession triggered by *COVID-19* has already ended. Accordingly, we believe it is a great time for long-term investors to invest in bank stocks for the upcoming multi-year bull market. However, it should be noted that a worsening of the pandemic and a resumption in mass quarantine will undoubtedly have a negative implication for struggling small businesses.

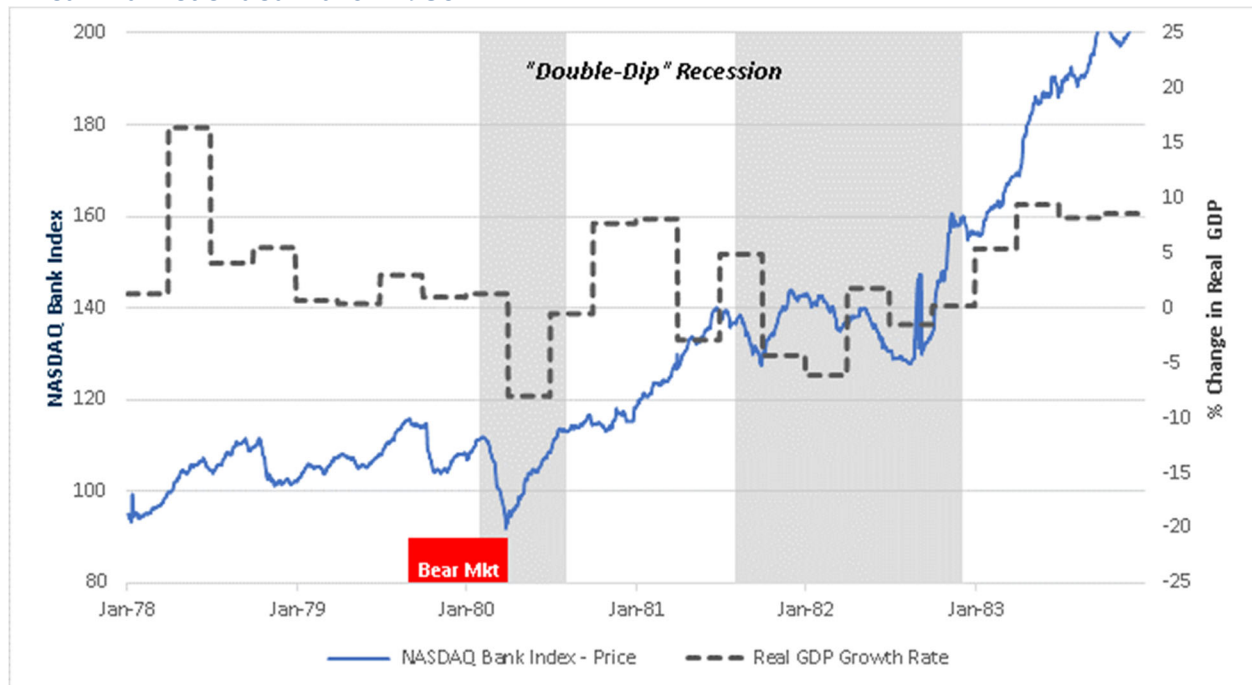
Bank Stock Bear Market				End of Recession	Months Bear Market Ended Ahead of Recession Ending	Bank Stock Bull Market			
Start	End	Duration (Months)	Price Return			Start	End	Duration (Months)	Price Return
Aug-79	Mar-80	7	-21%	Aug-80	4	Mar-80	Aug-89	115	434%
Aug-89	Nov-90	14	-52%	Apr-91	5	Nov-90	Apr-98	91	877%
Apr-98	Mar-00	23	-42%	Dec-01	21	Mar-00	Dec-06	83	158%
Dec-06	Mar-09	27	-66%	Jul-09	4	Mar-09	Jun-18	113	272%
Historical Median		19	-47%		5			102	353%
Jun-18	Mar-20*	22	-51%	?	?	?	?	?	?

*Near-term trough on 3/23/2020

Over the past 40 years prior to the current bank stock bear market, there have been four major bank stock bear markets and four major bank stock bull markets. We summarize these market stages in the preceding table, which was developed by examining the behavior of *the NASDAQ Bank Index* since its first trading day 1/3/1978.

The bank stock bear markets all had unique causes, but the pattern is consistent regarding the end of the bear market preceding each recession by at least four to five months. On a median basis, the four bank stock bear markets lasted 19 months with median 47% stock price correction, and in each case was followed by a powerful multi-year bull market with a median return of 353%.

Bear market ended March 1980

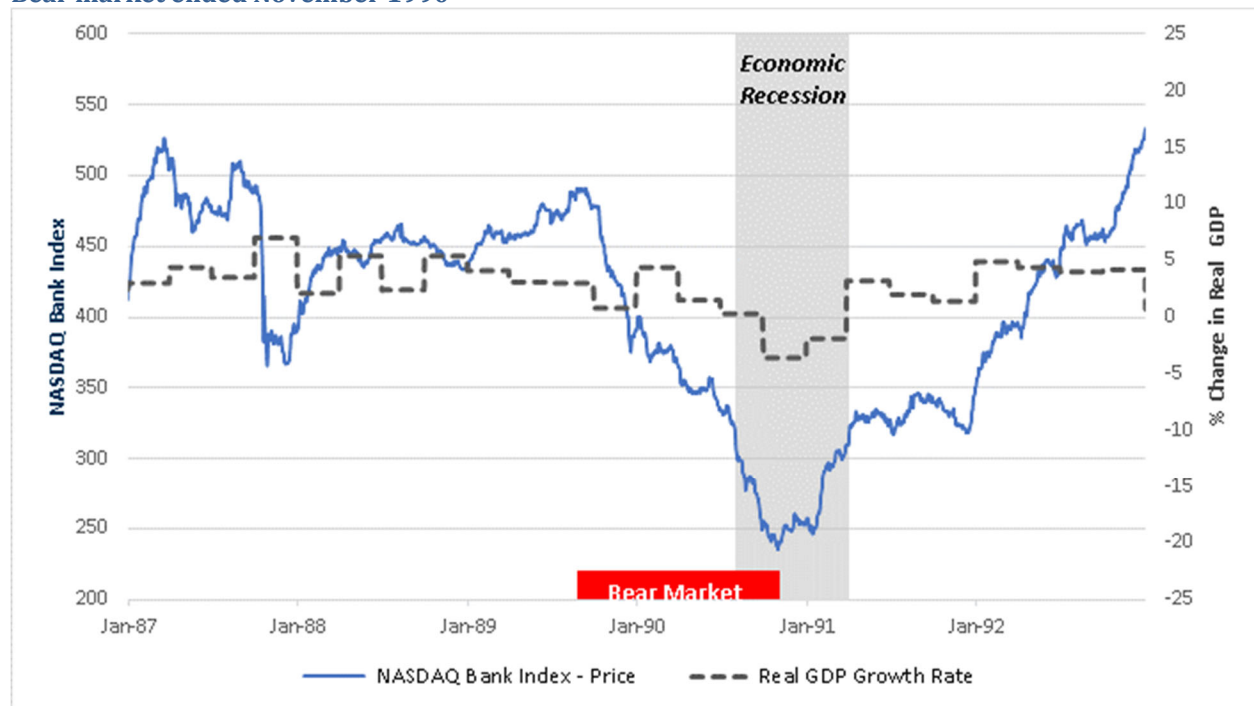


Sources: Factset

In the bear market ended March of 1980, bank stocks began their bull market phase four months before the end of the recession, or seven months after they began to decline. While the early 1980's saw a double-dip recession that covered nearly three years, the time to buy bank stocks was before the first recession began, as bank stocks began a bull market run that lasted almost 10 years.

The bear market was driven by *Middle Eastern* political tensions (*Iranian Revolution*) that roughly doubled oil prices over a year's time resulting in an oil shock, highlighted by long lines at gas stations nationwide. After spiking, oil prices began a decline lasting several years. The *Fed's* massive interest rate hikes also led to the second half of the double-dip recession. Economic growth finally resumed after the *Fed* broke the back of inflation and interest rates began their decent, accompanied by declining oil prices.

Bear market ended November 1990

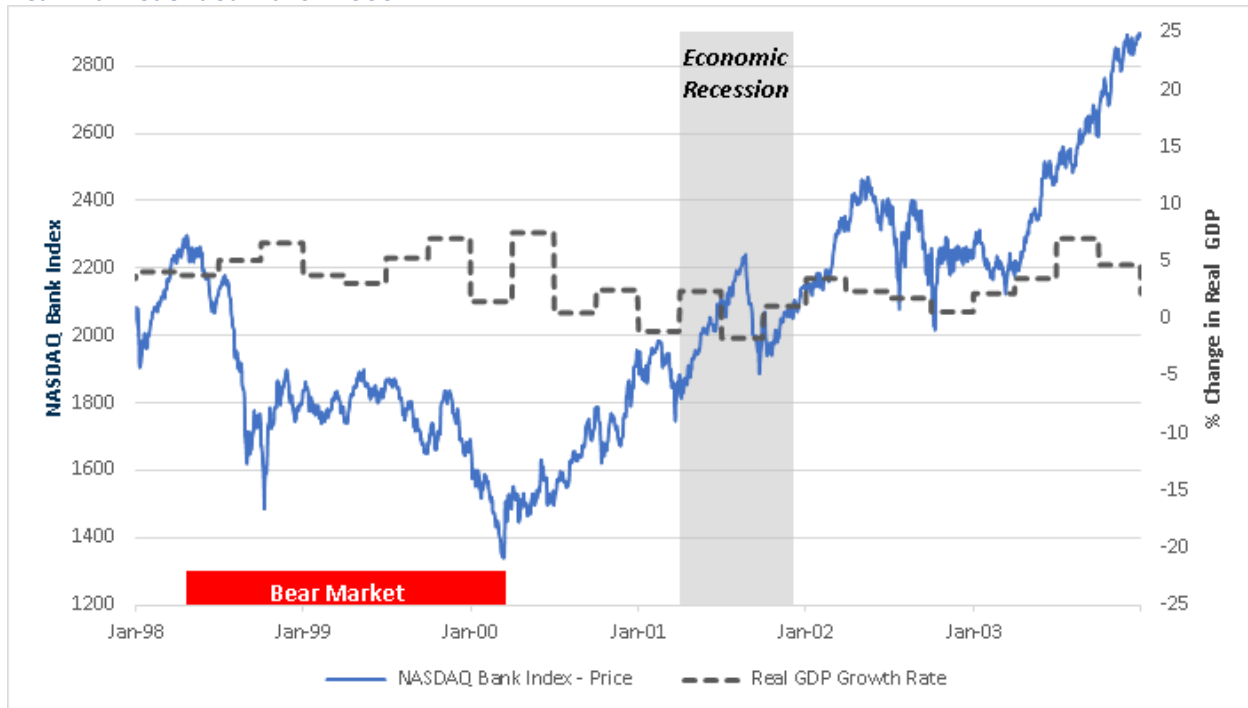


Sources: Factset

In the bear market ended November of 1990, bank stocks began their bull market phase five months before the end of the recession, or fourteen months after they began to decline. Looking back, the best time to buy banks was undoubtedly in the middle of the recession. The bear market was tied to the *Savings & Loan (S&L) Crisis*, higher interest rates and another oil shock relating to the *Gulf War*.

The recession was short and modest, paving the way for another bull market for banks that lasted more than seven-and-a-half years. That bull run would come to an end in 1998 as Russia defaulted on its debt after devaluing the ruble, and *Long-Term Capital Management (LTCM)* failed. Banks, subsequently, were hurt by *Fed* rate hikes and an inverted *Yield Curve*.

Bear market ended March 2000

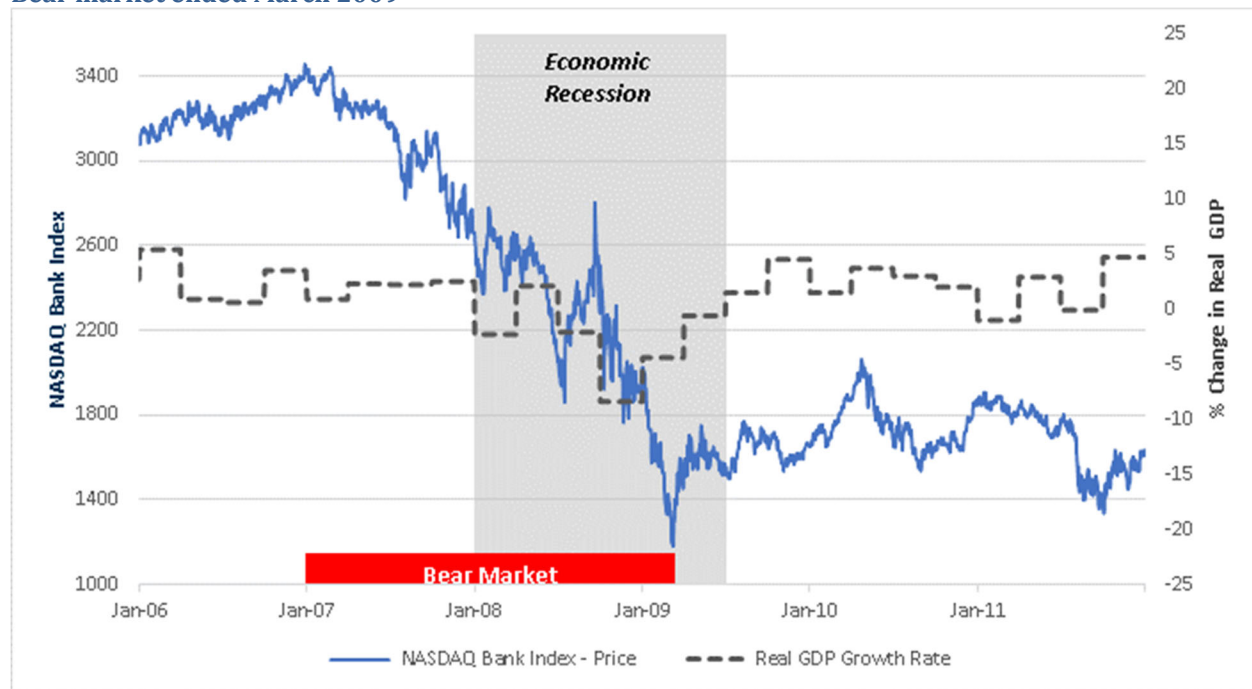


Sources: Factset

In the bear market ended March of 2000, bank stocks began their bull market phase 21 months before the end of the recession, or 23 months after they began to decline. March of 2000 marked the burst of the *dot.com bubble* and occurred in conjunction with the *Fed* hiking interest rates 175 bps between June 1999 and May 2000.

The best time to buy banks was nearly a year before the recession began in 2001, when they were over-sold and before money began to rotate out of tech firms and back into banks and other “old economy” companies. The aftermath of the bubble bursting, or “tech wreck”, left investors disillusioned by tech firms with once-lofty multiples that cratered as the firms failed to produce positive cash flows. Not surprisingly, tried and tested business models with positive cash flows and cheap valuations came back into vogue.

Bear market ended March 2009



Sources: Factset

In the bear market ended March of 2009, bank stocks began their bull market phase four months before the end of the recession, or 27 months after they began to decline. Once banks hit bottom, they began a bull market run lasting almost nine-and-a-half years with banks posting cumulative gains of 272%, based on the *NASDAQ Bank Index*. Once again, the best time to buy banks was before the recession ended.

The *GFC* or *Great Recession* became the worst recession since the *Great Depression* 80 years prior. The groundwork for the recession was laid as a massive residential real estate bubble formed and burst. Rising real estate prices fueled a “get-rich-quick” fad based on the notion that residential housing had historically experienced little downside and that future prices would only rise. Homebuilders cranked out an over-supply of homes to match massive demand from a large increase in the proportion of homes owned versus rented, while existing homeowners bought vacation homes and rental properties and a large number of house flippers also soaked up supply. Although many mortgage lenders relaxed standards or even resorted to fraud to capitalize on high borrower demand, inflated home prices put even reasonable lenders in jeopardy as unemployment began to rise. This is because loans originally underwritten with 80% loan-to-values (LTVs) left little real collateral for the banks once the bubble burst.

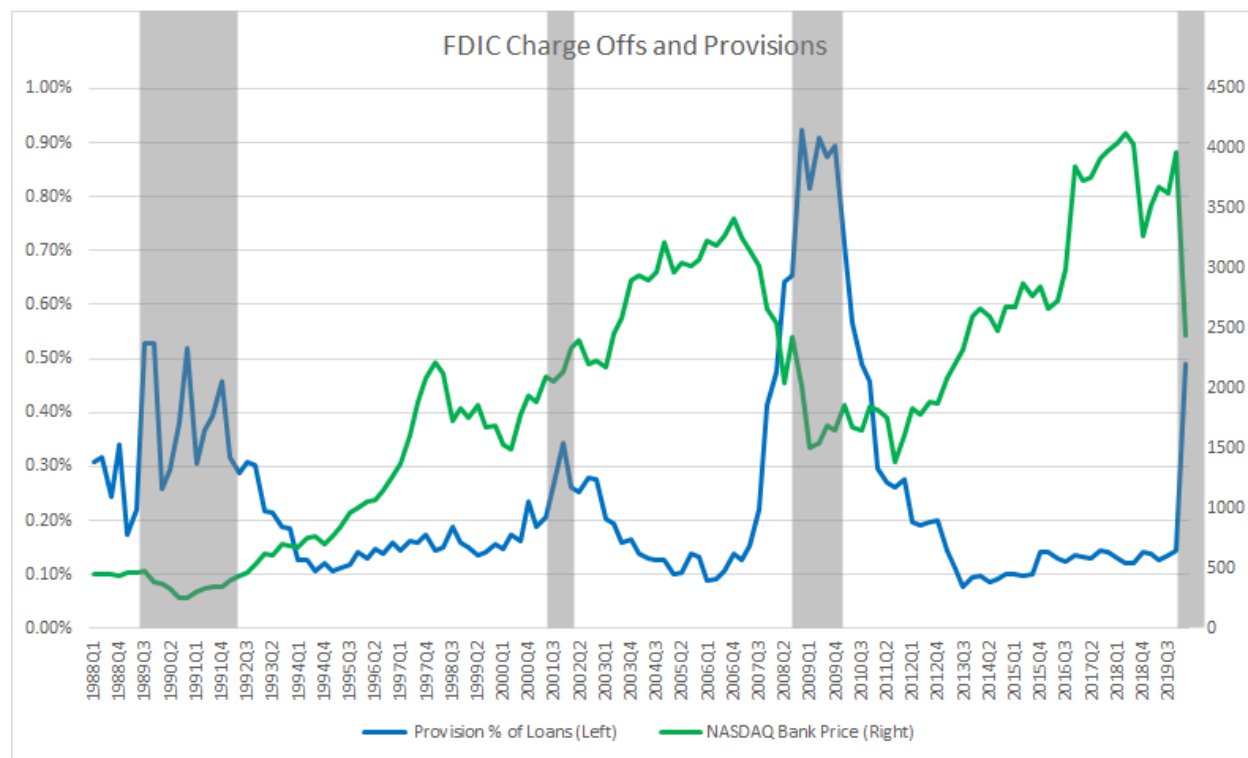
Banks and bank regulators learned tough lessons in the *GFC*, much of which has stuck with banks today. Lending standards have remained generally strong with nothing close to the sub-prime and no documentation/low documentation lending of the *GFC*. Importantly, banks have much higher capital levels than they did a decade ago. Most banks have *Tangible Common Equity-to-Tangible Assets (TCE/TA)* in a range of 8% to 10%, whereas these ratios were commonly 200 bps lower leading into the *GFC*. Banks were also slow to raise capital going into the recession, whereas many banks now have issued subordinated debt or preferred equity as a precautionary measure. Most banks have also prudently suspended buyback programs to maintain an elevated capital cushion in the current environment.

Peak Loan Loss Provisions, Contra-Indicators for Bank Stocks

Bank loan loss expense, known as the “provision for loan losses” on bank income statements, is a key metric monitored by the investment community used to help predict a bottom in bank stock prices. Increasing provisions portend lower valuations while lower provisions portend improving valuations. The importance of bank loan loss trends led us to examine loan loss provisions as a contra-indicator that could be used as a signal to buy banks when provisions are expected to peak. We also examined investment performance by taking advantage of such entry points.

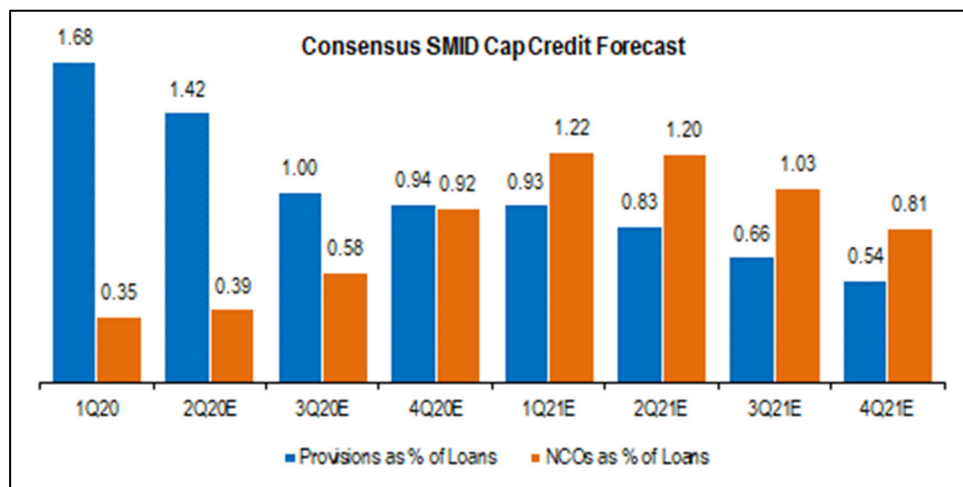
Provisions, as estimates of future losses, are generally forward-looking while net charge offs (recognition that it is time to write down the value of a troubled loan) historically have been a lagging indicator of credit performance. We expect that will especially be the case this cycle due to most public banks’ adoption of a new accounting standard last quarter. This standard is the *Current Expected Credit Loss* model, or simply “*CECL*”. Whereas under the old incurred loss accounting methodology, banks provisioned for losses that can currently be identified, *CECL* requires banks to front-load all estimated future losses over the life of any loans in its portfolio. This requires much larger up-front provisions when loans are booked and, of course, upon conversion to the *CECL* methodology, which has already occurred for many banks.

As provisions are intended to be forward looking, we review that as a factor to time the entry into bank stocks. Indeed, we find that when provisions are at their highest and earnings are depressed, this is the time to invest in banks. If one were to buy banks one quarter after peak provisions, historically that portfolio would have compounded 17% to 18% annually over long-time horizons afterwards. While the inverse correlation between stock price and provisions in the graph below is clear, it begs the question, when will provisions peak?



Sources: FDIC, Bloomberg

As CECL requires banks to adjust their loan loss allowances upfront, we expect earnings to bottom earlier this cycle. Consensus estimates hold that provisions peaked in Q1 of 2020, although there will many banks that will report higher provisions in Q2 of 2020. As we enter the back half of 2020, provision estimates begin to normalize despite that fact that charge offs should rise through the year. If provisions have already peaked and bank stocks have bounced off lows, is it too late the buy the banks?



Sources: Bank of America, Visible Alpha

We reviewed the historical performance of buying banks one quarter after peak provisions and found that returns typically compounded for a very long time after that. While there is evidence of volatility during the first year, despite still averaging a positive 9% return, buying banks near peak provisions would have allowed an investor to compound returns at 17% to 18% annually for two, three and five years afterwards. Furthermore, with hold periods of two years or longer, returns were positive in all cases that provisions spiked since the early 90's. While timing the exact bottom will prove difficult, we believe anyone with a medium- to- long-term investment outlook will benefit from buying banks as they move through peak provisions.

Peak Provision	1 Yr Return (Ann)	2 Yr Return (Ann)	3 Yr Return (Ann)	5 Yr Return (Ann)
1989Q4	-15.32%	4.02%	19.66%	16.12%
1990Q4	27.78%	42.24%	29.56%	28.36%
2001Q4	-4.63%	14.91%	10.78%	9.43%
2008Q4	26.84%	12.53%	9.16%	14.58%
2020Q1	?	?	?	?
Average	8.67%	18.43%	17.29%	17.12%

Sources: FDIC, Bloomberg

Government and Central Bank Support Has Been Off the Charts

A comparison of the *COVID-19* health crisis to that of the *GFC* reveals numerous differences with limited similarities. At the highest level, recessions usually have resulted from economic imbalances and excesses that eventually pop, driving vulnerabilities to extreme shocks. However, the cause of this recession is quite different than nearly all previous recessions. This is a true tail-risk, “black swan” health crisis that has created an “economic stoppage.”

Beyond this general commentary, one of the most substantial differences between this crisis and others has been the very swift and substantial monetary and fiscal policy efforts. During the *GFC*, a “playbook” was not established upfront to confront the significant challenges imposed by the crisis, and it therefore took meaningful time for the *Federal Reserve (Fed)*, *Treasury* and Congress to take action – the playbook was basically “made up” as they went along. This time, however, more of playbook has been established upfront and in short order; and what has resulted is highly coordinated action that may end up driving over \$10 trillion in stimulus, support, and liquidity to small businesses, consumers and capital markets.

Importantly, this stimulus has all come about in approximately 3 months, and we believe there is still more progress to come, as a \$1 to \$2 trillion “Phase 4” stimulus plans are now already in the works. This support should go a long way in stabilizing small businesses and drive lower bank loan losses. Below, the massive program of fiscal and monetary response is summarized, first in high level tabular form, and thereafter in more detailed discussion. In fact, as this white paper has been written, there has been promising movement in loans that were deferred due to *COVID-19*. Many banks are reporting significant reduction in deferrals (stressed customers) and loans that are fully paying interest and principal.

COVID-19 Fiscal and Monetary Response

Congress - \$ Billion		
Phase 1	8	
Phase 2 Legislation	192	
Phase 3 Legislation	2,260	
Phase 3.5 Legislation	483	
Congress SubTotal	2,943	
Fed Announced - \$ Billion		
Federal Reserve 13(3) Announced Facilities	2,300	~\$1.2T deployed
Fed MBS Purchases	469	
Fed UST Purchases	1,494	
Central Bank Liquidity Swaps	447	
Primary Dealer Credit Facility	6	Peaked at \$50B
Money Market Mutual Fund Liquidity Facility	30	
Commercial Paper Funding Liquidity Facility	13	
Total Fed	4,758	
Administrative - \$ Billion		
National Emergency Declaration	50	
Tax Filing Delay	300	
Total Administrative	350	
Total Allocated	8,051	
Fed Firepower Not Yet Allocated	2,590	
Total	10,641	

Phase 3 - \$ Billions		
Direct Payments/Rebates	293	
Unemployment Insurance	268	
Impacted Industries		
Airlines and Cargo	29	
National Defense	17	
Federal Reserve 13(3)	454	
Total Impacted Industries	500	
Tax Benefits	252	
Small Business		
PPP	349	
Loan Subsidies	17	
Other	11	
Total Small Business	377	
Direct Spending and Other Outlays	388	
Airline Wage Support	32	
State/Tribal Funding	150	
Total Phase 3.0	2,260	
13(3) Facilities - \$ Billions		
Primary Market Corporate Credit Facility	50	500
Secondary Market Corporate Credit Facility	25	250
Term Asset-Backed Securities Loan Facility	10	100
Municipal Liquidity Facility	35	500
PPP Lending Facility		350
Main Street Lending Program	75	600
Total	195	2,300
CARES Act Funding		
Used	195	
Remaining	259	
Leverage	10.0x	
Additional Firepower	2,590	

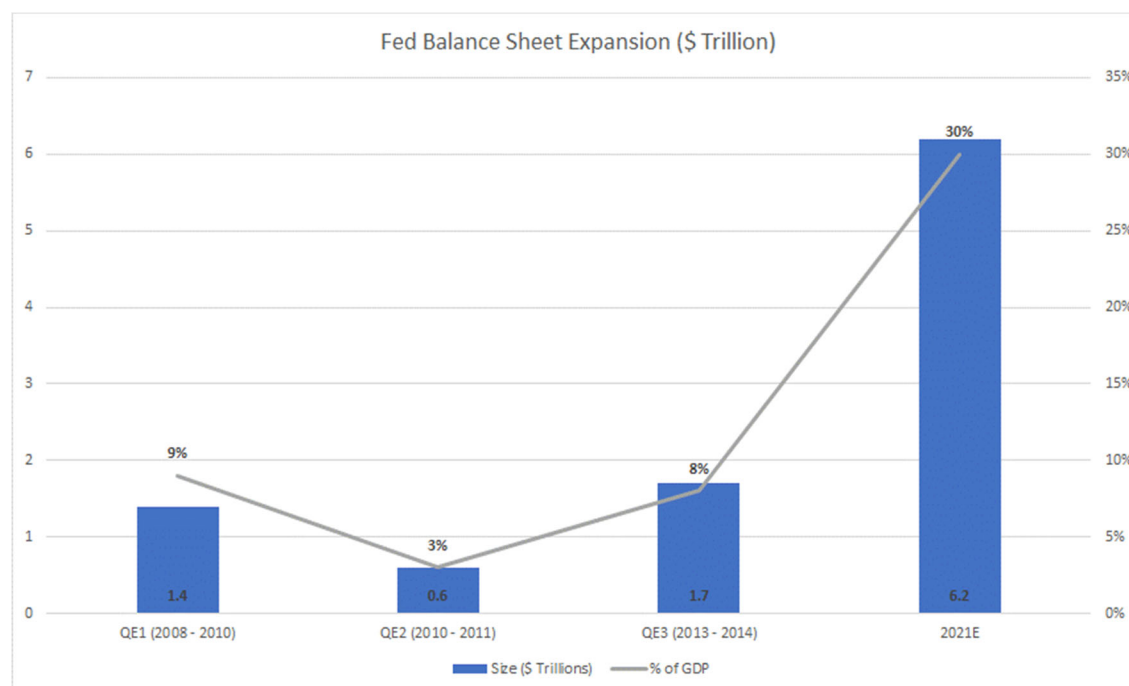
Fed Balance Sheet Expansion This Time Is Multiples Larger and Quicker Than the Past

Many investors hear the *Fed* is once again active with quantitative easing, buying U.S. Treasuries, agency MBS, and providing support through a variety of liquidity and stimulus programs as mentioned above. However, we believe many investors are underestimating or not fully grasping the magnitude or size of these efforts.

Since resuming quantitative easing in mid-March, estimates suggest the *Fed's* balance sheet will expand by around \$6.2 trillion by year-end 2021 based on programs announced to date (though not yet all fully implemented such as the *Main Street Lending Program – MSLP*), future asset purchases to come, along with additional potential programs in the future. This would bring the *Fed's* balance sheet to over \$10 trillion, compared to around \$4 trillion in mid-March 2020, and currently at a little over \$7 trillion.

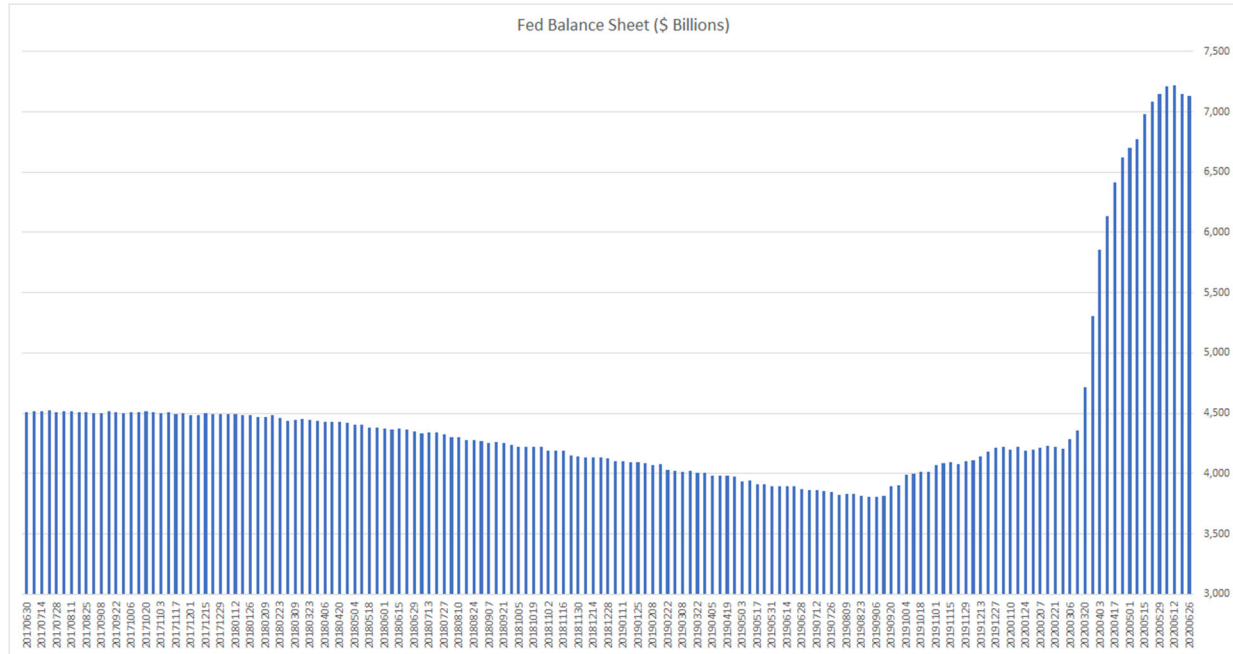
To put this into context, \$6 trillion of balance sheet expansion is a massive 30% of GDP! In the prior quantitative easing phases, the *Fed's* balance sheet expanded by only \$3.7 trillion combined, or an aggregate of 20% of GDP. Plus, those programs lasted roughly six years. Impressively, the *Fed's* current balance sheet expansion of ~\$3 trillion has taken just 3 months, and it is expected to take just 18 months to get to a \$10 trillion total balance sheet, three times quicker than the previous easing phases despite growing the balance sheet 1.7x more.

Fed Balance Sheet Expansion



*Morgan Stanley Estimates for 2021E

Fed Balance Sheet (\$ Billions)



Composition of Fed Balance Sheet (\$ Billions)

	20200515	20200522	20200529	20200605	20200612	20200619	20200626
Total Factors Supplying Reserve Funds	6,983	7,086	7,146	7,213	7,218	7,143	7,131
<u>Securities Held Outright</u>	<u>5,843</u>	<u>5,955</u>	<u>5,947</u>	<u>5,972</u>	<u>5,988</u>	<u>6,090</u>	<u>6,143</u>
U.S. Treasury Securities	4,057	4,089	4,110	4,134	4,150	4,169	4,197
Federal Agency Debt Securities	2	2	2	2	2	2	2
Mortgage Backed Securities	1,784	1,863	1,835	1,836	1,836	1,919	1,943
Repurchase Agreements	157	157	181	212	167	79	70
<u>Loans</u>	<u>115</u>	<u>109</u>	<u>107</u>	<u>102</u>	<u>98</u>	<u>95</u>	<u>95</u>
Primary Credit (Discount Window)	24	20	18	11	8	7	6
Primary Dealer Credit Facility	10	8	6	6	6	5	4
Money Market Mutual Fund Liquidity Facility	40	36	33	30	27	25	23
Paycheck Protection Program Liquidity Facility	41	45	49	55	57	58	63
Commercial Paper Funding Liquidity Facility	4	4	13	13	13	13	13
Corporate Credit Facility	0	2	35	36	37	39	41
Municipal Liquidity Facility	0	0	0	16	16	16	16
Main Street Lending Facility	0	0	0	0	32	32	38
TALF	0	0	0	0	0	0	9
Central Bank Liquidity Swaps	441	446	449	447	445	352	275
Other Federal Reserve Assets	579	571	595	627	588	506	502

Paycheck Protection Program (PPP)

Congress allocated \$659 billion to the *Paycheck Protection Program (PPP)*; a cash flow assistance loan program designed to help small businesses stay afloat during this challenging economic period resulting from *COVID-19*. With the goal to primarily keep employees on the payroll, the program featured loan forgiveness options, making these loans akin to grants if borrowers followed program guidelines. Congress passed a second round of *PPP*, following the first \$349 billion round which was completed just two weeks after implementation. This brings the total program to date to \$659 billion.

As of June 20th, \$515 billion or 4.67 million loans, has been approved, leaving material capacity north of \$128 billion to be used by new borrowers. As we have noted on several occasions, community banks specifically have played a key role in the deployment of capital in the *PPP*. Since inception, lenders with less than \$10 billion in assets have originated ~44% of loans by dollar volume and ~50% of loans by unit count. Additionally, on June 5th, *President Trump* signed the *Paycheck Protection Program Flexibility Act of 2020 ("Act")* to enhance flexibility for borrowers.

At the end of the day, small businesses account for ~50% of U.S. employment. Keeping these businesses operating during this challenging period will help ensure that the true economic recovery can be swifter when it materializes in greater depth. We would be remiss not to mention that greater take-up in the *PPP* helps community banks earn more fee income in the near-term, along with generating valuable new customers for future business. More importantly though, over the long-term, usage of the program will provide better protection against credit losses in banks' loan portfolios as these customers are the precise customers community banks are already lending to. Funding of the *PPP* to these customers will reduce the ultimate loss content for existing bank loans as it helps small businesses make their way through this crisis.

Key Terms and Features of the Paycheck Protection Program

Item	Detail
Eligible Businesses	Businesses and non profit organizations with 500 or fewer employees
Maximum Loan Size	Approximate equivalent of 10 weeks of payroll costs; 250% of average monthly payroll, up to \$10 million
Loan Uses	At least 60% for payroll costs, with remaining for interest on mortgage obligations, rent, and utilities
Interest Rate on Loans	1% annual
Lender Origination Fee	5% for loans up to \$350,000; 3% for loans \$350,000 - \$2,000,000; 1% for loans greater than \$2,000,000
Maturity	Loans issued on or after June 5, 2020 - 5 years; Prior to that date - 2 years
Deferral	Principal and interest deferral for 1 year
Forgiveness	Up to 100% of the PPP loan to the borrower is forgivable to the extent applicable terms are met
Time to Deploy Proceeds	Must be spent during the 24-week period immediately following disbursement or December 31, 2020, whichever earliest
Time to Rehire	Staffing and wage levels must be restored by December 31, 2020
Payroll Taxes	Payroll taxes may be deferred for businesses who loans are forgiven
Loan Guarantee	100% guarantee by SBA to the lender
Loan Liquidity	Can be put back to the SBA after 7 weeks based upon expected forgiveness; Can be funded using the PPPLF from the Fed

Main Street Lending Program (MSLP)

The *Main Street Lending Program (MSLP)* is a \$600 billion facility via a *Special Purpose Vehicle (SPV)* created by the *Fed* with \$75 billion in support from the *Treasury* to increase lending to small and medium sized businesses. Banks will originate these loans, keeping a 5% risk retention with the *SPV* purchasing the remaining 95% of the loan. Banks will earn an origination fee on the loan, along with an interest component on the amount retained. The *MSLP* has three different products available, including the *Main Street New Loan Facility (MSNLF)*, the *Main Street Priority Loan Facility (MSPLF)*, and the *Main Street Expanded Loan Facility (MSELF)*. All three are similar in concept and differ primarily in terms of minimum and maximum loan sizes, thereby serving a broader range of customers.

The bottom line for banks - the *MSLP* is an important mechanism to generate incremental spread- and fee-income, while at the same time deepening relationships with new and existing customers given more comprehensive underwriting with true extensions of credit. Further, given the *Fed's* significant participation in the program, banks may also open the "credit box" to customers they previously would not have banked, thereby potentially increasing market share from non-banks and alternative "FinTech" lenders. For borrowers, the *MSLP* could be an attractive source of financing to help manage through these tough economic times, given the loans have a 5-year duration, low all-in interest rate, and options for both principal and interest deferral.

Overview of the Main Street Lending Program

	Main Street Lending Program (MSLP)		
	Main Street New Loan Facility	Main Street Priority Loan Facility	Main Street Expanded Loan Facility
Acronym	MSNLF	MSPLF	MSELF
Program Summary	New loans to qualifying firms	New loans to qualifying firms already with more indebtedness	Upsized loans to existing borrowers
Loan Term	5 years		
Minimum Loan Size	\$250,000		\$10,000,000
Maximum Loan Size	The lesser of \$35M, or an amount that, when added to outstanding and undrawn available debt, does not exceed 4.0x adjusted EBITDA	The lesser of \$50M, or an amount that, when added to outstanding or undrawn available debt, does not exceed 6.0x adjusted EBITDA	The lesser of \$300M, or an amount that, when added to outstanding or undrawn available debt, does not exceed 6.0x adjusted EBITDA
Lender Risk Retention	5%	5%	5%
Principal Repayment	Principal deferred for two years, years 3-5: 15%, 15%, 70%	Principal deferred for two years, years 3-5: 15%, 15%, 70%	
Interest Payments	Deferred for one year		
Interest Rate	LIBOR + 3.00%		
Program Fees	100bps of principal paid to SPV (cost can be passed to borrower). Borrowers can be charged up to another 100bps of principal amount at the lender's discretion		Lenders must pay SPV 75bps of upsized tranche's principal amount (cost can be passed to borrower); borrowers can be charged up to another 75bps of principal amount at the lender's discretion
Servicing Fee	SPV pays lender 25bps of the principal amount of its participation per annum		

Troubled Debt Restructuring (TDR) Relief

Section 4013 of *Coronavirus Aid, Relief, and Economic Security Act (CARES Act)* provided an extremely important provision for banks, notably significant relief for *Troubled Debt Restructuring (TDRs)*. In conjunction with this legislation, the primary bank regulatory bodies, the *Office of the Comptroller of the Currency (OCC)*, *Federal Reserve Board (FRB)*, and *Federal Deposit Insurance Corporation (FDIC)*, issued joint guidance that gave banks enhanced flexibility to work with customers during the *COVID-19* crisis by allowing the deferral of payments for up to six months, among other tools, without having to classify such loans as TDRs. A TDR may occur when a lender modifies an existing debt agreement with a borrower due to the borrower's financial difficulties. Determining whether a loan modification is a TDR is a complex process, but typically requires a determination that the borrower is troubled and that the modified terms are more attractive than standard market terms.

A TDR classification is typically a negative event for banks, as some investors treat them as nonperforming loans (NPLs) and regulators also scrutinize credits classified as TDRs more heavily. But under the *CARES Act*, banks may suspend GAAP requirements to loan modifications related to the virus that would otherwise be categorized as a TDR. Loan modifications related to the pandemic are also suspended from TDR treatment. Modifications included are forbearance agreements, interest-rate modifications, repayment plans, or similar arrangements that defer or delay payments of principal or interest.

Allowing a grace period in which a bank can work with its customer without the taint of the TDR classification served as a catalyst to allow the banking industry to create a bridge for borrowers experiencing temporary stress from the pandemic. Some may argue loan deferrals may end up simply delaying eventual credit problems, which in normal times may be true. During a pandemic and resulting economic crisis, however, the rules change. Consider a local restaurant that is forced to close during the pandemic. With revenue disappearing and a plethora of bills to pay, six months of a loan deferral could be the difference between survival and the business going under. Once a vaccine is made available and economic activity resumes, the restaurant can resume its debt payments. If a bank had not worked with the customer and taken a loss on the credit, the bank not only would have lost money on the credit but could have faced reputational risk as well. Thousands of banks across the country collectively helping millions of customers get to the other side of this pandemic likely will be viewed as a major shot in the arm that prevented catastrophic economic damage.

Notably, this TDR relief did not exist during the *GFC*, the absence of which exacerbated bank loan losses. And once a loan is labelled a TDR, it invites higher regulatory scrutiny and is harder to reverse. In times of distress, allowing banks to work with borrowers on loan modifications and deferrals without imposition of the "penalty" to classify a loan as a TDR is a significant positive step toward the reduction of future bank loan losses. Acknowledging that the borrower is facing difficulty as a result of *COVID-19*, small businesses are being granted deferrals and other modification programs to help borrowers from falling further into financial difficulties, while giving them time to stabilize, in conjunction with some of the small business programs mentioned above.

Our compilation of available data shows that banks have begun deferrals on nearly \$125 billion in just *Commercial and Industrial (C&I)* loans, or roughly 13% on average of their C&I loan books. We suspect 2Q20 results will reveal that loan deferrals are higher for banks in the aggregate. However, we believe banks are taking advantage of TDR relief in working with borrowers that ultimately will result in a better outcome for both the lender and the borrower.

Finally, we are optimistic that banks came into this pandemic-driven recession with loans that have much better underwriting and monitoring than they had going into the *GFC*. Following the *GFC*, banks significantly toughened underwriting criteria and risk management practices, resulting in little need of TDRs before the onset of the virus. Some of these measures include: higher debt-service-coverage ratios for loans, which measures the ratio of cash earnings to loan payments and is a primary source of repayment; lower loan-to-value ratios for collateral, which serves as secondary repayments for loans; increased use of guarantors, which is another form of secondary repayment; and greater diversification in loan portfolios so that a given shock is less likely to have major negative

impact to the portfolio. Regulators also stepped up enforcement efforts and have taken a harder stance in their monitoring efforts as they conduct annual bank reviews. And banks have made significant investments in technology and personnel devoted to risk management. We believe that a stronger mix of loans coming into the latest recession, accompanied by a multitude of regulatory, fiscal, and monetary stimulus will go a long way in preventing loan losses in these unusual times.

Banks Can Absorb Loan Losses with Earnings

The table below illustrates how banks can utilize their earnings to absorb loan losses, particularly given that loan losses tend to be recognized over many quarters as the circumstances for individual borrowers unfold differently in each case. Importantly, this means that bank equity levels can in many cases remain intact as banks earn their way through the recession. This also means *tangible book values (TBVs)* should largely remain at or above pre-crisis levels, and that there is substantial unrealized value in bank stocks. In a non-recessionary environment, banks with solid liquidity and earnings power tend to trade well above *TBV*. Today, however, many banks trade at or near *TBV*. In addition, we think the market will begin to differentiate banks based on capital levels, risk management and the ability to earn through their respective losses. This will largely happen over the next 12 to 18 months as the market separates the haves from the have nots. Our research looks at 2021 normalized earnings power and *return on tangible common equity (ROATCE)* relative to price to book value. Based on that analysis, there has not been a better time to buy bank equities since the 2008 to 2010 timeframe.

A closer look at the table below shows four scenarios for a hypothetical bank with \$1 billion in tangible assets. In the first scenario, the bank earns a 13% *ROATCE*, which is a level of earnings power that many banks earned or surpassed before the current crisis. In this case, the bank could absorb loan losses equivalent to 2.3% of loans. This is a loss rate consistent with what banks tended to generate during the 2009 to 2010 period of the *Great Financial Crisis*. In short, the bank could cover two years of losses with one year of earnings assuming a 13% *ROATCE*. A bank with a 10% *ROATCE* could cover 1.5% to 1.75% of losses. **It is therefore unlikely that many banks will see a decrease in *TBV* as the current crisis plays out. Moreover, as loan loss provisions start to decline across the industry *P/TBV* multiples should rise as investor confidence returns for *TBV* and *ROATCE*.**

\$ in 000's

Tangible Assets	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
TCE/TA	10.0%	10.0%	10.0%	10.0%
Tangible Common Equity	\$100,000	\$100,000	\$100,000	\$100,000
Loans/Tangible Assets	75%	75%	75%	75%
Loans	\$750,000	\$750,000	\$750,000	\$750,000
Annual Return On Tangible Common Equity (ROATCE)	13.0%	12.0%	11.0%	10.0%
Net Income	\$13,000	\$12,000	\$11,000	\$10,000
Tax Rate	25%	25%	25%	25%
Pre-Tax Income	\$17,333	\$16,000	\$14,667	\$13,333

Hypothetical 2-Year Cumulative Loan Loss Rate:	Loss \$	Loss \$	Loss \$	Loss \$
0.50%	\$3,750	\$3,750	\$3,750	\$3,750
0.75%	\$5,625	\$5,625	\$5,625	\$5,625
1.00%	\$7,500	\$7,500	\$7,500	\$7,500
1.25%	\$9,375	\$9,375	\$9,375	\$9,375
1.50%	\$11,250	\$11,250	\$11,250	\$11,250
1.75%	\$13,125	\$13,125	\$13,125	\$13,125
2.00%	\$15,000	\$15,000	\$15,000	\$15,000
2.25%	\$16,875	\$16,875	\$16,875	\$16,875
2.31%	\$17,333	\$17,333	\$17,333	\$17,333

Current Bank Stock Positioning

There has been a clear dichotomy between the have and have nots across recent stock market performance – the “stay at home” growth stocks versus the cyclical value stocks. While that disparity has been especially stark in recent months, it is a trend that has persisted for several years. Given this dynamic, the prudent question is whether anything has changed to create an opportunity in value stocks generally, and financial stocks specifically. The degree of investor crowding into growth and tech stocks at the expense of value stocks like financials has hit an extreme historical level. Valuation spreads are near their widest levels; and we see signs that the economic variables that correlate with value outperformance are rebounding (while the stocks have lagged). The relative health and staying power of the banking sector, fund positioning, and the signs of bottoming in important economic factors suggest a generational opportunity to invest in financial stocks.

Historically low investor positioning in financials implies that any indication of a rebound in key economic factors could lead to a substantial flow of money into the space. Evidence of extreme under-positioning in financials is apparent based on observable trends in the past decade of *Morgan Stanley* prime brokerage data. This data shows that current net positioning in financials ranks only at the 3rd percentile during that time, while positioning in technology is at the 98th percentile.

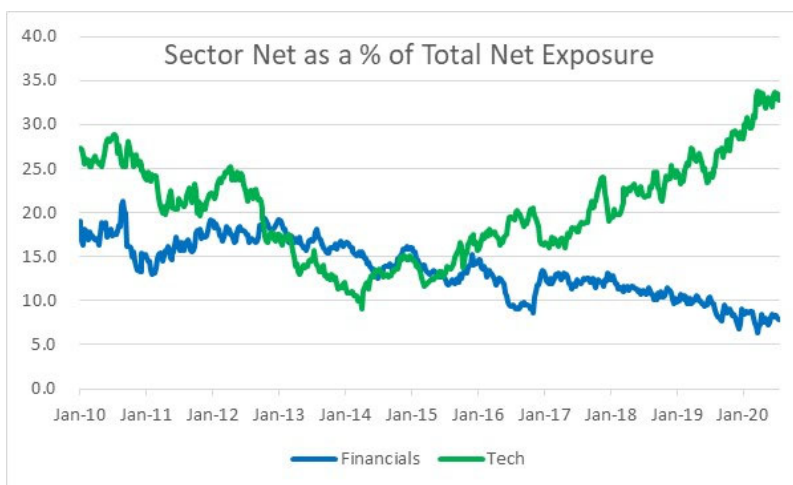
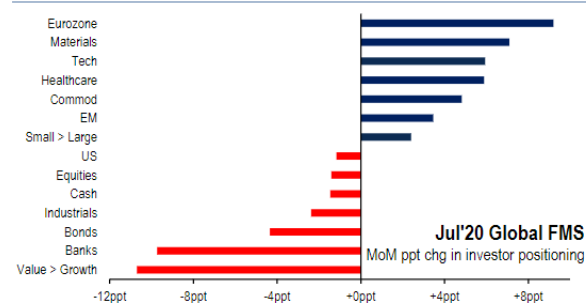


Exhibit 11: Europe most favored but global banks saw biggest drop and no love for value

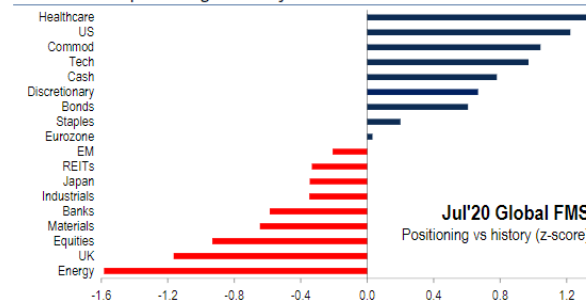


Source: BofA Global Fund Manager Survey

Furthermore, the *Bank of America Fund Manager Survey* highlights how value stocks and bank stocks were the most sold categories over the past month and are underweights across the investor base.

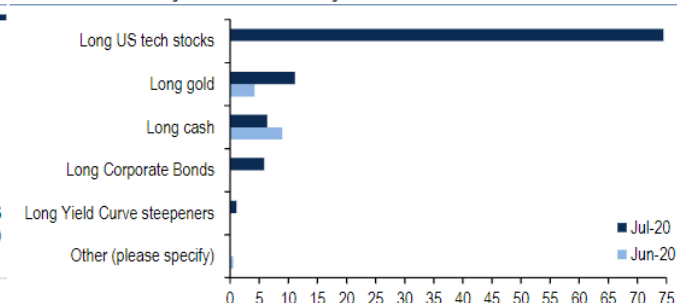
A record high 74% of the survey respondents also highlight, on the opposite end of spectrum, that U.S. tech stocks are the most crowded trade.

Exhibit 12: FMS positioning vs. history



Source: BofA Global Fund Manager Survey

Exhibit 29: What do you think is currently the most crowded trade?



Source: BofA Global Fund Manager Survey

The data clearly indicate that financials are out of favor, which is further validated by the fact that banks are the only group trading at a discount to their historical P/E multiple across all major sectors, depicted in the chart below. The combination of this out-of-favor positioning and valuation suggests that any return to historical norms could drive substantial inflows and re-rating to the sector. To return to those norms, we look for a turn in the key variables that drive value stocks. Variables with the high correlations to financials include the *10-Year U.S. Treasury breakeven inflation rate* and economic activity.

Index	Current P/E	Average	Next Year EPS		-1 Standard Deviation	% Below -1 Std Dev	+1 Standard Deviation	% Above +1 Std Dev
			Premium (Discount to Average)	% Premium (Discount) to Average				
S&P 500	19.9x	15.2x	4.7x	30.9%	12.3x	N/A	18.1x	10.0%
Russell 2000	26.1x	18.5x	7.7x	41.4%	15.5x	N/A	21.5x	21.7%
S&P Consumer Discretionary	32.1x	16.9x	15.3x	90.4%	13.7x	N/A	20.0x	60.5%
S&P Consumer Staples	20.2x	17.2x	3.0x	17.6%	14.7x	N/A	19.7x	2.7%
S&P Energy	31.1x	15.4x	15.7x	101.9%	9.1x	N/A	21.7x	43.2%
S&P Financials	12.6x	11.9x	0.7x	5.6%	9.9x	N/A	13.8x	N/A
KBW Regional Bank Index*	10.5x	13.3x	-2.8x	-20.9%	11.2x	-6.0%	15.4x	N/A
NASDAQ Regional Bank Index*	11.5x	13.9x	-2.4x	-17.3%	12.2x	-6.1%	15.5x	N/A
S&P 500 Banks	11.1x	11.1x	0.0x	-0.3%	9.0x	N/A	13.3x	N/A
S&P Healthcare	16.1x	15.8x	0.3x	2.0%	11.8x	N/A	19.9x	N/A
S&P Industrials	19.2x	15.4x	3.9x	25.2%	12.8x	N/A	17.9x	7.4%
S&P Information Technology	23.2x	18.0x	5.2x	28.8%	10.9x	N/A	25.2x	N/A
S&P Materials	20.4x	14.3x	6.2x	43.3%	11.5x	N/A	16.6x	23.1%
S&P Real Estate	19.0x	16.2x	2.8x	17.1%	13.3x	N/A	19.1x	N/A
S&P Telecommunications	21.0x	16.4x	4.5x	27.6%	14.0x	N/A	18.9x	11.2%
S&P Utilities	18.3x	14.0x	4.2x	30.2%	11.5x	N/A	16.6x	10.1%

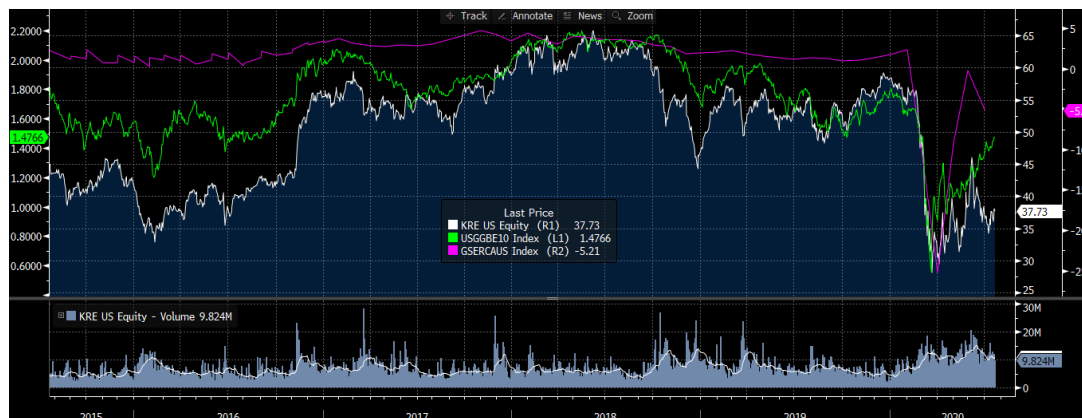
*Excludes 2009 - 2010 Due to Large Variations

The chart below illustrates the relationship between the *10-Year U.S. Treasury breakeven inflation rate*, *Goldman Sachs Economic Activity Index*, and bank performance. While not trying to forecast rising interest rates, we would make the following three observations.

First, the breakeven rate (*10-Year U.S. Treasury breakeven inflation rate*) has already rebounded off its lows, driving a gap versus financials stocks, which have historically converged. In other words, there is already a divergence at current breakeven rate levels.

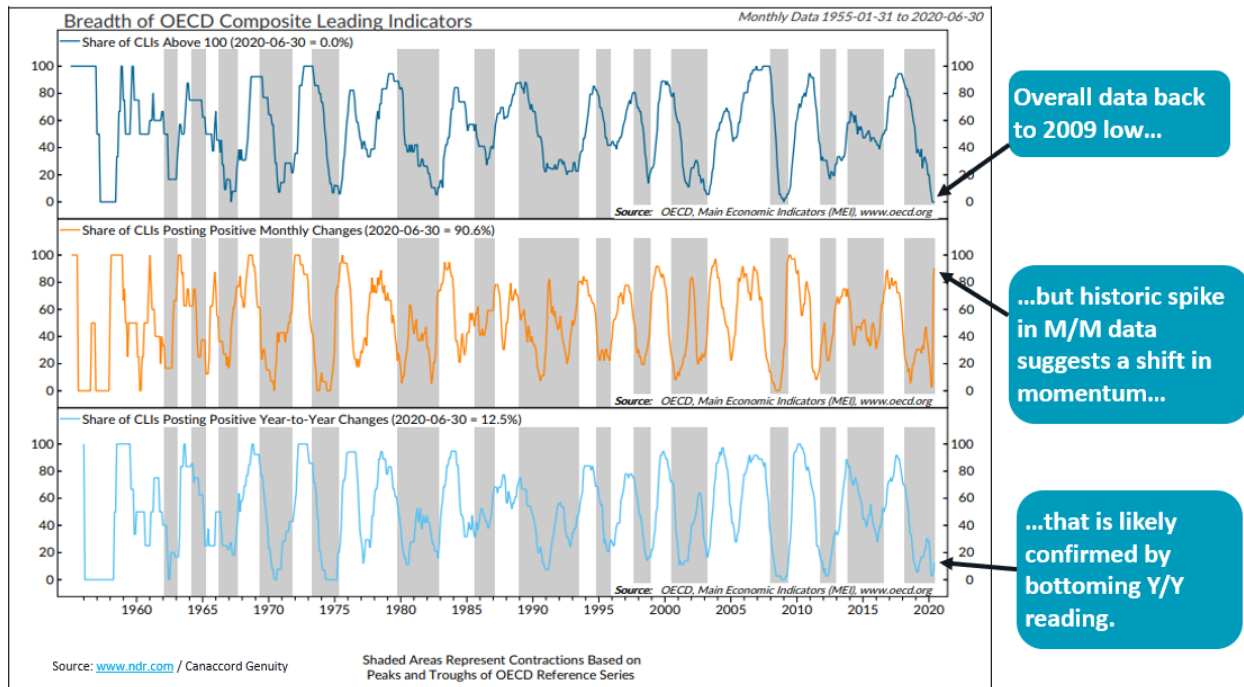
Second, we are nearing a lower bound in rates to the extent they do not go negative. *Fed Chairman Powell* has strongly suggested he will not push rates negative. As falling rates have been a key factor driving outflows from financials, at these lower bounds that flow metric becomes asymmetric with less pressure to the downside.

Lastly, economic data has rebounded from the trough (shown by the *GS Index* and *Canaccord* charts below) and while the length of the recovery remains uncertain, economists agree there will be a recovery which should bode well for financial stock prices.



Sources: Bloomberg, Goldman Sachs

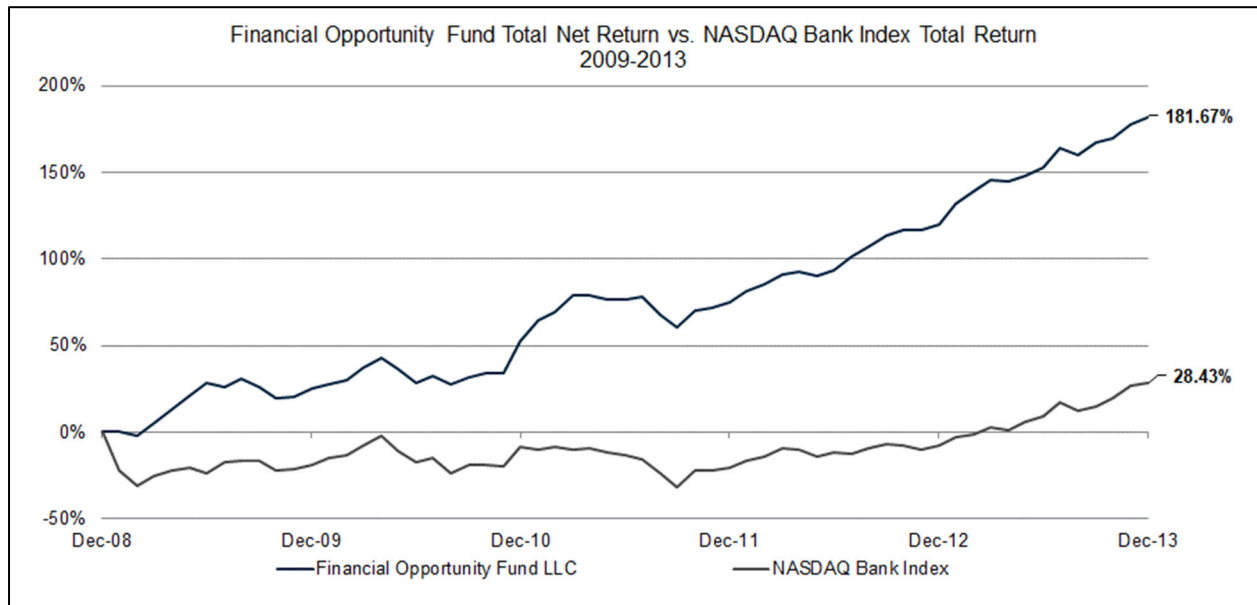
Tony Dwyer, Chief Market Strategist at the investment bank *Canaccord Genuity*, observes that green shoots suggest a shift in momentum of the economic variables that can drive value factors. He points to the *OECD Composite Leading Indicators*, which all read below 100, the lowest level since 2009. However, the spike in month-over-month data is pulling those indices up, which is reflected in the turn in year-over-year growth. Assuming this is the beginning of an economic recovery and given the correlations between financial and value stocks with those economic variables, this very well could be the beginning of a financial stock recovery. In fact, Mr. Dwyer said that given this momentum shift in economic variables, he has never been more convicted of a rotation in favor of value sectors like financials over the medium term. Further, if growth stocks are still leading the way in 12 months, he believes the economy is in trouble and investors will likely not want to own any stocks. If the economy is recovering (as he expects) or there is a vaccine, then financials should be owned.



Extreme positioning away from financials creates massive potential for inflows should tastes change, valuation suggests opportunity for rerating, and the recovery in economic variables indicates a momentum shift, which together create a compelling opportunity to buy financial stocks.

FJ Capital Management Investment Returns Post-GFC

The below performance summary from *FJ Capital Management* illustrates actual returns for investors as the markets recovered from the *GFC*. Given the cyclical nature of banks, and the degree to which bank valuations are currently depressed versus many other sectors, we believe similar returns could be achievable as the banking industry recovers. This chart also shows that stock picking within the sector is important. During the lead up to and during the recession, all banks are painted with the same broad brush. After a few quarters, this trend breaks down and the cream rises to the top as the capital and loss rates of stronger institutions are below industry averages, thus creating very attractive returns and higher valuations.



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