Q1 2017 In Review

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Q1 2017 In Review

For the quarter ended March 31, 2017, 3-Sigma Value, LP (the “Partnership”) had an estimated gain of 1.5% (net of management fees and expenses) with average gross exposure of 110.8% and net exposure of negative 20.6%.

As is custom, dating back to 2011, we use our first quarter investor letter to describe the 3-Sigma Value approach to investing in banks and the process of constructing a portfolio of deeply undervalued securities. The opportunity to profit in banks is born out of complexity and the resulting divergence in valuation. Over the past six years, we have developed and refined a repeatable alpha-generating investment process that discriminates winners from losers and identifies value.
Bank Investing in 2017

2016 Review

Before the U.S. presidential election on Tuesday November 8, 2016, 3-Sigma Value’s bank portfolio returned 26.7%. After the election, it returned 28.8%, roughly a similar amount.

<table>
<thead>
<tr>
<th>The 2016 Bank Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price as of</td>
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<tr>
<td></td>
</tr>
<tr>
<td>KeyCorp (KEY) - Cleveland, OH</td>
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<tr>
<td>Huntington Bank (HBAN) - Columbus, OH</td>
</tr>
<tr>
<td>TCF Financial (TCB) - Wayzata MN, d.b.a. TCF National Bank</td>
</tr>
<tr>
<td>Customers Bank (CUBI) - Wyomissing, PA</td>
</tr>
<tr>
<td>Fidelity Southern (LION) d.b.a. Fidelity Bank - Atlanta, GA</td>
</tr>
<tr>
<td>Stonegate Bank (SGBK) - Pompano Beach, FL</td>
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<tr>
<td>Park Sterling Corp (PSTB) - Charlotte, NC</td>
</tr>
<tr>
<td>Average</td>
</tr>
</tbody>
</table>

In the first quarter of 2017, 3-Sigma Value sold Stonegate Bank (SGBK), Park Sterling Bank (PSTB), and Customers Bank (CUBI), all excellent banks, simply because their valuations approached our target prices. Shortly after selling our stake in SGBK, it was acquired by Home Bancshares (HOMB) d.b.a. Centennial Bank for $778 million, equal to 2.68x TBV, a 21% core deposit premium, and 21x 2017 EPS. HOMB is a high octane M&A machine sporting P/TBV in excess of 4x TBV, which it uses as currency to make accretive deals. The U.S. banking system is still in the early innings of consolidation, led by those banks with the highest value currency. We expect M&A to continue to be a major driver of value over our investment time horizon of one to three years.

3-Sigma Value also sold KeyBank (KEY), Huntington Bank (HBAN), and TCF National Bank (TCB) as their valuations approached our target prices. KEY and HBAN smoothly

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1 Headquarters in Conway, AR.
integrated First Niagara Bank ($39.9 billion in assets) and First Merit Bank ($25.5 billion in assets) respectively, proving the ability of these management teams to cut costs and improve returns. Initially, both stocks reacted negatively; however, now that the deals are financially successful, valuations have mean-reverted.

TCB is different from the other banks in the 2016 portfolio in that it has a national lending platform (leasing and equipment, inventory finance, auto) in addition to its branch network. In the pursuit of diversification, however, TCB has expanded aggressively into certain loan segments that are coming under investor scrutiny, such as auto (15% of total loans). Moreover, a Consumer Financial Protection Bureau (CFPB) investigation into overdraft fees calls into question earnings quality and compliance. Despite a 1%+ ROA, TCB warrants a valuation discount.

The only bank from the 2016 portfolio that remains in 2017 is Fidelity Southern (LION) d.b.a. Fidelity Bank as it remains the highest performing under-valued bank in the all-important Atlanta market.

2017 Outlook

We expect a myriad of positive factors to continue driving earnings growth in 2017 – higher interest rates and potentially a steepening yield curve that could improve net interest margin (NIM), tax reform that could boost after-tax earnings, and regulatory reform that could enable earning a higher return on equity (ROE).

Since Donald Trump’s election, bank multiples have expanded, especially at the high end – while small-to-mid cap banks have not enjoyed universal multiple expansion – some are still cheap, both relatively and on an absolute basis.

3-Sigma Value identifies 3 themes that constitute the 2017 bank portfolio:

1. Consolidation in the U.S.
2. Demonetization in India
3. The Internet

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2 NIM expansion depends on asset sensitivity. Offsetting factors in a rising interest rate environment include the decline in market value of fixed-rate securities and loans, and the decline in mortgage origination.
1. Consolidation in the U.S.  Every week comes news of new deals. The U.S remains over-banked, in terms of branches and in terms of bank charters. 5,913 banks reported at the end of 2016. While this is down from 7,658 at the end of 2010, it still represents an inefficient system. We expect the number of banks to continue to decline; the only question is the trajectory.

### M&A Analysis of High-Performing Banks - Recent Transactions

<table>
<thead>
<tr>
<th>Buyer / Seller</th>
<th>Announce Date</th>
<th>Value (M)</th>
<th>P/TBV</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Southeast</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pinnacle Financial (PNFP) / Bank of North Carolina (BNCN)</td>
<td>1/17</td>
<td>1,900</td>
<td>2.90x</td>
<td>NC</td>
</tr>
<tr>
<td>F.N.B. Corp (FNB) / Yadkin Bank (YDKN)</td>
<td>1/16</td>
<td>1,400</td>
<td>2.32x</td>
<td>NC</td>
</tr>
<tr>
<td>Centennial Bank (HOMB) / Stonegate Bank (SGBK)</td>
<td>3/17</td>
<td>778</td>
<td>2.68x</td>
<td>FL</td>
</tr>
<tr>
<td>Yadkin Bank (YDKN) / NewBridge Bank (NIBC)</td>
<td>10/15</td>
<td>456</td>
<td>1.97x</td>
<td>NC</td>
</tr>
<tr>
<td>Bank of the Ozarks (OZRK) / C1 Financial (BNK)</td>
<td>11/15</td>
<td>403</td>
<td>2.03x</td>
<td>FL</td>
</tr>
<tr>
<td>AmeriSave Bank (ABCB) / Jacksonville Bancorp (JXSB)</td>
<td>10/15</td>
<td>97</td>
<td>2.37x</td>
<td>FL</td>
</tr>
<tr>
<td><strong>South</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Simmons First National (SFNC) / Southwest Bank (OKSB)</td>
<td>12/16</td>
<td>564</td>
<td>2.12x</td>
<td>OK</td>
</tr>
<tr>
<td>Simmons First National (SFNC) / First Texas BHC</td>
<td>1/17</td>
<td>462</td>
<td>2.50x</td>
<td>TX</td>
</tr>
<tr>
<td>Independent Bank Group (IBTX) / Carlisle Bancshares (private)</td>
<td>11/16</td>
<td>434</td>
<td>2.45x</td>
<td>TX</td>
</tr>
<tr>
<td>Pinnacle Financial (PNFP) / Avenue Bank (AVNU)</td>
<td>1/16</td>
<td>210</td>
<td>2.26x</td>
<td>TN</td>
</tr>
<tr>
<td>Renasant (RNST) / Metropolitan Bank Group</td>
<td>1/17</td>
<td>190</td>
<td>2.18x</td>
<td>MS</td>
</tr>
<tr>
<td><strong>Northeast / Mid-Atlantic</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Banksshares (UBSI) / Cardinal Bank (CFNL)</td>
<td>8/16</td>
<td>912</td>
<td>2.24x</td>
<td>VA</td>
</tr>
<tr>
<td>Peoples United Financial (PBCT) / Suffolk Bank (SCNB)</td>
<td>6/16</td>
<td>402</td>
<td>1.96x</td>
<td>NY</td>
</tr>
<tr>
<td>Community Bank System (CBU) / Merchants Bancshares (MBVT)</td>
<td>10/16</td>
<td>304</td>
<td>1.96x</td>
<td>VT</td>
</tr>
<tr>
<td>United Banksshares (UBSI) / Bank of Georgetown</td>
<td>11/15</td>
<td>269</td>
<td>2.18x</td>
<td>DC</td>
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<tr>
<td>Access National Corporation (ANCX) / Middleburg Financial Corporation (MBRG),</td>
<td>10/16</td>
<td>245</td>
<td>1.95x</td>
<td>VA</td>
</tr>
<tr>
<td>Bryn Mawr Bank (BMTC) / Royal Bank of Pennsylvania (RBPAA)</td>
<td>1/17</td>
<td>128</td>
<td>2.24x</td>
<td>PA</td>
</tr>
<tr>
<td><strong>Midwest</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>CIBC / Private Bancorp (PVTB)</td>
<td>6/16</td>
<td>3,800</td>
<td>2.23x</td>
<td>IL</td>
</tr>
<tr>
<td>MB Financial (MBFI) / American Chartered (private)</td>
<td>11/15</td>
<td>449</td>
<td>2.20x</td>
<td>IL</td>
</tr>
<tr>
<td>First Merchants Bank (FRME) / Independent Alliance Bank (JALB)</td>
<td>2/17</td>
<td>250</td>
<td>2.65x</td>
<td>IN</td>
</tr>
<tr>
<td>First Busey Corporation (BUSE) / First Community Financial Partners (FCFP)</td>
<td>2/17</td>
<td>236</td>
<td>1.98x</td>
<td>IL</td>
</tr>
<tr>
<td>WesBanco / Your Community Bank (YCB)</td>
<td>5/16</td>
<td>221</td>
<td>1.80x</td>
<td>IN</td>
</tr>
<tr>
<td>First Busey Corporation (BUSE) / Palaski Bank (PULB)</td>
<td>12/15</td>
<td>212</td>
<td>1.80x</td>
<td>MO</td>
</tr>
<tr>
<td><strong>West</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royal Bank of Canada (RY) / City National Bank (CYN)</td>
<td>1/15</td>
<td>5,400</td>
<td>2.40x</td>
<td>CA</td>
</tr>
<tr>
<td>Hope Bancorp (HOPE) f.k.a. BBCN Bancorp (BBCN) / Wilshire Bancorp (WIBC)</td>
<td>12/15</td>
<td>1,027</td>
<td>2.24x</td>
<td>CA</td>
</tr>
<tr>
<td>PacWest Bancorp (PACW) / California United Bank (CUNB)</td>
<td>4/17</td>
<td>705</td>
<td>2.84x</td>
<td>CA</td>
</tr>
<tr>
<td>Columbia Banking System (COLB) / Pacific Continental Corporation (PCBK)</td>
<td>1/17</td>
<td>660</td>
<td>3.13x</td>
<td>CA</td>
</tr>
<tr>
<td>First Interstate BancSystem (IBK) / Cascade Bancorp (CAB)</td>
<td>11/16</td>
<td>589</td>
<td>2.15x</td>
<td>OR</td>
</tr>
<tr>
<td>Pacific Premier (PPBI) / Heritage Oaks Bank (HEOP)</td>
<td>12/16</td>
<td>406</td>
<td>2.21x</td>
<td>CA</td>
</tr>
<tr>
<td>Mechanics Bank (MCHB) / California Republic Bank (CRPB)</td>
<td>4/16</td>
<td>330</td>
<td>1.94x</td>
<td>CA</td>
</tr>
<tr>
<td><strong>Meta-Avg</strong></td>
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</table>
The range of price-to-tangible book value (P/TBV) reflects relative profitability and the high correlation between return on tangible common equity (ROTCE) and P/TBV. The average P/TBV of 2.26x is at the high end of data going back to 1990. We use this data to project take-out valuations for acquisition candidates.

Banks benefit from economies of scale and it follows that valuation multiples are positively correlated to size. In an over-banked market with thousands of chartered banks, it is easier to buy then build. As a result, the U.S. is an active and consolidating M&A market that has the power to elevate the valuation of any well-managed and profitable bank.

Valuation is not in the eyes of the beholder, it is neither art nor love. It is science. Every input must be validated; every output must be cross-checked. Based on (1) the high correlation between return on tangible common equity (ROTCE) and P/TBV, (2) earnings growth, and (3) comparable bank valuations, we employ a range of price-to-tangible book value multiples (P/TBV) and price-to-earnings (P/E) – to estimate future values.

Empirically, the higher the return on equity the higher the multiple of book value. This basic relationship between P/TBV and ROTCE generally holds across all banking (spread) businesses. Based on data from SNL Financial going back to 1990, the median P/TBV of announced M&A transactions is 1.8x. In the early 1990s, banks were sold in the range of 1.3x to 1.8x before elevating above 2x in 1997 and remaining there for 10 years except during the brief recession that followed the bursting of the internet bubble. By 2003, M&A multiples were back over 2x, peaking at 2.3x in 2006.

A similar empirical relationship exists between return on tangible common equity (ROTCE), earnings growth, and the multiple of price-to-earnings (P/E). Using data going back to 1990, the mean/median P/E multiple\(^3\) across all banks has been 14.1x/14.2x, with a high north of 20x during the credit bubble in the mid-2000s. From the standpoint of M&A, P/Es have averaged over 20x historically, and have risen from 18.3x in 2009 to over 20x in 2017. We apply P/E multiples as a sanity check to the primary analysis based on the relationship between ROTCE and P/TBV, and adjust accordingly if the results are statistically disparate.

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\(^3\) Based on LTM (latest twelve months) EPS.
Building on our analysis in Bank Investing in 2016, 3-Sigma Value employs a proprietary framework for evaluating banks in terms of four factors:

1. Return on assets (ROA) in excess of 0.90% in 2017 – a bank that earns 0.90% (the minimum level) will earn a return on tangible common equity (ROTCE) of at least 10% given an optimized capital structure. A bank earning a consistent 10%+ ROTCE is worth at least 1.8x tangible book value (TBV) based on historical M&A data (using data from SNL going back to 1990). Using recent M&A data only, high performing banks (defined as 10%+ ROTCE) are trading around 2.3x TBV.

2. Franchises that are tightly managed, as reflected in a below-average efficiency ratio. By cross-checking efficiency ratios with ROA, we identify profitable banks where the high level of profitability is (in part) due to efficient cost management.

3. Management is always the predominant factor in any bank investment, or any investment in financial services for that matter. Financial services is a human capital business.

4. A catalyst to unlock value over 3-Sigma Value’s investment time horizon of one to three years.

We begin our consolidation analysis in the Southeast, the busiest geography in terms of deal volume, where consolidation has been and continues to define the competitive environment. More banks were formed and more banks failed in Florida and Georgia than any other states during the bubble. Now that the dust has settled, the southeast remains a powerful demographic that continues to attract money from all over the world.

**Bank #1: BankUnited (BKU),** headquartered in Miami, FL. After the credit bubble burst, legendary CEO John Kanas (who is now the Chairman) led a team of former Northfork Bank executives, including current CEO (former COO) Raj Singh, in acquiring a failed BankUnited from the FDIC with financial assistance. While the original deal was a tremendous success for the pre-IPO investors (WL Ross, Blackstone, Carlyle, Centerbridge, and management), since the

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4 Not just banks but all spread businesses.
5 Efficiency ratio equals non-interest expense divided by (net interest income plus non-interest income). Ironically, a 100% efficiency ratio means a bank is not being efficient. The lower the ratio the better, with most banks striving for a sub-60% ratio.
6 Capital One acquired Northfork Bank in 2006.
January 2011 IPO at $27, the stock price has only appreciated 41% to $38.20, significantly lagging its peer group.

BKU’s stock price has stagnated because EPS has stagnated around $0.50 per quarter (~$2 per annum), and the reason why EPS is stagnant despite impressive loan growth is the waning contribution of purchase accounting benefits stemming from the original FDIC deal. The profit embedded into purchasing assets at a discount is amortized over the life of the acquired loan portfolios and this profit must be replaced in order for earnings to grow. On the fourth quarter 2016 conference call, CEO Singh called for an inflexion point in earnings growth. After the past few years of treading water around $0.50 per quarter, EPS came in at $0.61, and Singh confidently guided to more earnings growth (to ~$0.75 per q by 2019; $3 per annum).

Interim conclusion – as EPS inflects, BKU’s valuation discount will narrow.

BKU operates 3 geographic segments:
1. Florida (35% of loan portfolio at 12/31/16) – a diverse loan portfolio with a focus on C&I;
2. New York (34%) – mostly CRE, with a focus on multi-family; growing the C&I book;
3. National (31%) – through two commercial lending subsidiaries, BKU engages in equipment leasing, franchise finance, and municipal finance on a national basis. BKU also originates small business loans through programs sponsored by the SBA and to a lesser extent the USDA and provides mortgage warehouse finance on a national basis.

Management is guiding to $3 billion in loan growth in 2017 versus $4 billion in deposit growth, leading to a loan-to-deposit ratio that will tighten slightly from 102% to below 100%.

BKU’s loan portfolio breaks down as follows:
1. Single-family residential (20.9% of total loan portfolio at 12/31/16) – BKU no longer originates residential loans, instead, it buys them, mostly jumbos (high 700 FICO, low 60s LTV) from an established correspondent network (they re-underwrite all loans before purchase). The primary objectives of the residential business are (1) yield, and (2) geographic diversification away from Florida and New York. California is the biggest exposure.
2. Multi-family (19.8%) – zero NPAs despite the OCC’s concern about an asset bubble forming. BKU’s pace of multi-family loan growth has slowed.

3. Commercial real estate (CRE) – investor / O&O (19.3% / 9.0%) – 0.43% NPAs across a diverse portfolio of single-tenant commercial, industrial, healthcare, etc. property loans. With a CRE concentration ratio at 288%, BKU intends to continue managing the ratio close to 300% until it gets updated feedback from the OCC.

4. C&I / Commercial Lending Subsidiaries (17.5% / 11.8%) – C&I is mostly in Florida with an urban concentration and diverse SMB industry exposure. Non-performing loans (NPLs) are 0.70% while the allowance for loan and lease losses (ALLL) as a % of total loans is 0.79%. This translates to reserve coverage (ALLL as a % of NPLs) of 112.55% and relatively-insignificant credit risk. The one area where there is risk is in the NYC taxi medallion portfolio.

$169 million in NYC taxi medallion loans continue to be a source of risk, albeit a shrinking one. According to CFO Leslie Lunak, taxi loans are cash flow-based loans that are mostly 3-year bullets with 25-year amortization. This structure enables the loans to be modified, which enables cabbies to stay in their cabs. About half the fourth quarter reduction in taxi exposure ($13.7 million) was related to pay-offs ($6.8 million) and the other half to charge-offs ($6.9 million), dropping the reserve to $35 million (21% of total taxi loans and 58% of non-performing taxi loans).

BKU carries its medallion loans at a value of $570,000 per medallion. Through March 2017, only two NYC medallions have been sold – one for $550,000 and the other at $241,000. While the $241,000 could be anomalous, at the very least it foretells incremental write-offs. Using $241,000 as a marked-to-market price, BKU’s medallion loans are worth only $82 million ($87 million reduction). Assuming a run-down of the $35 million ALLL, the pre-tax loss is $52 million. At a 35% tax rate, the net loss is $34 million, equal to $0.33 per share.

5. Consumer (0.1%) – no credit card or auto loan exposure. BKU is a commercial, not a consumer bank.

BKU’s securities portfolio is adjustable-rate and set to increase as the bank’s loan-to-deposit ratio shrinks to 100%. While this will increase income, it will be offset by a high beta deposit base. BKU’s cost of deposits in Q4 2016 was a relatively high 0.70%, 34 bps higher than its peer group (cost of interest bearing deposits = 0.82%). Only 16% of deposits are non-interest
bearing, while 10% are brokered. With asset and liability sensitivity offsetting, BKU is relatively interest-rate neutral. Non-interest income ex. FDIC-related items was only $78 million in 2016 compared to $904 million of net interest income. While management expects fee income to continue to rise – e.g. deposit fees, lease financing fees, gain on sale of SBA loans – BKU is and will continue to be principally a margin bank.

BKU is exceptionally well-managed as evidenced by its 50% efficiency ratio (ER) and 11% return on tangible common equity. Based on comparable M&A transactions in the southeast (2.38x TBV), BKU is worth $60.11, representing 59.8% total return, including 3 years of dividends ($0.84 annual dividend, representing a 35% payout ratio).

**Bank #2: Fidelity Southern Corporation (LION) d.b.a. Fidelity Bank**, headquartered in Atlanta, GA, is not only the lone holdover from 3-Sigma Value’s 2016 portfolio, but also it was a member of the 2015 portfolio. LION is still the highest performing under-valued bank in the all-important Atlanta market. With $4.4 billion in assets and $3.6 billion in deposits, LION ranks #7 in deposit market share in the Atlanta MSA and 12th in the state of Georgia.

Atlanta is a prosperous MSA with job growth and corporate relocations proving the resiliency of one of the higher growth markets in the U.S. Atlanta ranks fourth in the number of Fortune 500 companies headquartered within city boundaries, behind New York City, Houston and Dallas. While Wells Fargo (WFC) and Bank of America (BAC) are prominent banks operating in Georgia, the money center banks collectively play a small roll in Georgia banking. The largest bank in Georgia is also based in Atlanta and that is SunTrust Bank (STI). Following SunTrust is a pair of regional banks – BB&T (BBT) based in Columbus North Carolina, and Regions Financial (RF) based in Birmingham Alabama. Both are consolidators.

Deposits are concentrated in metro-Atlanta where the franchise is woven into the community. Nearly all of the growth at LION has been organic, with a 10% per annum target for loan growth. Approx. 50% of the loan book is commercial and 50% consumer. Almost all of the commercial real estate (CRE) is owner-occupied (O&O), with $8 million of multi-family, and only one strip mall. Non-performing loans are only $48 million, out of a total loan portfolio of $3.6 billion, representing a minor 1.3% of total loans\(^7\). Translation: there is little credit risk here.

Another important reason why LION is an attractive bank investment is it is less sensitive to the level of interest rates than its peer group because a majority of its revenue is derived from non-

\(^7\) Net of $30 million of ALLL (allowance for loan and lease losses).
interest income. In 2016, net interest income totaled $129 million while non-interest income was $141 million, derived from four primary sources:

1. Mortgages – LION is a leading mortgage originator in metro Atlanta. In addition to earning origination fees, LION earns income in two ways: by selling the loans to earn a gain on sale, and by retaining the servicing rights ($7.8 billion total). Add these three sources of income together and total mortgage revenue as a % of mortgage production averages around 3%. For example, in Q4 2016, LION earned $24.3 million\(^8\) on mortgage production of $760 million (~$250 million per month, mostly purchase activity (~80%) rather than refi activity (~20%)). This 3% rate varies quarterly due to volatility in the gain on sales. In 2017, management is guiding to flat-to-slightly-higher mortgage revenue based on ~$3 billion of mortgage production.

2. SBA – LION’s Small Business Administration business will generate $100 million of loans in 2017 ($80 million in 2016) according to CEO Palmer Proctor. Similar to the economics of the bank’s mortgage banking business, in addition to origination fees, LION earns income by selling the loans to earn a gain on sale, and by retaining the servicing rights.

3. Autos – LION is a leading auto lender in metro Atlanta, generating $75-$90 million per month in “car paper” that is short in duration (28 months avg.) and high in credit quality (no subprime programs). The average FICO score is 758 and the non-performance rate was a mere 18 basis points in Q4 2016. This paper is in high demand by ABS investors, and similar to its approach to mortgages and SBA, LION retains the servicing rights.

4. Trust & Wealth Management – the wealth management group is not yet a significant contributor to non-interest income.

LION’s management team is excellent, led by Chairman Jim Miller and CEO Palmer Proctor, who have delivered on organic loan growth (10%) and fee income diversification (mortgages, SBA, autos, trust & wealth management). Moreover, LION is a bite-sized $4.4 billion in assets, giving it enough scale to drive efficiency while rendering it an ideal acquisition target for any consolidator or regional bank.

\(^8\) Excluding $13 million MSR valuation mark-up due to higher interest rates.
With a solid organic loan origination program and a diverse set of sources of fee income, 1% ROA / 10%+ ROTCE appear sustainable. Based on comparable M&A transactions in the southeast (2.38x TBV), LION is worth $37.35, representing 66.2% total return, including 3 years of dividends ($0.48 per annum, equal to a 28% payout ratio).

**Bank #3: Great Southern Bank (GSBC)**, headquartered in Springfield, MO (in southwestern Missouri, home to Missouri State University) is #7 in Missouri with $2.3 billion of in-state deposits, and $3.7 billion in total deposits spread across 108 retail banking centers in Missouri and its neighboring states of Iowa, Minnesota, Nebraska, Kansas, and Arkansas. Joe Turner has been CEO since 1999 and has done an excellent job of consolidating five FDIC-assisted acquisitions plus two branch office acquisitions. When I asked Joe about the FDIC deals, he called them “once in a generation deals” in which the FDIC paid them to take over banks, and provided loss sharing on acquired loans (called “covered loans”).

Economically, Great Southern’s FDIC deals were similar to Bank United’s FDIC deals. EPS has been stagnant, similar to Bank United, in this case around $0.80 per quarter (~$3.20 per annum) despite impressive loan growth. This is because of the waning contribution of purchase accounting benefits stemming from the FDIC deals. The profit embedded in purchasing assets at a discount (called bargain purchase gain) is amortized over the life of the acquired loan portfolios and this profit must be replaced in order for earnings to grow.

GSBC has ~$150 million of remaining covered loans on its balance sheet, most of which will be paid down in 2017. Therefore, while EPS will stagnate again in 2017 ~$3.20, it should increase moderately in 2018 (to ~$3.57), and perhaps more rapidly in 2019 ($4+).

In terms of the Missouri economy that is base to GSBC’s operations, outside of St. Louis and Kansas City to a lesser extent, the state economy is solid with low employment. St. Louis is relatively weak due to industry downsizing, and Kansas City is showing signs of the same. While **U.S. Bancorp (USB)** and **Bank of America (BAC)** are prominent banks operating in Missouri, the money center banks collectively play a small role in Missouri banking. **Commerce Bank (CBSH) – 2.7x TBV**, headquartered in Kansas City, MO is #3 in deposit market share, followed by **UMB Financial (UMBF) – 2.3x TBV**, **Enterprise Financial Services (EFSC) – 2.6x TBV**, and then **Great Southern Bank (GSBC) – at a discounted 1.68x TBV**.

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$6.3 million of remaining accretable yield, offset by $2.5 million of indemnification asset amortization, equals $3.8 million of net accretion headwind, equal to $0.27 per share.
GSBC doesn’t provide formal guidance, but in analyzing the components of its loan portfolio, we are able to estimate mid-single digit loan growth, diversified across:

1. Commercial Real Estate (CRE) – 33% of loan portfolio is CRE, mostly investor-owned, only 4.4% is owner-occupied. The portfolio is diversified both geographically and by industry: 32% of CRE is retail, mostly national credits, 19% is office buildings, 15% is healthcare, mostly acute (hospital) and long-term care, 10% industrial, 8% motels/hotels, and 6% restaurants. NPAs of only 0.80% illustrate the low-risk profile of this portfolio of excellent credits.

2. Multifamily (18%) – 60-70% LTV, long-term relationships, and geographic diversification produce strong credit performance as evidenced by a 0.73% NPA.

3. Single-family (17%) – not a focus of the bank but a business that grows organically via commercial loan growth. Nearly all fixed rate mortgages are sold, while some adjustable rates are held on the balance sheet.

4. Consumer (15%) – mostly auto loans (13%), 95% of which are indirect loans for used cars sold out of new car dealerships. The average origination balance is $16,282 and the average FICO is 701. Management recognizes the increased risk profile in subprime auto lending and has raised credit standards leading to a decrease in the size of the auto portfolio.

5. Construction and land development (11%) – mostly for apartments that are being developed by bank clients in the multifamily portfolio.

Non-performing loans are only $59 million, out of a total loan portfolio of $3.8 billion, representing a minor 1.6% of loans. ALLL of $37 million covers 63% of NPAs. Translation: there is little credit risk in this bank.

GSBC earned a relatively small amount of non-interest income (fee income) – $35 million in 2016 compared to net interest income of $163 million – mainly from gain on loan sales, and checking account/debit card fee income. According to CEO Joe Turner, GSBC is a “margin bank”. Efficiency ratio is tight ~60% and improving, while ROA is ~1%. With ROTCE solidly

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10 Net of $37 million of ALLL (allowance for loan and lease losses).

11 Reduced by indemnification asset amortization.
above 10% and poised to rise with interest rates and the run-off of the covered loan portfolio, GSBC is one of the cheapest, well-run banks in the Midwest. Based on comparable M&A transactions in the Midwest (2.11x TBV), GSBC is worth $70.93 (up 60.4%), including 3 years of dividends ($0.88 per annum, equal to a 28% payout ratio).

Bank #4: First Financial Bank (THFF), headquartered in Terra Haute, IN, 75 miles west of Indianapolis, has $3.0 billion of assets spread across 69 branches in West Central Indiana and East Central Illinois. The economy in central Indiana is largely rural-based, with a strong agriculture industry and burgeoning auto. The market is competitive, although banks like First Financial have sticky low-cost deposits and enduring small business relationships. JP Morgan (JPM), Wells Fargo (WFC), PNC Bank (PNC), Fifth Third Bank (FITB), KeyBank (KEY), and Huntington Bank (HBAN) are all prominent in Indiana, operating alongside a coterie of well-managed Indiana-based banks, including: Old National Bank (ONB) – 2.1x TBV, First Merchants Bank (FRME) – 2.6x TBV, 1st Source Bank (SRCE) – 2.1x TBV, Lakeland Financial d.b.a. Lake City Bank (LKFN) – 2.7x TBV, MainSource Bank (MSFG) – 2.4x TBV, German American Bank (GABC) – 2.8x TBV, Horizon Bank (HBNC) – 2.3x TBV, and then there’s First Financial Bank (THFF) at a discounted 1.54x TBV.

According to CFO Rodger McHargue, who joined THFF in 1994, loan growth matches loan demand in the mid-single-digits (4% in 2016). Accordingly, the loan portfolio breaks down as follows:

1. C&I (27% of loan portfolio) – small-to-mid size manufacturing, $1-$2 million average loan with few > $5 million; long-standing local relationships with NPAs = 0.66%.
2. Residential (19%) – single-family and HELOCs – few fixed rate originations, hold adjustable and non-conforming (i.e. jumbo) loans related to C&I customers.
3. Auto (13%) – 50% direct / 50% indirect through dealer network; 95% used; 58% >700 FICO, 21% 650-699. Avg. loan size = $18,834. Duration = 29 months. This is the one component of the loan book that is at risk. While NPAs at 1.05% are still low, they are creeping up.
4. CRE (11%) – less than 1% is O&O – mainly single-tenant commercial and more recently student housing around four local universities.
5. Agriculture (9%) – excellent credit, zero NPAs.
6. Farmland (6%) – tied to Agriculture.
7. Construction (5%) – tied to CRE.
8. Multi-family (4%) – zero NPAs.
9. Consumer ex. Auto (1%)
Non-performing loans are only $24 million, out of a total loan portfolio of $1.8 billion, representing a minor 1.4% of total loans. ALLL of $16 million covers 65% of NPAs. Conclusion: there is little credit risk in this bank.

The defining characteristic of First Financial (THFF) is its low cost deposit base costing a rock bottom 18 basis points. A full 24% of deposits are non-interest bearing. I asked CFO Rodger McHargue how they are able to retain so many 0% interest-bearing deposits, especially given the national competition, and he waxed poetic on the benefits of community banking, how they know their customers better and have worked with many of them for decades. Add it all up, and a bird in the hand is worth more than two in the bush.

The biggest issue facing THFF is utilization of its balance sheet. Loan-to-deposit ratio is only 66% when it should be 90%+. In fact, 90% is management’s goal. And they expect to get there but not in a rush. The under-utilized balance sheet is a direct result of three acquisitions, one of which was FDIC-assisted and the other two branch acquisitions from Bank of America that were full of deposits but empty of loans.

In the place of loans is investment securities – plain vanilla 30% tax-free munis, 70% MBS / agency CMOs. Because the balance sheet is heavy with adjustable rate assets and non-interest bearing liabilities, THFF is very asset sensitive. As a result, 4%+ NIM is sustainable with many levers to pull.

Management doesn’t target efficiency ratio (ER) but expects it to decline from 63% in 2016 to sub-60%. At a robust 1.1%+ ROA, THFF is significantly undervalued at 1.54x TBV. With a TCE ratio of 11.1%, ROTCE is set to rise as THFF leverages its excess capital (down to 10% TCE) to drive additional returns. M&A is the preferred method of using capital but difficult when the currency (stock) is deeply undervalued. Recently, the Board of Directors has turned to stock buybacks, with 71,000 shares remaining on a 5% buyback authorization and its replacement in discussion. Finally, THFF pays a dividend of $1 per year, representing a 37% payout compared to a target payout ratio of 40%. Based on comparable M&A transactions in the Midwest (2.11x TBV), THFF is worth $68.96 (up 68.6%), including 3 years of dividends.
2. Demonetization in India – Private Indian Banks are Winners in Currency Reform

On November 8, 2016, the Reserve Bank of India (RBI) banned the country’s two largest currency notes, the 500 and 1,000 rupee notes, worth approximately US$8 and US$16, effectively removing 86% of the currency in circulation.

There are a multitude of reasons for the ban and even more consequences, intended and otherwise. Here are five. First, demonetization curbs the flow of counterfeit money – an issue that Prime Minister Modi had pledged to address in view of the rise of terrorist organizations. Second, it shrinks the portion of the economy that transacts in cash\textsuperscript{12} – which includes bribery and tax avoidance/evasion. Put simply, cash transactions are not taxed. Ergo, demonetization should lead to more taxable transactions and a higher level of tax receipts. This will help India's fiscal deficit. Third, by forcing cash into the banking system, India is creating supply for more loans, which should finance more economic growth. Fourth, deposit growth will significantly increase, enabling banks to lower interest rates on borrowers. And fifth, demonetization is catalyzing a rapid uptake in credit cards/debit cards and new technologies.

These reasons are overwhelmingly bullish for retail banks in India, and although there are a number of negative consequences from demonetization to address, the negatives are mainly short-term in nature. Most important is the disruption facing businesses that transact primarily in cash. GDP growth could be down in 2017, with the rural economy hardest hit. However, this is almost certain to invert later this year. \textit{Short-term pain for long-term gain}. The other short-term negative is excess liquidity that pressures profitability and could lead to adverse selection. Loan demand is weak as the Indian credit cycle is turning after a 7 year decline in quality with NPLs peaking at 7.5% of total system assets in 2016. In connection with the elevated level of NPLs, the Texas Ratio\textsuperscript{13} for the banking system as a whole is 70%, a level comparable to the peak of the US credit cycle. However, most of the distress is at the legacy state-owned enterprise (SOE) banks, enabling the private banks to grab market share.

\textsuperscript{12} Approximately 78\% of transactions in India were made in cash in 2016, compared to 20\% to 25\% in the United States, Britain and other countries, according to a report by Google India and the Boston Consulting Group.

\textsuperscript{13} The Texas Ratio is a simple, straightforward statistic to evaluate the health of a bank; Texas Ratio = Non-Performing Assets divided by Tangible Equity plus Loan Loss Reserves. In normal times, Texas Ratios approach zero. A 50\% ratio is considered sick. A 100\% Texas Ratio means the bank is a zombie bank.
On March 30, 2017, India’s government approved an overhaul of its tax system, replacing a complex tangle of federal and state sales taxes with a nationwide goods and services tax (GST) that will capture taxes in a wider net of small businesses. In conjunction with demonetization, the GST will force more companies into the formal economy and thus more business into the banking system.

In India, there are 3 categories of banks:

1. **SOE Banks** – the state-owned banks have deep credit issues and rightfully trade ~1x TBV. State Bank of India (SBIN.BO) is the largest Indian bank and was nationalized by Indira Gandhi; it is majority-owned by the government with a 41.4% stub owned by the public. The other SOE banks are: Bank of Baroda, Punjab National Bank, Union Bank, Canara Bank, and Bank of India.

2. **NBFCs** – non-banking financial companies do not accept demand deposits and generate higher ROA (1.5% - 3.0%). Accordingly, they trade at higher P/TBV (1.5x - 5.0x).

3. **Private Banks** – India’s private banks generally don’t face the same credit issues as the SOEs and should continue gaining market share.

### Private Banks in India are Winners in Currency Reform

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Bank Name</th>
<th># of Branches</th>
<th>Deposits (in billions of Rs)</th>
<th>Loans</th>
<th>Loan-to-Deposit Ratio</th>
<th>Deposits per Branch</th>
<th>ROA</th>
<th>ROE</th>
<th>Efficiency Ratio Opex-to-Income</th>
<th>P/BV</th>
<th>P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADS:HDB</td>
<td>HDFC Bank</td>
<td>4,555</td>
<td>6,347</td>
<td>4,950</td>
<td>78%</td>
<td>1.393</td>
<td>1.8%</td>
<td>17.9%</td>
<td>44%</td>
<td>3.3x</td>
<td>20x</td>
</tr>
<tr>
<td>ADS:IBN</td>
<td>ICICI Bank</td>
<td>4,504</td>
<td>4,653</td>
<td>4,575</td>
<td>98%</td>
<td>1.033</td>
<td>1.4%</td>
<td>4.06</td>
<td>34%</td>
<td>1.1x</td>
<td>10x</td>
</tr>
<tr>
<td>AXBK*</td>
<td>Axis Bank</td>
<td>3,211</td>
<td>3,708</td>
<td>3,472</td>
<td>94%</td>
<td>1.155</td>
<td>0.6%</td>
<td>17.9%</td>
<td>40%</td>
<td>3.4x</td>
<td>3.1x</td>
</tr>
<tr>
<td>KTKM*</td>
<td>Kotak Bank</td>
<td>1,348</td>
<td>1,494</td>
<td>1,293</td>
<td>87%</td>
<td>1.108</td>
<td>1.6%</td>
<td>11.1%</td>
<td>40%</td>
<td>3.3x</td>
<td>2.0x</td>
</tr>
<tr>
<td>INBK</td>
<td>Indusind Bank</td>
<td>1,075</td>
<td>1,192</td>
<td>1,109</td>
<td>86%</td>
<td>1.028</td>
<td>1.6%</td>
<td>1-1.1</td>
<td>49%</td>
<td>3.3x</td>
<td>16x</td>
</tr>
<tr>
<td>YESB</td>
<td>Yes Bank</td>
<td>964</td>
<td>1,280</td>
<td>1,102</td>
<td>86%</td>
<td>3.4x</td>
<td>1.8%</td>
<td>34%</td>
<td>47%</td>
<td>3.4x</td>
<td>21x</td>
</tr>
</tbody>
</table>

* Axis Bank and Kotak Bank are merging in order to build scale, lower costs, and more effectively compete with retail leaders HDFC and ICICI.

** Projected 2019.
HDFC Bank (HDB) is the highest quality retail bank, has a very conservative credit culture, and is ahead of its peers in terms of technology adoption. In order to more effectively compete with HDFC, Axis Bank (AXBK) and Kotak Mahindra Bank (KTKM) are merging. Axis is a retail bank, while Kotak brings a conservative credit culture. The combination will make for a solid competitor. Indusind Bank (INBK) and Yes Bank (YESB) are sub-scale, and trading at a full 3x+ TBV. Which leads us to ICICI Bank (IBN) – trading at such a massive discount to its peer group that unless its asset quality is in such distress that it needs a capital infusion, this bank represents an incredible buying opportunity.

Domestic loan growth slowed to 12% last quarter, which was not unexpected given demonetization and the chaos in its immediate aftermath. Management’s goal is 20%. Offsetting a portion of this growth in the short-term is ICICI’s international business – ICICI Bank UK barely broke even in 2016 while ICICI Bank Canada lost money in the quarter ended 12/31/16. ICICI’s strategy for international banking is focused on serving the international banking requirements of its Indian corporate clients; and establishing ICICI Bank as the preferred bank for Non-Resident Indians (NRIs) in key global markets. In both the UK and in Canada, ICICI has struggled with poor credit performance, and in direct response, production will be lower in 2017. As a result, total ICICI loan growth should approach 15%.

Originally a corporate bank, ICICI has rapidly built its consumer bank into #2 behind HDFC with retail loans comprising 49% of total loans (55% home / 17% vehicle / 14% rural / 3.2% credit cards / 5.7% personal loans). The rest of the loan book is split 28% domestic corporate, 18% international, and 12% SME. The credit risk in ICICI is mainly in the corporate loan book, and specifically in natural resources / commodities where power (5.4% of loans), iron and steel (3.8%), construction (2.7%), mining (1.6%), cement (1.1%), and rigs (0.5%) are all experiencing elevated non-performance. Net non-performing assets (NPAs) at 12/31/16 were Rs380.85 billion equal to a huge 7.20% of assets, the vast majority of which (Rs340 billion) are corporate. On the retail side, there are only Rs13.59 billion of NPAs, representing a small 0.61% of retail loans.

With ALLL of Rs179.3 billion (47% reserve coverage), ICICI might be under-reserved. ICICI has Rs940 million in tangible common equity supporting total assets of Rs7,578, representing a TCE ratio of 12.4%. By extrapolating credit trends in the corporate loan book, we can make broadly conservative assumptions about future losses. In a Downside case operating scenario in which roughly half of the Rs202 billion of net NPAs are charged-off, ICICI’s equity would be cut by around Rs100 billion, leaving Rs839 billion, equal to a still robust 11.1% TCE ratio.
Therefore, credit risk is real but limited, and highly unlikely to require a dilutive capital raise. At a projected P/BV of 1.1x, the market anticipates distress where we see value.

In addition to commercial and retail banking, ICICI is the parent of ICICI Prudential (ICIR), the largest life insurance provider in India, ICICI Prudential Asset Management, the largest asset management company in India based on AUM, ICICI Securities, ICICI Home Finance, and a matrix of other operating subsidiaries providing financial services from property & casualty insurance (P&C) to pension funds management.

ICICI has a low cost of funds (2016 avg. = 5.5%) – due in part to corporate deposits which are transaction-based, and low-to-no interest-bearing. NIM should remain stable as lower deposit costs are offset by lower yielding loans and securities. ROA of 1.4% should increase as NIM is stable and fee income increases. ICICI’s peers earn 1.6% - 1.8% ROA. In conjunction, ROE should increase from 11% to 15%, and along with it P/TBV should rise to the level of its peers (2x+). By the end of 2019, TBV should approach $7 (1.1x), which means ICICI’s stock price (ADR ticker is IBN) should approach $12 (up from $7.75 at 1/31/17).

Final thought on investing in India – by investing in ICICI, we are waving one of the criteria that we use in evaluating banks, and in fact it is usually the most important one. While I have heard positive things about the management team and am impressed with their cost management (34% efficiency ratio), I have not yet had the opportunity to meet with or speak to them. As a result, we continue to limit the size of our investment in ICICI.

3. The Internet. Last summer I received a call from a potential investor who wanted to know if I knew of any internet banks for sale, and by internet bank, he meant a bank with no more than 1 or 2 locations yet a national charter to gather deposits in all 50 states. I didn’t know any off hand but it sparked my interest in the business model. Obviously without physical branches, internet banks benefit from a lower cost infrastructure and, thus, are more efficient than traditional brick-and-mortar banks, enabling them to attract deposits rapidly by offering a higher rate on deposits. However, internet banks generally face the risk of a "negative interest rate gap" when liabilities reprice faster than assets. Specifically, the cost of funding (deposits) rises faster than the yield on assets (loans and securities rolling over) in a rising interest rate environment. In order to retain hot money attracted to the highest CD rates, internet banks have to continually pay up, while holding securities earning below-market yields. Moreover, without personal relationships, the customer base is inherently price sensitive. Because of this weaker quality of funding, internet banks are viewed as less stable and generally trade at a discount to the bank universe.
### Internet Banks - defined as banks with 1 office and a national charter

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Price as of 12/31/19</th>
<th>Market Capitalization</th>
<th>Deposits</th>
<th>Loans*</th>
<th>Assets</th>
<th>TBV</th>
<th>P/TBV</th>
<th>ROA</th>
<th>ROTCE</th>
<th>TBV Multiple</th>
<th>Target</th>
<th>Dividend</th>
<th>Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>EverBank Financial (EVER)</td>
<td>19.43</td>
<td>128</td>
<td>2,480</td>
<td>19,778</td>
<td>23,454</td>
<td>27,829</td>
<td>15.30</td>
<td>1.28x</td>
<td>0.57%</td>
<td>8.2%</td>
<td>19.25</td>
<td>1.62x</td>
<td>28.84</td>
</tr>
<tr>
<td>BOFI Holding (BOFI)</td>
<td>29.50</td>
<td>63</td>
<td>1,869</td>
<td>6,611</td>
<td>8,891</td>
<td>10,852</td>
<td>11.90</td>
<td>2.48x</td>
<td>1.62%</td>
<td>17.6%</td>
<td>19.33</td>
<td>2.48x</td>
<td>39.68</td>
</tr>
<tr>
<td>Live Oak Bank (LOB)</td>
<td>20.45</td>
<td>35</td>
<td>1,499</td>
<td>889</td>
<td>1,388</td>
<td>1,701</td>
<td>6.51</td>
<td>3.14x</td>
<td>0.81%</td>
<td>6.1%</td>
<td>7.78</td>
<td>3.14x</td>
<td>20.23</td>
</tr>
<tr>
<td>The Bancorp Bank (TBBK)</td>
<td>5.99</td>
<td>56</td>
<td>333</td>
<td>797</td>
<td>1,217</td>
<td>4,830</td>
<td>5.04</td>
<td>1.19x</td>
<td>NM</td>
<td>NM</td>
<td>5.84</td>
<td>1.19x</td>
<td>5.74</td>
</tr>
<tr>
<td>Marin Business Services (MRLN)</td>
<td>22.95</td>
<td>12</td>
<td>280</td>
<td>697</td>
<td>977</td>
<td>892</td>
<td>13.03</td>
<td>1.76x</td>
<td>1.94%</td>
<td>10.9%</td>
<td>17.77</td>
<td>2.01x</td>
<td>29.62</td>
</tr>
<tr>
<td>American Business Bank (AMIZ)</td>
<td>38.35</td>
<td>7</td>
<td>250</td>
<td>788</td>
<td>848</td>
<td>1,854</td>
<td>20.77</td>
<td>1.85x</td>
<td>0.71%</td>
<td>9.7%</td>
<td>27.39</td>
<td>2.01x</td>
<td>45.65</td>
</tr>
<tr>
<td>First Internet Bancorp (INBK)</td>
<td>31.15</td>
<td>6</td>
<td>202</td>
<td>1,463</td>
<td>1,240</td>
<td>1,854</td>
<td>23.03</td>
<td>1.56x</td>
<td>0.74%</td>
<td>9.2%</td>
<td>29.99</td>
<td>2.01x</td>
<td>49.99</td>
</tr>
</tbody>
</table>

Average: 2.01x | 1.1% | 10.3%

EverBank - subsidiary of Steel Partners Holdings LP (SPLP) is a bank that finances Prosper loans and other marketplace loans.

Other banks with large online deposit bases include COF - ING Direct and Capital One National Direct Bank, ALLY - formerly GMAC, diversified away from auto, SCHW, DFS, AXP, ETRD, MET.

I have a mortgage with Everbank (EVER). Everbank generally focuses on residential mortgages with a high portion of jumbos in Florida. My banker is excellent and the bank’s loan portfolio is growing at a robust 15%\(^{14}\) rate. However, deposits have not kept up with loans, resulting in a loan-to-deposit ratio that has ballooned to 119%, the highest in its group and especially dangerous for a liability-sensitive bank. When interest rates rise, deposits will reprice immediately. The cost of deposits is ~0.90%, an extreme premium compared to many banks still reporting average cost below 0.35%. Meanwhile, residential loans ($13 billion) and commercial loans ($11 billion) will roll-over in a contractually agreed-upon timeframe. This negative interest rate gap will pressure earnings over the foreseeable future. With return on assets (ROA) ~0.57%, and unlikely to materially increase given its liability sensitivity, Everbank will struggle to earn a 10% return on tangible common equity (ROTCE). Nevertheless, in August 2016, TIAA-CREF announced the $2.5 billion acquisition of EVER for 1.5x TBV (at the time) and 21.7x LTM EPS, a fair price given the weak return profile, but one that may be undervaluing the strategic value of the franchise.

Another internet bank that was acquired is Square 1 Bank (SQBK) with 1 office in Durham NC. In March 2015, it was acquired by PacWest Bancorp for $849 million, equal to 2.63x TBV.

Before I took a mortgage from Everbank (EVER), I reached out to BOFI Holdings (BOFI) d.b.a. Bank of the Internet. The banker I worked with charged me an upfront fee of $495 that was supposed to be reimbursable if the loan were not originated. Yet, once the loan process

\(^{14}\) Year over year in Q3 2016 (9/30/16).
ended without an origination or reimbursement she stopped returning my emails and phone calls. I had to call the bank’s CFO to intervene. At 2.48x TBV, BOFI is fairly, if not fully, valued.

Other internet banks include: **Live Oak Bancshares (LOB)** at 3.14x TBV. LOB generates revenue primarily from SBA and USDA-guaranteed loans, focusing on small businesses in niche industries across the US. LOB is ranked #2 nationally in SBA's 7(a) loan-guarantee program. **The Bancorp Bank (TBBK)** mainly offers a private-label branchless banking program for non-bank companies such as wealth management providers (30,000+ financial advisors served, $2.2 trillion in partner assets under management). TBBK is also a leading payments franchise with 88 million prepaid cards in circulation (as of 12/31/16). Prepaid cards are a low cost source of deposits at 0.12% (average total deposit cost = 0.32%). 2015 and 2016 results were negatively impacted by write-downs of commercial real estate loans out of a Philadelphia-based real estate operation that was shut in 2014, and expenses remain elevated with an Efficiency ratio > 100%. TBBK raised $75 million in Q3 2016 to improve capital ratios and management expects ROE to approach 5% in the near term. Although TBBK may ultimately prove cheap at 1.19x TBV, for a bank barely covering its cost of capital we deem it appropriately priced.

Which leads us to **First Internet Bank (INBK)**, headquartered in Fishers, IN (outside Indianapolis) with an office in Phoenix Arizona. The office in AZ was added to attract a group of successful mortgage bankers. INBK started off competing mainly on price but has since matured by adding additional products and services including commercial and industrial (C&I) lending, owner/occupied (O&O) commercial real estate, and public finance.

Loan growth is expected to remain robust at 25-30% per annum despite a 15-20% slowdown in mortgage revenues in 2017. Total loans were $1.3 billion at 12/31/16, split between consumer ($414 million, including $81 million of horse trailer loans and $52 million for recreational vehicles, geographically diversified across the U.S) and commercial ($833 million).

On the consumer side, the strategy is mainly based on lead generation via Zillow, Bankrate, and other high traffic aggregators. On the commercial side, the strategy is to hire experienced bankers who add new loan products to the platform. Most recently, in January 2017, INBK launched public finance after hiring a specialist. According to CFO Ken Lovik, the budget for public finance is $90 million loans in 2017, and they “will exceed that”. The largest component of the loan portfolio is single-tenant leases, accounting for $607 million of loans, equal to 48% of the total. The average loan size is $1.5 million, LTV is 53%, and there are zero delinquencies. Red Lobster franchises account for 10% of the single-tenant lease portfolio, CVS = 6.4%, Walgreens = 6.1%, Rite Aid = 5.2%, and Wendy’s = 4.1%. In addition to INBK’s national...
single-tenant lease program, local C&I loans total $102 million, and owner-occupied (O&O) CRE is $58 million.

Credit risk is low – non-performing loans (NPLs) are low at 0.09%, while ALLL is high at 0.88%. ALLL coverage of 1,013.9% basically precludes near-term credit losses.

Cost of deposits is high as expected. Interest bearing demand deposits cost 0.55%, while CDs (accounting for 66% of total deposits) cost 1.58%. The average yield on interest bearing deposits is 1.28%, a high rate compared to brick and mortar banks but relatively consistent with its internet brethren.

Offsetting the high cost of deposits is a low cost infrastructure. Efficiency ratio is in the 56-57% range with a long-term goal <50%. Return on assets (ROA) is currently ~0.7% but expanding. The goal is a 1.0% ROA when assets total $3 billion. Loan-to-deposit ratio is also sub-optimal in the low 80s (90% is target). The combination of better balance sheet utilization, economies of scale, and higher yielding loans should drive ROA to at least 0.90% (3-Sigma Value’s threshold) by 2019. At the internet banking peer group average of 2.01x TBV, IBNK is worth $49.99, up 63.0% including 3 years of dividends assuming a 10% payout ratio (per guidance).
Final Thoughts

When I talk to investors about bank stocks, most are only invested in the largest regional and money-center banks, leaving 90% of the opportunity set unexamined. Maybe it’s because there are not enough bank analysts? Maybe it’s because most investors are content with beta? Most investors I talk to view bank stocks as a uniform group, whose multiple has expanded. Isn’t it easier to buy Citi (cheap), JP Morgan (best), and/or Goldman (government sachs) then it is to spend countless hours sifting through FDIC Call reports? The answer is yes, but only if your goal as an investor is to be the market as opposed to beat the market. I love finding cheap stocks that are cheap for idiosyncratic and temporary reasons, and I do this for one reason – to generate alpha.

Collectively, I expect 3-Sigma Value’s 2017 bank portfolio to return 62.6% over our investment time horizon of one to three years. The portfolio is constantly monitored and updated based on receipt of new information. Positions are sold down as they approach their target prices. New ideas may be added at any time.

Please contact me with any comments or questions.

Benjamin Weinger
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