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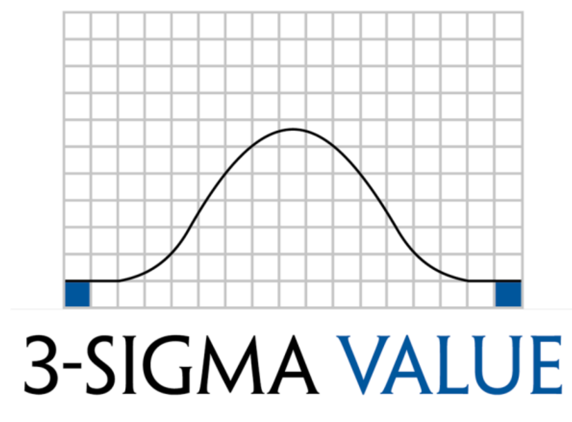

Q1 2018 In Review

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Q1 2018 In Review

For the quarter ended March 31, 2018, 3-Sigma Value, LP (the "Partnership") had an estimated gain of 18.3% with average gross exposure of 164.6% and net exposure of *negative* 15.2%.

3-Sigma Value, LP

PERFORMANCE AND EXPOSURE STATISTICS

	Monthly Performance				Average Fund Exposure			
	Gross	Net[1]	Long	Short	Long	Short	Gross	Net
2011	37.4%	29.9%	1.9%	34.8%	78.6%	89.4%	168.1%	-10.8%
2012	32.3%	25.8%	17.1%	13.1%	64.8%	79.0%	143.8%	-14.1%
2013	-12.8%	-12.8%	7.3%	-19.0%	46.7%	72.4%	119.1%	-25.7%
2014	18.1%	17.0%	-0.3%	18.4%	7.4%	54.9%	62.3%	-47.4%
2015	12.8%	10.2%	-7.0%	21.0%	22.9%	41.6%	64.5%	-18.7%
2016	12.3%	9.9%	13.0%	-1.8%	37.7%	55.6%	93.3%	-17.9%
2017	0.3%	0.2%	7.6%	-6.9%	59.6%	74.0%	133.6%	-14.4%
January	6.3%	5.0%	3.4%	3.0%	81.3%	94.4%	175.8%	-13.1%
February	10.1%	8.1%	-3.1%	13.2%	70.9%	88.5%	159.4%	-17.6%
March	1.1%	0.8%	-1.0%	2.0%	71.9%	86.8%	158.7%	-15.0%
2018	18.3%	14.5%	-0.8%	18.9%	74.7%	89.9%	164.6%	-15.2%
Cumulative	180.9%	131.7%						
Annualized	15.3%	12.3%						

(1) Net of incentive fee.

The top contributors to positive performance in the first quarter of 2018 were mostly on the short side; they were Universal Display (OLED), Xunlei (XNET), Roku (ROKU), Impinj (PI), Wayfair (W), and Hertz (HTZ). On the long side, we had two significant positive contributors: Shutterfly (SFLY) and Tecnoglass (TGLS).

As is custom, dating back to 2011, we use our first quarter investor letter to describe 3-Sigma Value's 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 seven years, we have developed and refined a repeatable alpha-generating investment process that discriminates winners from losers and identifies value.

Phone (212) 605-0433 Fax (646) 349-3725

575 Madison Avenue, 10th Floor, New York, NY 10022

Bank Investing in 2018

Thesis

The U.S. banking industry is in the midst of massive consolidation that is making banks more efficient, and hence more profitable. Every week comes news of new deals. Yet, the U.S remains over-banked, in terms of branches and in terms of bank charters. 5,670 banks reported to the FDIC at the end of 2017. 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.

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. has an active and consolidating M&A market with the power to elevate the valuation of any well-managed and profitable bank.

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 2.2x is at the high end of data going back to 1990. We use this data to project take-out valuations for acquisition candidates.

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.

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575 Madison Avenue, 10th Floor, New York, NY 10022

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[1] across all banks has been 14x, 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.

Building on our analysis in Bank Investing in 2017, 3-Sigma Value employs a proprietary framework for evaluating banks[2] in terms of four factors:

1. Return on assets (ROA) in excess of 0.90% in 2018 – 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[3]. 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.

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[1] Based on LTM (latest twelve months) EPS.

[2] Not just banks but all spread businesses.

[3] 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.

Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022

Stock Selection

The 2018 Bank Portfolio

	in US$ unless noted	Price as of	Shares	Market	Q4 2017					2018		Dividend, EPS, Payout Ratio, and P/E				12/31/2020	Take-out		Plus: 3 yrs	Equals:
		12/31/17	Out	Capitalization	Assets	MktCap/Ass	TCE / TA	TBV	P/TBV	ROA	ROTCE	2017	2018	2019	2020	TBV	Multiple	Target (1)	Dividend	Total Return
1	**First Internet Bancorp (INBK)**	38.15	9	325	2,768	11.8%	8.0%	26.09	1.46x	0.90%	11.2%	0.24	0.32	0.40	0.44	35.87	**1.92x**	57.00	3.0%	52.5%
	1 office in Indianapolis IA; d.b.a. First Internet Bank of Indiana; David Becker is CEO.											2.13	3.25	3.87	4.40	Implied P/TBV:	**1.59x**			
	Take-out multiple correlates to ROTCE; P/E sanity check											11.3%	9.8%	10.3%	10.0%					
											P/E:	**17.9x**	**11.7x**	**9.9x**	**8.7x**	**P/E @ Target**	**13.0x**			
2	**BankUnited (BKU)**	40.52	106	4,298	30,347	14.2%	9.6%	27.59	1.47x	1.00%	10.4%	0.84	0.96	1.08	1.20	37.09	**1.84x**	56.41	8.0%	47.2%
	Miami, FL; John Kanas is Chairman.											2.44	3.03	3.25	3.60	Implied P/TBV:	**1.52x**			
	Take-out multiple correlates to ROTCE; P/E sanity check											34.4%	31.7%	33.2%	33.3%					
											P/E:	**16.6x**	**13.4x**	**12.5x**	**11.3x**	**P/E @ Target**	**15.7x**			
3	**Fidelity Southern Corporation (LION)**	21.69	27	586	4,577	12.8%	8.5%	14.41	1.51x	0.95%	11.2%	0.48	0.56	0.64	0.72	19.80	**1.92x**	31.42	8.9%	53.7%
	Atlanta, GA; Palmer Proctor is CEO.											1.49	1.68	1.92	2.16	Implied P/TBV:	**1.59x**			
	Take-out multiple correlates to ROTCE; P/E sanity check											32.2%	33.3%	33.3%	33.3%					
											P/E:	**14.6x**	**12.9x**	**11.3x**	**10.0x**	**P/E @ Target**	**14.5x**			
4	**Customers Bank (CUBI)**	25.99	33	847	9,840	8.6%	7.3%	21.90	1.19x	0.90%	12.4%	0.00	0.00	0.00	0.00	31.10	**2.04x**	52.54	0.0%	102.2%
	Wyomissing, PA; Jay Sidhu is CEO.											1.97	2.71	3.28	3.85	Implied P/TBV:	**1.69x**			
	Take-out multiple correlates to ROTCE; P/E sanity check										**P/E:**	**13.2x**	**9.6x**	**7.9x**	**6.8x**	**P/E @ Target**	**13.6x**			
5	**Ally Bank (ALLY)**	29.04	445	12,922	167,148	7.7%	7.5%	28.07	1.03x	0.80%	10.7%	0.52	0.60	0.68	0.72	38.08	**1.60x**	50.44	6.9%	80.6%
	f.k.a. GMAC focuses on prime rather than sub-prime borrowers. Strong deposit growth enabling ALLY to replace maturing debt with lower cost deposits, boosting NIM.											2.39	3.07	3.53	4.00	Implied P/TBV:	**1.32x**			
	Take-out multiple correlates to ROTCE, adjusted for auto concentration; P/E sanity check											21.8%	19.5%	19.3%	18.0%					
											P/E:	**12.2x**	**9.5x**	**8.2x**	**7.3x**	**P/E @ Target**	**12.6x**			
6	**AerCap Holdings (AER)**	52.61	150	7,891	34,748	22.7%	23.7%	54.83	0.96x	3.14%	13.3%	0.00	0.00	0.00	0.00	79.72	**1.00x**	79.21	0.0%	50.6%
	P/E based valuation (10x) translates to ~1x 2020 TBV											6.43	7.00	7.43	7.87	Implied P/TBV:	**0.99x**			
											P/E:	**8.2x**	**7.5x**	**7.1x**	**6.7x**	**P/E @ Target**	**10.0x**			

(1) Target = PV (6.5%) of (TBV growth through 12/31/2020) x (take-out multiple based on ROE). ALLY and AER valuations use P/E analysis in addition to ROTCE vs. P/TBV.

During 2017, we sold three banks, invested in two new ones, and re-invested in a bank that was in the 3-Sigma Value portfolio between 2013 and 2016.

We sold **ICICI Bank (IBN)** for a 33% gain after the initial benefits from India's demonetization began to wane, and we re-evaluated risk in light of a language barrier and limited communication with management. We also sold **Great Southern Bank (GSBC)** and **First Financial Bank (THFF)** for a negligible loss after re-evaluating mid-year and finding more upside in the other banks in the portfolio.

Three banks profiled in ***Bank Investing in 2017*** remain in the portfolio in 2018 – they are:

1. **BankUnited (BKU),** headquartered in Miami, FL, was up 11% during 2017, a lackluster performance given excellent execution and an upward trajectory to earnings. After the credit bubble burst, legendary CEO John Kanas (who is now the Chairman) led a team of former Northfork Bank[4] 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 January 2011 IPO at $27, the stock price has only appreciated 50% to $40.52, significantly lagging its peer group. BKU is exceptionally well-managed as

[4] Capital One acquired Northfork Bank in 2006.

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575 Madison Avenue, 10th Floor, New York, NY 10022

evidenced by its sub-50% efficiency ratio (ER) and 10%+ ROTCE, yet valuation remains cheap at only 1.5x TBV and 13x EPS. Based on the correlation between P/TBV and ROTCE, BKU is worth $56.41, representing 47.2% total return, including 3 years of dividends ($0.84 annual dividend, representing a 34% payout ratio).

2. **Fidelity Southern (LION) d.b.a. Fidelity Bank**, with headquarters in Atlanta, GA, was flattish over the course of the year despite being the highest performing under-valued bank in the all-important Atlanta market. With $4.6 billion in assets and $3.9 billion in deposits, LION ranks #7 in deposit market share in the Atlanta MSA and 12th in the state of Georgia. 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 $4.6 billion in assets, giving it enough scale to drive efficiency while rendering it an ideal acquisition target for any consolidator or regional bank. With a solid organic loan origination program and a diverse set of sources of fee income, 1% ROA / 10%+ ROTCE, LION is worth $31.42, representing 53.7% total return, including 3 years of dividends ($0.48 per annum, equal to a 32% payout ratio).

3. **First Internet Bank (INBK)** has one office and a national charter. Without physical branches, INBK benefits from a lower cost infrastructure and, thus, is more efficient than traditional brick-and-mortar banks, enabling it to attract deposits rapidly by offering a higher rate on deposits. In September 2017, INBK fell from $33 to $29 ahead of a secondary common stock offering. While dilution is never inherently good for shareholders, the equity infusion allows INBK to take full advantage of the growth opportunities in a diversifying loan portfolio. As such, 3-Sigma Value increased its exposure to INBK at the offering, and since then the stock price has jumped above $40. The combination of better balance sheet utilization (loan-to-deposit ratio up from low 80% to high 90%), economies of scale, and higher yielding loans should drive ROA to at least 0.90% (3-Sigma Value's threshold) by 2019. CEO David Becker and his team have done an excellent job building scale and diversifying the loan book. Asset quality is outstanding with NPAs of only 0.21% (negligible credit risk). First Internet Bank is a unique asset, likely to be acquired at a price in excess of 3-Sigma Value's $57.00 target price, representing a total return of 52.5% including 3 years of dividends assuming a 10% payout ratio (per guidance).

For more analysis of BKU, LION, and INBK, please see 3-Sigma Value's ***Bank Investing in 2017***, available in the research section of www.3sigmavalue.com.

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575 Madison Avenue, 10th Floor, New York, NY 10022

The two banks new to the portfolio in 2017 are **Ally Financial (ALLY)** and **AerCap (AER)**.

4. **ALLY Bank (ALLY)** – f.k.a. GMAC focuses on prime rather than sub-prime borrowers. Strong deposit growth is enabling ALLY to replace maturing unsecured debt with lower cost deposits, boosting NIM from 2.63% in 2016 to 2.76% in 2017 to nearly 3% by 2020, and ROTCE towards management's target of 12% (10.8% in 2017). Given the high correlation between ROTCE and P/TBV, ALLY's multiple should expand along with its return, however, because of the bank's high concentration in auto loans, ALLY is not diversified enough to warrant a comparable bank multiple. Typically, a bank earning 10%+ ROTCE is worth at least 1.8x TBV. Assuming ALLY's P/E remains constant at 12.6x, we estimate ALLY is worth ~$50, representing ~77% total return, including 3 years of dividends (payout ratio ~ 20%). This translates to a future P/TBV of 1.3x, representing a significant 0.5x discount to banks with comparable earnings power.

ALLY Bank (ALLY) - P/E Sanity Check					
	2017	2018	2019	2020	
EPS	2.39	3.07	3.53	4.00	
% growth	10.6%	28.5%	15.0%	13.3%	
P/E	12.61x			12.61x	
Worth				**50.44**	
% Upside				67.4%	
ROTCE				10.8%	
Implied P/TBV (12/31/2020)				1.29x	This is still cheap

5. While not technically a bank, **AerCap Holdings (AER)** is a non-bank financial that employs a spread-based business model akin to a traditional bank. AER is the world's largest independent aircraft leasing company, benefiting from global jet fleet consolidation and increasing demand for operating leases. AER generates a solid 13% ROTCE yet trades below book value of $57.20 (like a cheap bank). $6.43 of EPS in 2017 is growing to $6.60-$7 in 2018 and ~$8 in 2020 ($7.87 Base Case Operating Scenario 1). Using the back of an envelope, AER is worth at least $78.71 (10x P/E).

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575 Madison Avenue, 10th Floor, New York, NY 10022

AerCap leases the majority of its aircraft to airlines under operating leases whereby the lessee is responsible for ongoing maintenance and servicing. Airlines benefit from acquiring aircraft under leases because it greatly reduces their upfront capital requirements and allows them to manage their fleets more efficiently. The proportion of the global fleet on operating leases has more than doubled from 21% in 1996 to 42% in 2016.

AER's average lease rate is 13% and its cost of debt is 4%, which means AER is currently earning a 9% net spread on the $35 billion of aircraft assets on its balance sheet. Management expects net spread to range between 8% (Downside) and 10% (Upside). With 6.9 years remaining on its average lease term and 95% of lease revenue contracted through 2019, earnings visibility is exceptional, warranting a higher valuation.

In addition to net spread (a.k.a. net interest margin (NIM)), AER earns gain on asset sales by selling older aircraft with a nice profit margin (premium ranges from 5-10%; was 8% in 2017), and then replacing and growing the fleet with new aircraft. Selling assets above book value and buying back stock below book value (repurchased $1.1 billion in 2017) is a very accretive strategy.

At 10x EPS (in 2020) and 1.0x TBV (at 12/31/2020), AER is worth $79, representing ~50% total return. The fact that both P/E and P/TBV-based valuations generate the same result gives us extra confidence in our analysis.

AerCap Holdings (AER) - Valuation Summary - Base Case Operating Scenario 1

	2017	2018	2019	2020	
EPS	6.43	7.00	7.43	7.87	
% growth	16.6%	8.8%	6.1%	5.9%	
Worth 10x P/E				**78.71**	
% Upside				49.6%	
ROTCE				13.1%	
TBV - 12/31/2020				79.30	
Implied P/TBV				0.99x	This is still cheap
Worth 1x TBV				**79.30**	
% Upside				50.7%	
Average of P/E and TBV				**79.00**	
% Upside				50.2%	

Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022

6. The last but not least bank in 2018 is **Customers Bank (CUBI)**, which returned to the 3-Sigma Value portfolio in October 2017 after its stock price collapsed from $33 to $25 on news that the sale of its money-losing mobile banking operation BankMobile was being restructured as a spin-off. Instead of receiving cash, CUBI's shareholders will now receive a Bank Mobile stock dividend that is worth $3.50-$4.00 per share. While a negative reaction is understandable, no value was lost, and spinning-off a money-losing operation will accelerate/solidify 15% EPS growth at the bank. Management's EPS guidance for 2018 is $2.75-$3.00, which is expected to rise to $3.28/$3.85 (7.9x/6.8x) in 2019/2020. At 1.2x TBV, CUBI is the cheapest, high-performing bank in the Northeast.

3-Sigma Value was introduced to Jay Sidhu in the middle of 2012 when he was raising private capital for Customers Bank to acquire failed banks in the wake of the credit bubble bursting. Previously, Jay was the CEO of Sovereign Bank, which he and his team built over the course of twenty years into a major financial institution with over $89 billion in assets at the time of Jay's "retiring" in 2006.

The rapid demise of Sovereign after the 2006 change in leadership is a morality tale lost in the tragedies of Lehman, Fannie and Freddie, and the overall collapse of the financial system in 2008. Under Jay's leadership, Sovereign was a conservatively run bank that was under-leveraged and under-earning relative to its peers during the credit bubble until activist investor Ralph Whitworth of Relational Investors orchestrated Jay's removal.

To boost return on equity, the new management team, pressed by Whitworth, lowered credit standards and loaded up on an alphabet soup of structured products[5] , and sure enough, on October 13, 2008 what remained of Sovereign was acquired by Spain's Banco Santander SA for a measly $2.51 per share. In contrast, two years earlier when Jay was still CEO, Sovereign sold a 19.8% stake to Banco Santander in a strategic transaction for $2.4 billion cash ($27 per share). Included in the deal was an option for Banco Santander to buy the rest of the bank for $40 per share for one year beginning in the middle of 2008. Instead, they were able to get it for $2.51.

Jay went on record saying about Whitworth, "*Every single action taken under his leadership of the risk management committee destroyed value. You need a long-term view with prudent risk-management strategies and not the short-term view of a hedge fund manager*."

[5] Buried in "other securities" in the footnotes to the financial statements.

Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022

As far as the notion that Jay was the one responsible for the downfall of Sovereign and by the time Whitworth showed up it was too late, that version of the story is not supported by the data. It wasn't until 2008 that Sovereign was a financial wreck. In 2007, a year after Jay was retired, nonperforming loans (NPLs) were only 0.53% of total loans, slightly elevated but generally consistent with the 0.38% to 0.44% rate during the prior three years, 2004 to 2006. In 2008, NPLs more than tripled year-over-year to 1.64%.

After watching the disintegration of his work and much of his fortune, in 2009, Jay raised $22 million of equity ($7.5 million from Jay) to acquire New Century Bank, a failed bank in Pennsylvania with $270 million of assets. Jay and his team restructured the operations of the newly rechristened Customers Bank and worked through its non-performing assets (NPAs) before embarking on an acquisition strategy that, along with organic growth, would raise total assets to $10 billion in 2017.

Customers Bank's lending strategy is highly conservative with a focus on "superior" credit quality. Non-performing loans (NPLs) are only 0.30% of total loans. Meanwhile, the Bank's allowance for loan and lease losses (ALLL) is equal to 0.56% of total loans (187% of NPLs). Therefore, even if all of the defaulting loans in the portfolio were written-down to zero, shareholders' equity would still not be pierced.

In summary, Customers Bank has a simple formula for success: (1) superior credit quality, plus (2) revenues = 2x expenses (50% efficiency ratio), equals ~1.1% ROA and 12% or greater ROTCE.

Customers Bank is a significantly undervalued bank at 1.2x TBV and 8x 2019 EPS. Given its superior ROE driven by superior cost management, CUBI should trade at a premium (or at least in line) with its peer group.

Ultimately, an investment in a bank is an investment in people. While I can't say that we at 3-Sigma Value have a spotless record investing in bank management teams, we do have an extensive one, during which time we have conducted due diligence on over 150 past, present, and potential bank management teams.

When I first met Jay, a fellow investor in Customers Bank warned me not to be "overly-wowed" by Jay's knowledge of banking – a contradiction given knowledge is what we are seeking. Jay is

Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022

not "shareholder friendly," I am told over and over again – based on a version of the Sovereign tale that history has proven false.

The basic reason Customer Bank is undervalued is the so-called "Jay Sidhu discount" – a discount that we strongly believe is unwarranted and depreciating with each impressive year of revenue growth and cost management. Based on the correlation between P/TBV and ROTCE, CUBI is worth $52.54, representing 102.2% total return.

Final Thoughts

A bank charter is a license to make money. Deposits carry the cheapest cost of capital of any liability while leverage enables narrow spreads to expand into double-digit returns on equity. Moreover, the environment for banking is stable, supported by favorable regulatory and legislative changes, lower taxes, rising interest rates (most banks are asset-sensitive), and a benign credit environment outside of a few distressed segments such as subprime auto and student loans. Banks collectively will continue to post a healthy return on assets ~1.00% in 2018.

Without a catalyst, however, none of the banks in our portfolio will obtain a fair valuation, no matter how cheap they become. In many cases, it is M&A that will drive valuations. Or marketing. These bankers all have stories to tell, their banks are all objectively undervalued, and the more these fine CEOs market to investors the more demand will be created for their stock. What all six of these banks have in common, more than anything else, is they are all run by experienced first-rate management teams.

Please contact me with any comments or questions.

Benjamin Weinger
Portfolio Manager
3-Sigma Value, LP

Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022

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Phone (212) 605-0433 Fax (646) 349-3725
575 Madison Avenue, 10th Floor, New York, NY 10022