EJF Investments Manager LLC
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Executive Summary

- **EJF Investments Limited ("EJFI") believes that 2021 could be a meaningful year for U.S. community bank credit and equity exposures as they have the potential to outperform following the downturn caused by the Covid-19 pandemic.**
    - **Higher interest rates, yield curve steepening and improved loan growth create a cyclical opportunity in bank equities and underpin credit quality in a manner not yet fully appreciated by some investors.**
    - **Acceleration of M&A activity in 2021 should also have a positive impact on prepayment speeds within bank trust preferred securities ("TruPS") CDOs; higher interest rates and tightening credit spreads should positively affect TruPS valuations.**

Dear EJFI Shareholders,

Although 2020 was incredibly volatile, the efficiency of capital markets resulted in an abbreviated downturn mid-year and ultimately led to a strong rebound in investor optimism in the fourth quarter. In the last 12 months, indices of publicly-traded U.S. banks witnessed a nearly 50% peak to trough correction with historic stimulus injected to counteract the destabilising impact of Covid-19.

As we look towards 2021, we believe the election of Joe Biden and a narrow Democratic majority in Congress offers the financial sector a 'Goldilocks' backdrop. Additionally, we believe that additional relief or stimulus measures should be supportive to credit quality while also translating to meaningful GDP growth, likely higher interest rates and a steepening yield curve. EJF believes that the secular trends supporting the U.S. bank credit and equity exposures remain very attractive with potential return profiles that have been enhanced by discounted valuation entry points caused by the Covid-19 pandemic.

US Banking Industry is Thriving

We believe that the health of the U.S. banking sector is no longer a debatable point. Average capital levels of 8.54% tangible common equity represent a robust level historically[1]. Over the nearly 12 months since the onset of the pandemic, many U.S. banks have utilised strong revenues from the Paycheck Protection Program ("PPP"), capital markets businesses and mortgage banking fees to bolster loan loss reserves in anticipation of eventual credit losses. Actual loan losses, though, have so far been modest given the historic safety net provided by the Federal Reserve, U.S. Treasury and banking regulators as part of the $2.2 trillion CARES Act. Moreover, the additional Covid-19 relief provided in the $900 billion bill in December should go a long way towards bridging the hardest hit industries until the economy fully re-opens. Small businesses within the hospitality, restaurant and entertainment venue segments were the centerpiece of a second round of PPP and the associated Small Business Administration relief programs. Given that these subsectors comprise just 5-6% of a typical bank's loan portfolio, we believe that the actual loss experience will be well covered by reserves on hand. In fact, many small and medium sized US banks began to 'release' reserves back into earnings in the fourth quarter of 2020.

[1] Source: S&P Global Market Intelligence as of December 31, 2020.

As credit quality appears to be well situated, we estimate that loss absorbing capital within the banking system is over 16.5% today, putting the industry in a heavily overcapitalised position. Importantly, the Federal Reserve eliminated the moratorium on share repurchases by the top 33 CCAR stress tested banks in December 2020. We believe that banks are in a strong position to return capital over the next two years, thus improving return on equity across the industry.

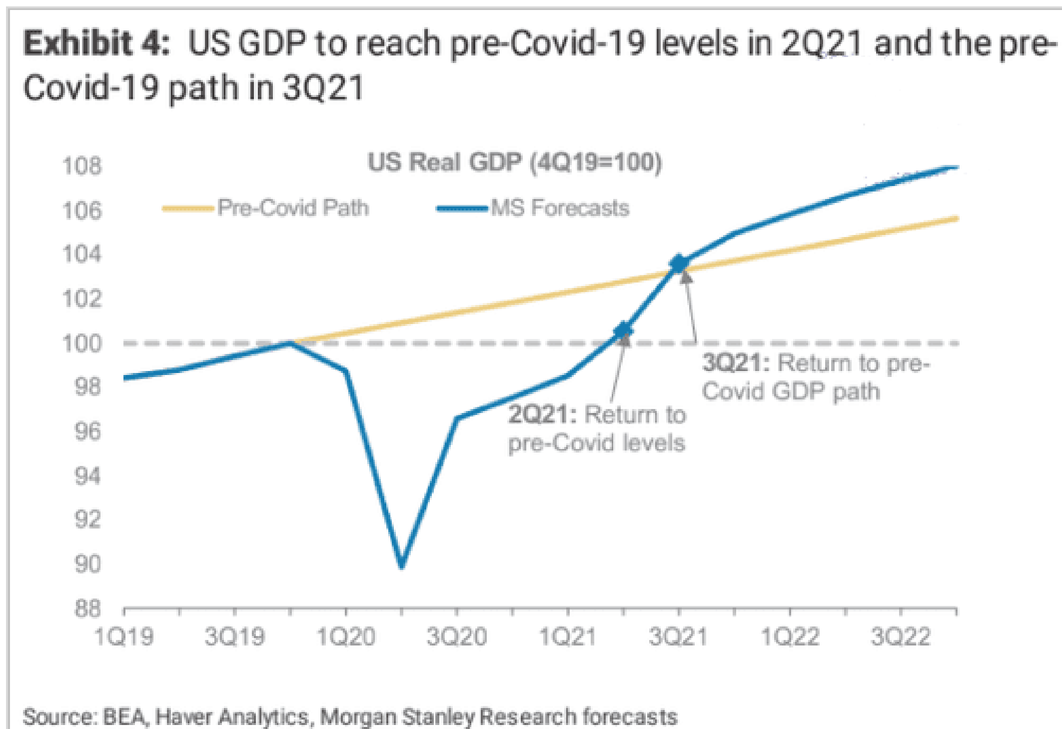
Favorable Regulatory & Political Backdrop

Although presidential administrations have changed multiple times since the Global Financial Crisis ("GFC") in 2008, we believe that community and regional banks benefit from bipartisan support on Capitol Hill. Both policymakers and banking regulators have supported these institutions by subjecting them to less complex capital requirements and keeping them from the burden of being deemed 'systemic'. Additionally, we see many examples of entrepreneurial activity, with more robust loan growth opportunities and a greater engagement with financial technology than ever before.

The bipartisan nature of rulemaking for banks has been a welcome sight in what has been a contentious political playing field these past four to five years. Since the 67 votes in the Senate to increase the Systemically Important Financial Institution ("SIFI") threshold from $50 billion to $250 billion of assets, we have noted numerous examples of Congress coming together to support small and medium sized banks. Most recently, Subtitle C of the December 2020 Covid-19 relief bill provided for a historic investment in CDFIs and MDIs. In particular, the $9 billion Emergency Capital Investment Program aims to expand lending activity in minority communities, especially those disproportionately impacted by Covid-19 and those with unmet financial service needs. The Treasury-led capital initiative will consist of cumulative preferred stock issued by qualifying Minority Depository Institutions ("MDIs") and Community Development Financial Institutions ("CDFIs"). The amount of capital requested may be up to 30% of risk-weighted assets, depending upon the size of the institution. Although the preferred stock will have a 2% dividend cap, the cap can be reduced to 0.5% if loans to targeted segments are at least 4 times the amount of capital issued.

With the ability to lower coupons to 0.5%, we believe that the Emergency Capital Investment Program would produce the lowest cost of capital instrument in the U.S. banking industry. Of the approximately 1,175 CDFI and MDI institutions, we estimate that approximately 10% of the outstanding TruPS universe is comprised of qualifying issuers and that there are approximately 42 public companies comprising approximately $25 billion in market capitalisation that would be able to take advantage of the capital program.

We view the current regulatory environment as 'Goldilocks' as we believe that narrow Democratic control in Congress will allow for continued support for community banks and the small businesses that they serve. We see greater certainty of additional relief or stimulus packages in 2021, which we believe is not only positive for credit quality, but also positive for loan growth and higher interest rates as fiscal stimulus translates to meaningful GDP growth. As can be seen in the chart below, Wall Street analysts expect strong GDP growth in 2021, with a return to pre-Covid-19 levels of economic growth by the second quarter.



Interest Rate Update

Rising interest rates and the shape of the yield curve will also be meaningful factors for bank credit and equity performance in 2021. As the economy has begun to recover, the benchmark 10-year Treasury yield rose to 1.06% as of January 31st and the spread between the 2-year and 10-year Treasuries climbed to 96 basis points. In past cyclical recoveries, we have noted that yield curves typically steepen between 200-300 basis points. Of course, we expect this cycle to look different given fiscal stimulus of as much as $1.9 trillion currently being negotiated in Congress. Moreover, in the back half of 2020, the Federal Open Market Committee ("FOMC") committed to an 'inflation averaging' approach which intends to keep short-term rates lower for longer. This approach would have the intended consequence of creating inflationary conditions beyond the FOMC's traditional 2% target. If interest rates were to continue to rise from here, we believe that the banking sector would see net interest margins begin to rise and earnings power accelerate.

Additionally, as it relates to TruPS, we expect these securities to benefit from rising interest rates given their floating rate structure. If investors continue to drive credit spreads tighter in a chase for yield, we view second pay and mezzanine tranches of TruPS CDOs as particularly interesting in that we see attractive economics in the arbitrage between legacy CDO tranche valuations and new capital market executions.

M&A Activity

Finally, we are also optimistic that bank M&A activity is set to rebound in 2021. Since the GFC in 2008, we have typically witnessed between 250 and 300 bank mergers per year. The Covid-19 pandemic slowed deal flow in 2020 to just 110 announced transactions. In the back half of 2020, the announcements of First Citizens BancShares, Inc.'s acquisition of CIT Group, PNC Bancorp's purchase of BBVA USA Bancshares and Huntington Bancshares' deal for TCF Financial Corp. were all received quite favourably by investors.

We believe that M&A is set to accelerate for three main reasons. First, record levels of subordinated debt and preferred equity were issued by banks at record low coupons throughout 2020. Given that capital is unlikely to be needed for credit losses, we expect it could be put to work in both loan growth and consolidation activity. Next, many community and regional banks have a stock currency again, in some cases between 1.5x and 2x tangible book value, which we believe will allow for highly accretive economics in M&A transactions with smaller public and private peers. Lastly, economies of scale and cost saving opportunities continue to be crucial in a generally low growth industry with interest rates very low from a historical perspective.

The robust levels of M&A activity seen in the few years leading up to 2020 proved to be a meaningful catalyst for prepayment activity within the TruPS CDO universe. Given the current access to cheap capital for banks we feel M&A picking up could again serve as a catalyst for prepayments within the bank TruPS CDOs.

EJFI appreciates the confidence of its investors and looks forward to what we believe will be an attractive year investing in financials and regulatory-driven themes.

Thank you for your continued confidence in EJFI.

Neal J. Wilson
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