



*CAPITAL  
MANAGEMENT, LLC*

**White Paper - Investing in Small & Mid-Cap  
Banks: Opportunity Driven by Credit Cycle,  
M&A and the Changing Regulatory Landscape**

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## **Executive Summary:**

- The current economic environment continues to be tenuous. The negative credit cycle persists, albeit at lower levels of losses than 2009. Financial institutions mirror the local economies they serve, thus fundamental bank performance likely will remain subpar over the next 12 months. Though fundamentals are challenged, history shows that stock performance often front-runs actual economic recovery, thereby creating extremely compelling investment opportunities. Further, the time to invest is likely sooner rather than later, not once the dust fully clears or the broader market sees the opportunity.
- If the past is indeed prologue, prudently investing in the space before the normalization of the credit cycle likely will lead to outsized returns. We refer to the early 1990s when bank equity valuations recovered well before credit deterioration reached its peak (see chart, page 8). While many losses are still to come, with an emphasis on the commercial real estate (CRE) space, investors must consider that these losses already may be baked into bank equities, which are trading at historically depressed levels.
- A focus on healthy small- and mid-capitalization banks and thrifts with strong balance sheets, marked by excess capital and solid credit quality, can produce outsized, risk-adjusted investment returns over a multi-year period. The market continues to take a broad, negative view on virtually all small- and- mid-cap financial institutions, regardless of their individual merits. Current bank equity valuations aside, these institutions are NOT all equal. In fact, the stronger banks view this environment as a generational opportunity to strengthen their franchises by taking market share from the weaker players. Eventually, the stronger banks will be distinguished from their weaker solvency-challenged peers, and the market values of the stronger banks' equities should rise appropriately.
- Consolidation will continue to be the most significant banking theme in 2010, led initially by opportunities in FDIC-assisted transactions and second in traditional standalone mergers & acquisitions activity. We estimate 100 to 300 banks could fail in 2010, with 300 to 500 total bank failures possible over the next 18 months. Furthermore, we believe merger of equals transactions may become more prevalent in this environment.
- Regulatory change is in the air. We foresee many regulatory changes, including changes in underwriting guidelines and capital requirements, as well as changes in the structure of the regulatory agencies themselves. As always, regulatory change will affect the profitability of the banking industry. Higher costs will result in increased consolidation as minimum return hurdles become harder for smaller banks to clear. Consolidation can mean takeout premiums for acquired banks.
- We anticipate higher levels of mutual-to-thrift conversions in 2010 and 2011 as the credit cycle normalizes. Moreover, the uncertain regulatory landscape likely

will accelerate the decision to convert for many bank management teams previously straddling the fence. Conversions can unlock value for previously non-public equity. Many converted thrifts opt to sell when eligible.

- Loan demand and growth will be muted during the next 12 months. We expect modest growth in loan demand as small businesses and consumers continue to de-lever. The credit picture will remain cloudy until there is upward momentum in job growth and, ultimately, greater demand for lending.
- Interest rates will rise eventually, but when? We project a favorable interest rate environment for the first half of 2010, and possibly for the entire year, if economic activity fails to awaken from its slumber in the near future.
- In this paper, we first discuss the composition of the U.S. banking system which consists of some 7,500 public and private banks and thrifts, with about \$18 trillion in total assets. We will then discuss stock valuations for small- and- mid-sized banks, as well as the valuation drivers, both historically and currently. Next we will focus on M&A activity, both historically and in a forward-looking context. Much-talked about FDIC-assisted transactions should help identify some of the potential winners in the space and transform the banking landscape in 2010 and early 2011, thereby reigniting the traditional standalone M&A market. We then touch on the mutual-to-stock conversion trend that looks to be heating up. We follow with a look at the changing regulatory landscape for banks, before closing with a discussion on drivers for bank and thrift valuations as well as the broader market.

## THE U.S. BANKING UNIVERSE:

### Industry Overview

	# of Institutions		Assets (\$ Billions)	
<b>Total Industry Banks &amp; Thrifts</b>	7,428	100%	\$17,826	100%
<b>Private</b>	6,146	83%	\$6,392	36%
<b>Public</b>	1,282	17%	\$11,434	64%

	# of Institutions		Assets (\$ Billions)	
<b>Public Banks &amp; Thrifts</b>	1,282	100%	\$11,434	100%
<b>Public Banks</b>	1,034	81%	\$11,025	96%
<b>Public Thrifts</b>	248	19%	\$409	4%

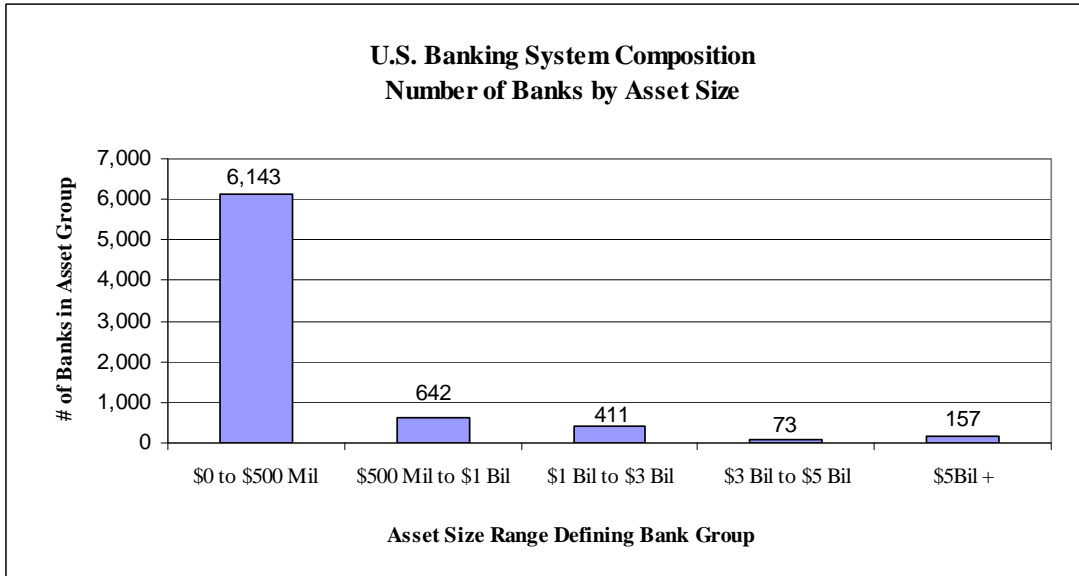
	# of Institutions		Assets (\$ Billions)	
<b>Public Thrifts</b>	248	100%	\$409	100%
<b>Fully Public</b>	174	70%	\$340	83%
<b>MHCs</b>	74	30%	\$69	17%

Sources: SNL Financial LC & FJ Capital Research

Data as of January 13, 2010

- The U.S. banking industry is very large and fragmented, as shown by the number of institutions and assets in the table above. While the majority of U.S. banks are privately owned (83%), public institutions hold the majority of banking assets (64%).
- Of the nearly 1,300 public banks and thrifts, the clear majority (81%) are banks. Although thrifts still tend to be defined as having higher concentrations of residential and commercial mortgage-based loans and securities than their bank peers, the lines have blurred between the two during the last decade or so. Thrifts have increased exposure to commercial business loans (financing operations, rather than real estate) and consumer loans, because the higher risk typically offers higher yields. The result is that thrifts as a group have become more “bank-like” in nature.
- For simplicity, we will refer to banks and thrifts collectively as banks, unless specifically stated otherwise.
- As the title implies, this white paper focuses on the compelling investment opportunity existing in the small and mid cap bank universe. Large cap money centers and regional banks are not a topic of focus as these larger institutions can be very complex, if not impossible, to analyze.
- Typically, the larger the institution, the higher the incidence of off-balance sheet risk, derivatives, complex securities, non-spread-based business lines requiring separate valuation analyses, more frequent capital raises and likely more frequent strategic or M&A activity. Consequently, we believe investors will be better served to focus on small and mid cap banks that can more easily be analyzed and understood than their larger more complex brethren.

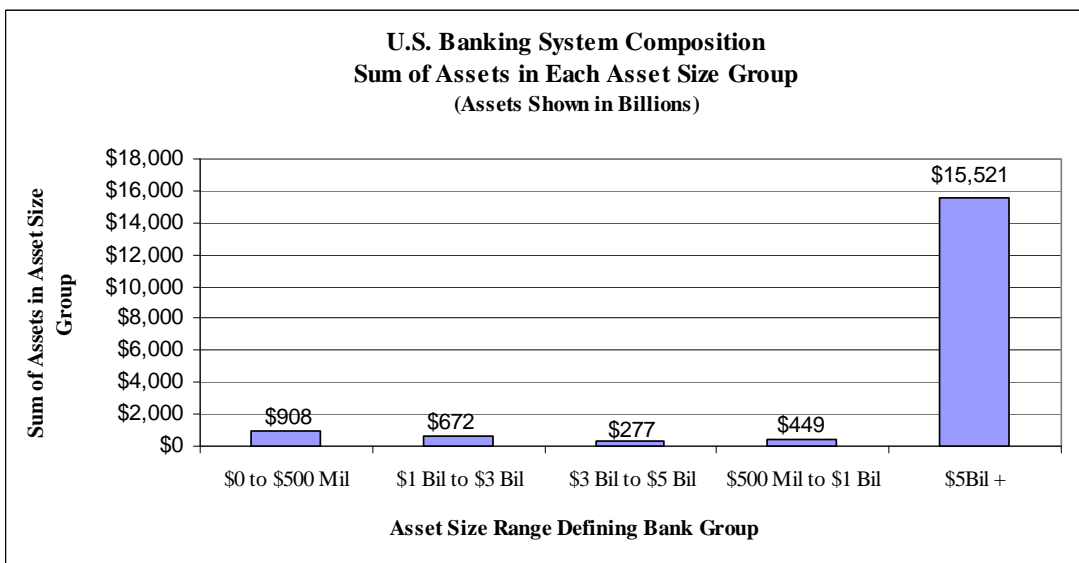
- The first chart below highlights the massive number of smaller banks in the U.S. banking system; we note, however, that the number of small banks should not detract from the fact that there are also a good number of larger banks in the U.S. versus other countries. Canada, for instance, has only a handful of banks, making for more oligopolistic banking conditions.



Sources: SNL Financial LC & FJ Capital Research

Data as of January 13, 2010

- The second chart below shows that the lion's share of assets is commanded by the largest tier of U.S. banks. In banking, scale and scope can mean competitive advantage and profits for the largest, most desirable banking relationships. The smaller and niche banks continue to find their places in the market, however, as banking is a relationship business in want of customized products for clients.



Sources: SNL Financial LC & FJ Capital Research

Data as of January 13, 2010

## **BANK VALUATION:**

SNL Bank & Thrift Indices	12/31/1994		3/22/2010	
	P/TBV	P/E	P/TBV	P/E
Large Cap (Market Cap > \$5 bil)	157%	8.3x	190%	15.7x
Mid Cap (Market Cap \$1 bil to \$5 bil)	151%	8.7x	189%	19.8x
Small Cap (Market Cap \$250 mil to \$1 bil)	153%	11.3x	160%	18.7x
Micro Cap (Market Cap < \$250 mil)	135%	11.9x	109%	15.7x

Sources: SNL Financial LC & FJ Capital Research

### Current Valuations – One of the Best Opportunities Since 1990!

- At the time of this analysis, 1,282 banks and thrifts were public. Of those public institutions, 787 of those with measurable price to tangible book values (P/TBVs) had a valuation level above 100%. This represented only 27% of the public bank population, leaving 61%, or 787 banks, with P/TBV valuation metrics below 100%. When considering this last group, bear in mind that all small/mid cap stocks are not created equal even if the market temporarily values them as such. Therefore, the investment opportunity lies in identifying those banks with sustainable balance sheets that weather the tough environment and potentially grab market share from competitors that do not weather the environment. The following table shows that many banks trading below TBV likely have ample capital and asset quality management to allow them to survive the credit cycle.

<b>Public Banks: Current Valuation and Credit Summary</b>		
Public Banks	1,282	100.0%
P/TBV is not available	146	11.4%
P/TBV > 100% as of close on 1/21/2009	349	27.2%
P/TBV < 100% as of close on 1/21/2009	787	61.4%
<b>P/TBV &lt; 100%</b>	<b>787</b>	<b>100.0%</b>
No TCE data available	5	0.6%
No NPA data available	49	6.2%
TCE > 6%	279	35.5%
TCE < 6%	188	23.9%
NPAs > 4%	288	36.6%
TCE < 6% AND NPAs/Assets > or = 4%	130	16.5%
TCE < 6% OR NPAs/Assets > or = 4%	266	33.8%

Note: Table based on most recently available GAAP data

Source: SNL Financial LC and FJ Capital Research

- The first table on the next page highlights the potential to find attractive investment opportunities in companies trading below tangible book value that have capital in excess of 6%. Banks with excess capital and lower than average credit issues will be the long-term survivors or winners in this cycle. And history has shown that their stocks aptly reward investors for finding them. As the following table indicates, banks with TCE above 6% trading below TBV tend to be a healthy group on the whole,

with a small number of outliers with extreme net charge offs (NCOs) and/or return on average tangible equity.

**387 Banks with TCE above 6% and P/TBV below 100%**

	Total Assets (\$000)	Tangible Equity/ Tangible Assets (%)	Total Capital Ratio (%)	Tang Common Equity/ Tang Assets (%)	NPAs/ Assets (%)	NCOs/ Avg Loans (%)	Return on Avg Tangible Equity (%)
Median	325,782	9.50	14.20	8.99	1.73	0.29	2.88
Mean	1,162,487	10.76	16.21	10.17	1.81	0.80	0.14
Max	139,986,000	38.66	77.50	38.66	3.96	9.92	36.11
Min	23,363	6.08	8.86	6.02	0.00	-4.10	-89.00

Sources: SNL Financial LC & FJ Capital Research

- The second table below highlights the credit quality of the banks trading below tangible book value, but with tangible common equity (TCE) below 6%. This group has lower capital, higher non performing assets (NPAs), higher net charge-offs (NCOs) and lower return on average tangible equity. Consequently, many of these institutions may be considered to have solvency risk since they lack the capital necessary to offset credit quality considerations.

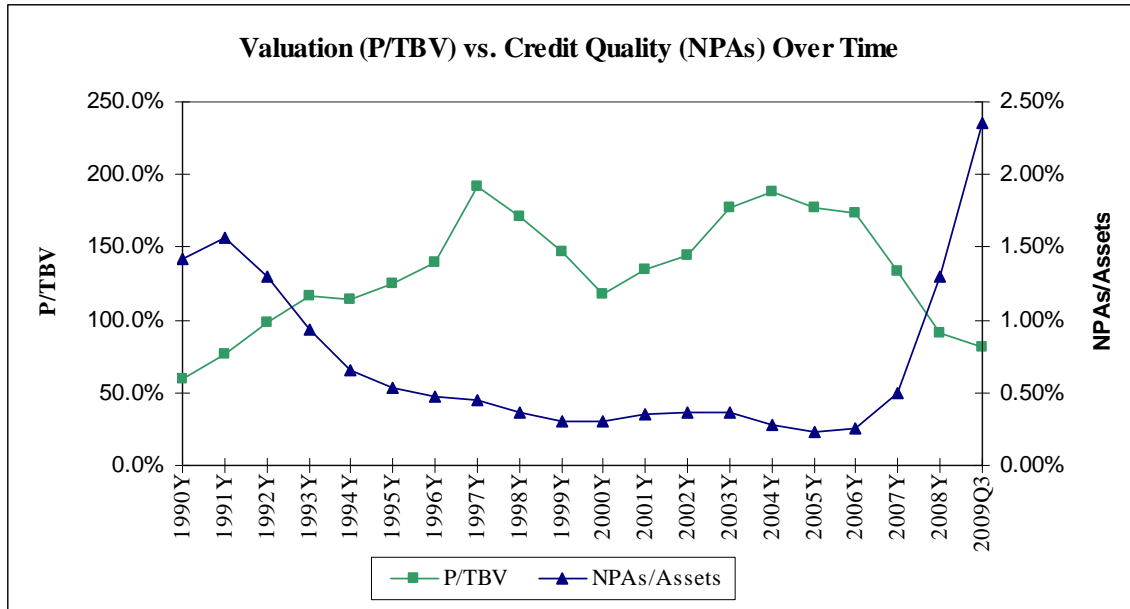
**346 Banks with TCE below 6% and P/TBV below 100%**

	Total Assets (\$000)	Tangible Equity/ Tangible Assets (%)	Total Capital Ratio (%)	Tang Common Equity/ Tang Assets (%)	NPAs/ Assets (%)	NCOs/ Avg Loans (%)	Return on Avg Tangible Equity (%)
Median	543,728	7.37	12.32	5.79	5.86	1.69	-7.30
Mean	1,526,331	7.75	12.57	6.79	6.94	2.53	-15.60
Max	53,403,672	33.29	46.14	33.29	42.70	15.63	85.07
Min	35,743	1.03	2.50	1.03	0.53	-0.54	-99.48

Sources: SNL Financial LC & FJ Capital Research

**Historical Valuation Drivers:**

- Credit Quality. By and large, credit quality is the key driver of a bank's profitability, in good times and bad. Not surprisingly, it is also the main driver of bank valuations. Credit quality changes are often driven by economic growth, which in turn affects unemployment levels; however, poor underwriting can just as easily adversely impact a bank's valuation, even during an economic boom. *The chart at the top of the next page highlights the strong link between bank valuation and credit quality, as measured by the ratio of NPA-to-assets. Note the 1990 timeframe in which stock valuations began to rise even as credit continued to deteriorate. This historical context makes a strong case for investing in the banking space well before fundamentals have fully normalized.*



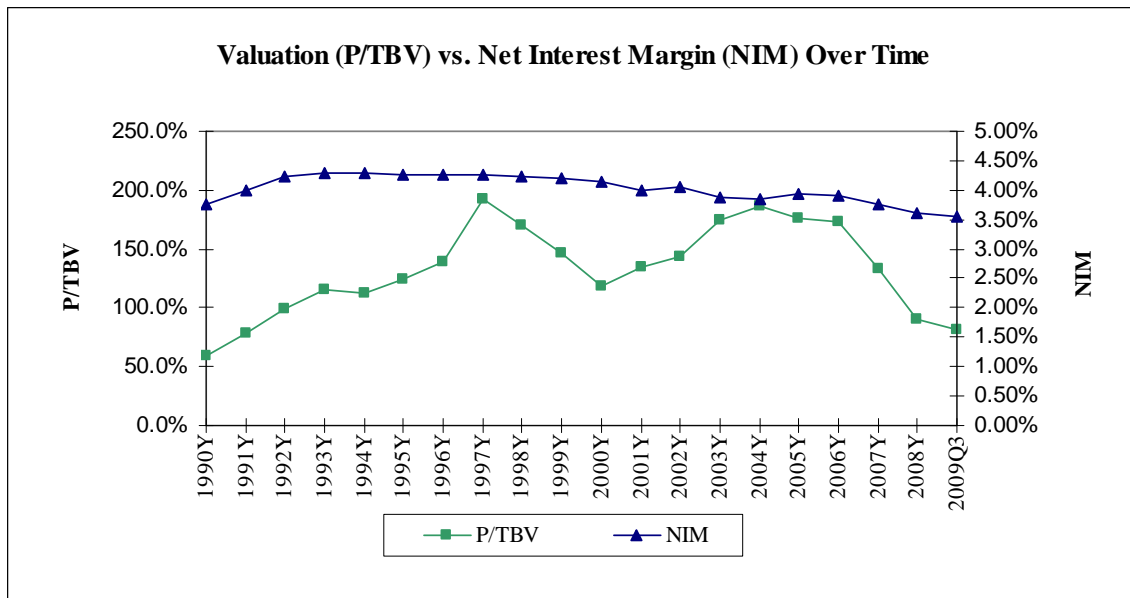
Note: Excludes MHCs  
Sources: SNL Financial LC & FJ Capital Research

Economic Growth. While economic growth influences unemployment levels and borrowers’ ability to repay debt, this pertains to an economic downturn’s impact on credit. During boom times, demand for credit is high and banks are typically more than willing to supply it, which generates massive top-line growth on banks’ income statements, or net interest income. Many bank investors often expect this growth to continue much longer than it actually will and, consequently, the market places a lofty valuation multiple on banks during credit booms. The opposite occurs to banks in credit busts, with investors believing the pain or, more accurately, the low net interest income, will last forever. In evaluating community banks, it is important to understand that for these institutions, profitability relates to the local markets they serve, not to the broad national economy that stock market pundits like to address.

**The market’s gross over-generalization that all smaller banks are equal creates tremendous opportunity for investors willing and able to do the work to differentiate and uncover the potential winners in the space.**

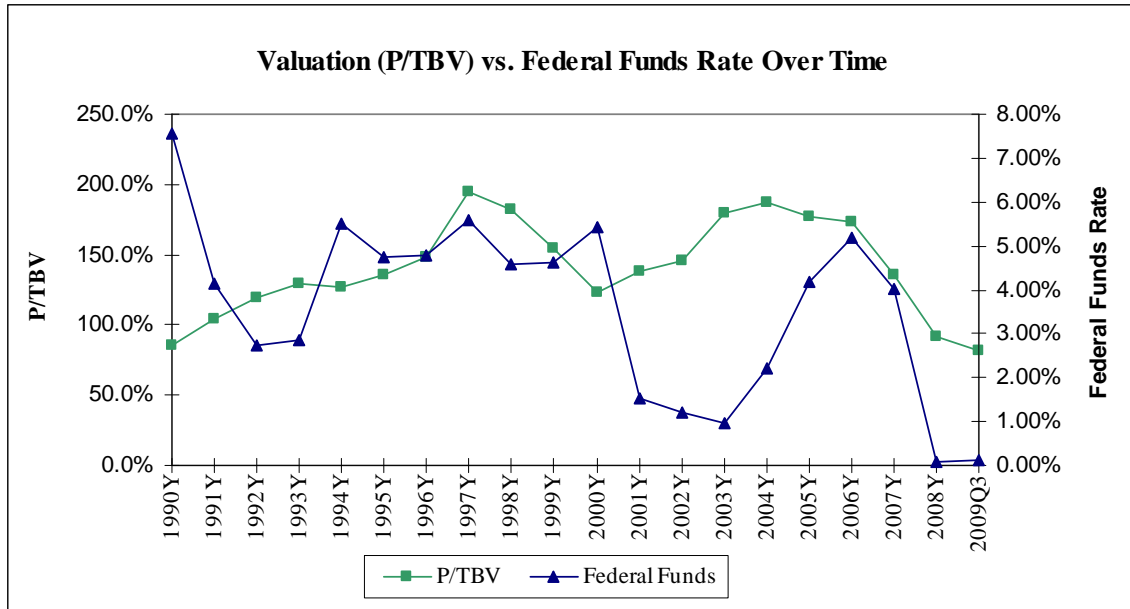
Community banks are a reflection on the economies they serve. While no local markets exist in an absolute vacuum from the rest of the country, all markets are not equal. By example, some banks, and by extension the local markets they serve, were much more active in making irresponsible loans, than others. Some local markets never saw the out-of-control housing bubbles that affected others. The stock market, however, has penalized almost all community banks uniformly, regardless of these differences. We would strongly suggest that community banks need to be viewed on a case by case or market by market basis. For investors, the market’s gross over-generalization that all smaller banks are equal creates tremendous opportunity for investors willing and able to do the work to differentiate and uncover the potential winners in the space.

➤ **Interest Rates.** Bank valuations are closely tied to interest rates in terms of loan volume. The lower the interest rate, the more borrowers want to borrow. That said, one bank can manage its cost of funds (COF) and credit quality quite differently from another bank; therefore, interest rate changes can have a wide degree of variance on valuations. With respect to net interest margin (NIM), bank valuations actually tend to be fairly neutral, because a widening NIM typically indicates an accommodative monetary policy that tends to be offset by higher credit costs arising from the weaker credit environment to which that policy is targeted. Contracting NIMs arising from a tightening monetary policy tend to be offset by higher loan growth arising from the favorable economic environment the policy has targeted. The lack of a strong link between valuations and NIMs is highlighted in the chart below. For 2010, we continue to see wide spreads that should positively impact bank revenues.



Note: Excludes MHCs  
Sources: SNL Financial LC & FJ Capital Research

There is, however, an observable correlation between Federal Reserve interest rate policy and bank valuations. This correlation can be seen on the following chart. The majority of the time, as the blue line (Fed Funds Rate) makes significant moves downward, the green line (P/TBV) subsequently trends upward, and vice-versa.



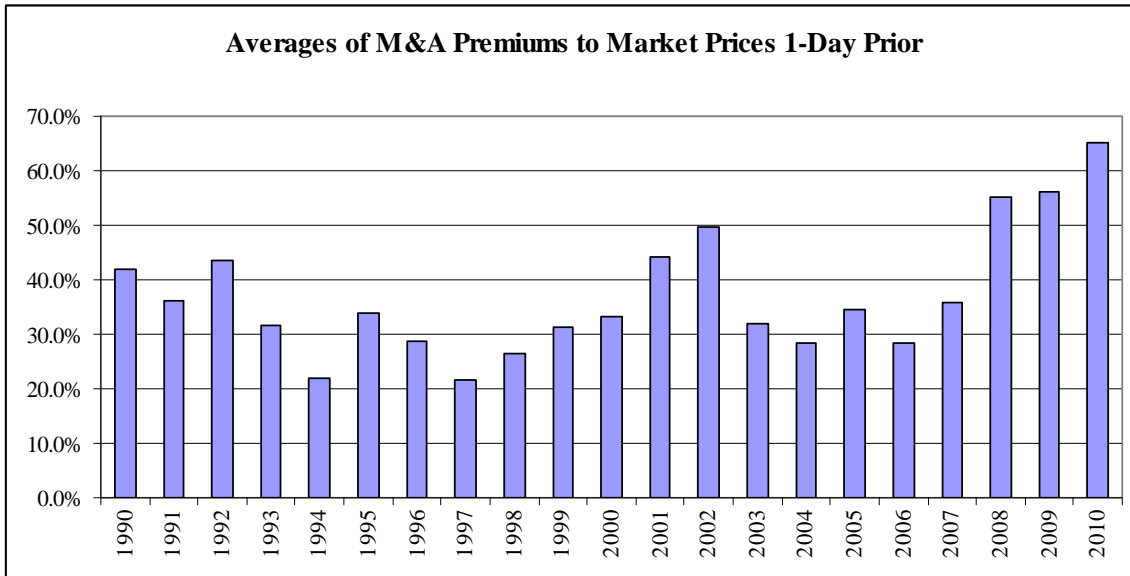
Sources: SNL Financial LC & FJ Capital Management, LLC Research

The most significant observation lies in what this chart tell us about the current environment. How can bank valuations rise if interest rates are poised to go nowhere but up? Looking back to the 2001 to 2002 timeframe, the same question would have been fair game. Yet, as the Fed Funds rate rose from 2003 through 2006, bank valuations rose through 2004 and tapered off gradually until 2006. A somewhat similar phenomenon occurred beginning in the 1992 to 1993 period, with the Fed Funds rate rising from 1993 through 1994, and bank valuations taking only a very small dip, followed by a jump in 1995. Clearly, banks’ valuations improved because the economies in which they operate improved. The pivotal question is: Will history repeat itself? Investors subscribing to the “new normal” philosophy expect a repeat, at least of sorts; however, they do not expect all of the theaters to play A-rated shows like we saw in prior recoveries. The trick is to know where the good shows will be playing – i.e., how to find the banks whose valuations will rise.

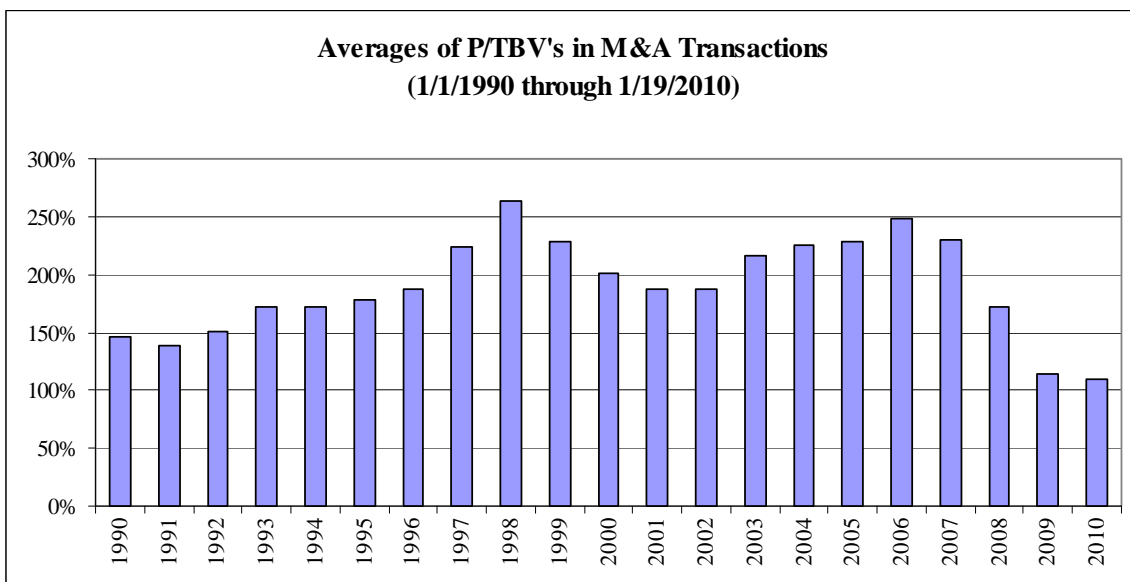
**Valuing Small/Mid Cap Banks:**

- The best way to value small/mid cap banks is by judging the price-to-tangible book value (P/TBV) ratio relative to the return on equity (ROE) ratio. In general, banks generating higher ROEs will trade at a premium to their tangible book values. In today’s environment, credit overrides traditional metrics as credit costs (loan loss provisions and charge-offs) create negative ROEs. While de novo or new banks are born every year, the small/mid cap space typically is viewed as a consolidation story. As such, we believe all banks are either buyers or sellers.
- In a stable credit environment, more traditional standalone M&A will drive valuation for the group. As credit normalizes, we suggest banks will once again be valued on potential franchise value. The ultimate franchise value will depend on geography, cost of funds, other sources of income and the branch network.

- The first chart below shows the substantial, average premiums buyers have paid above market values in public bank acquisitions since 1990. The second chart shows variations in average P/TBV's paid over the years in M&A transactions. For bank investors, the good news is the sale of a bank can result in substantial returns, sometimes almost nullifying the underlying fundamental performance of the bank. Of course, if the acquiring institution uses stock as currency in the transaction, then issues such as after-market performance of the buyer, and whether to sell the buyer's stock, will arise.



Note: The bar for 2010 is based on only one transaction with public or available information  
 Sources: SNL Financial LC & FJ Capital Research

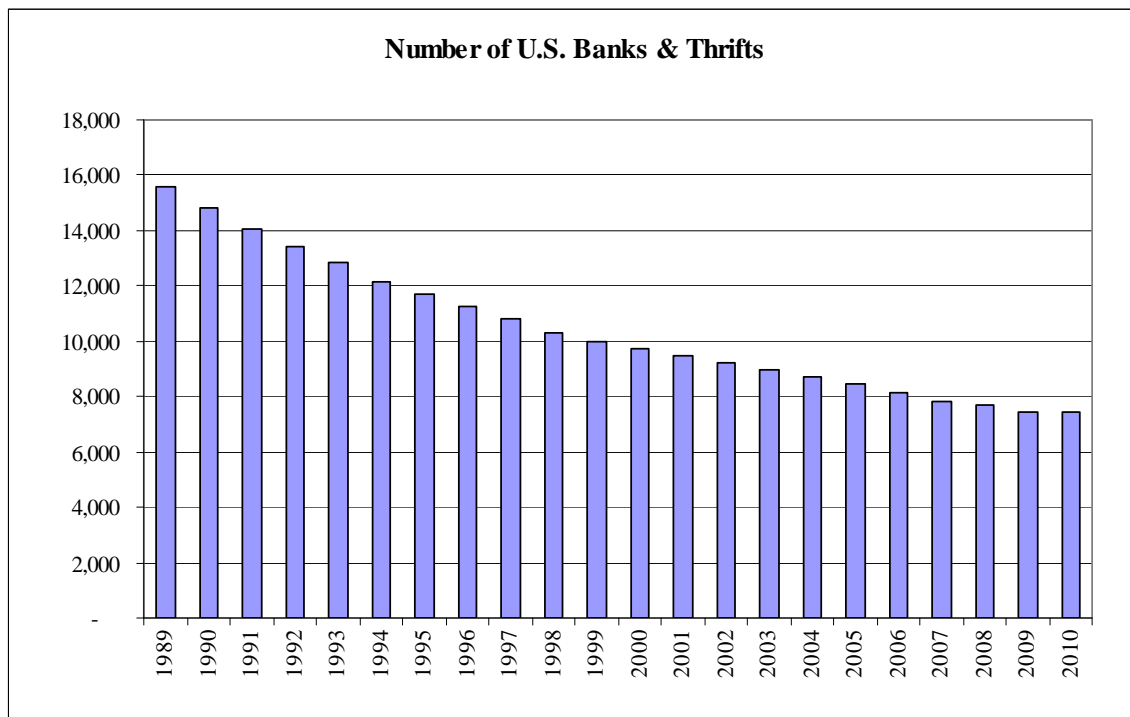


Note: The bar for 2010 is based on only one transaction with public or available information  
 Sources: SNL Financial LC & FJ Capital Research

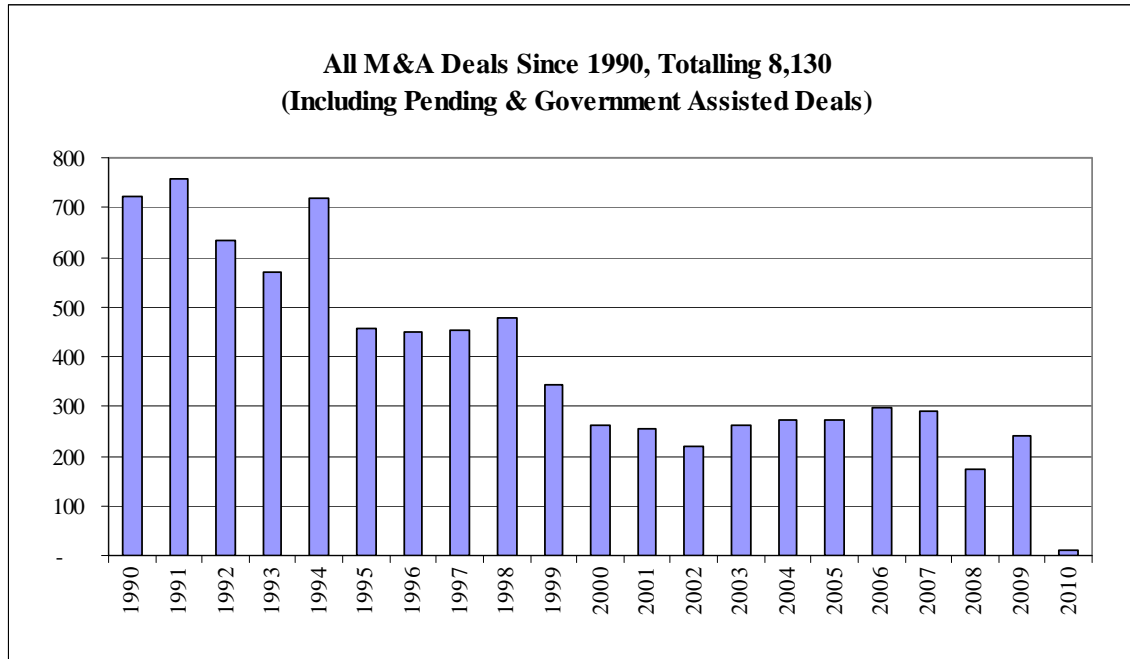
## **CONSOLIDATION:**

### **Banking – A Long History of M&A**

- Despite the large number of U.S. banks, the count decreases every year due to M&A and bank failures. Consolidation has long been a trend for the industry, although consolidation also has been offset somewhat by a fairly significant volume of new bank “de novo” formations. For instance, it is not uncommon for executives departing acquired institutions to launch new banks. In any event, M&A clearly has overwhelmed de novo activity.
- The first chart below highlights the degree of consolidation in the banking industry, with the number of banking institutions cut roughly in half in the past two decades. The exact number of institutions may be slightly imprecise, as the banking population figures were backed into using the banks and thrifts in business today and then subtracting M&A activity for each year, as reported in SNL Financial’s databases. The second chart highlights actual deal activity.



Sources: SNL Financial LC & FJ Capital Research



Sources: SNL Financial LC & FJ Capital Research

### **2010 – A Buyer’s Market**

We foresee two major M&A trends in 2010. First, we see continued FDIC-assisted transactions throughout the year. In these transactions, the FDIC agrees to take on the lion’s share of losses as it helps buyers of failed institutions assume that institution’s franchise. These attractive deals will not last forever, but for now, they represent an impressive boon to the buyers and spark an M&A reemergence for the industry, unlocking consolidation that has been pent up during the crisis of recent years. We are starting to see competition for these transactions that has already altered their return potential. While they may not be as attractive as earlier deals, we still believe they offer generational type opportunities for the acquirer.

A second likely trend is that companies with strong franchises, but which are weighed down by operational or capital troubles will be forced to align with willing partners in deals priced at or around tangible book value. This is an excellent way for strong banks to grow where FDIC deals are not present.

### **FDIC OPPORTUNITY- Picking the Winners:**

- Due to the prolonged recession, particularly in real estate assets, we estimate 300 to 500 bank failures during the next 18 months. FDIC opportunities will come primarily in areas experiencing the greatest housing market boom/bust cycles and that have banks with business models focused on residential construction and home lending. The winners likely will include banks with excess capital and/or access to the capital markets that have relatively clean balance sheets and the depth of management needed to work out troubled assets.

## **FDIC Opportunity - Deal Pricing**

- In FDIC transactions, the buyer typically gets the seller's deposits for little-to-no deposit premium. By definition, deposits are below market funding, so to pay nothing is a bargain. Some recent deals have seen more competitive pricing, however, and/or extension to the FDIC of upside via equity participation of some form.
- The FDIC typically covers a significant percentage of the seller's loan losses, absolving the buyer of much of the transaction risk.
- The FDIC may exclude entire classes of risky loans or other assets from the purchase – for instance, when New York Bancorp (NYB) acquired Cleveland-based Amtrust from the FDIC last December, NYB was not required to purchase acquisition, development and construction loans. They also had no obligation to purchase any private label securities or mortgage servicing rights.
- In these deals, the legal risks to the buyer are mitigated. For example, the FDIC resolution process eliminates “push-back” risk to the buyer – i.e., the buyer is not obligated to repurchase any loans incorrectly originated or underwritten by the seller.

## **2011 to 2012 – A Seller's Market**

- In 2011 and 2012, we expect credit quality to improve and normal M&A activity to resume, as FDIC-assisted deals subside with a clearing of the most troubled institutions from the banking landscape. These events likely will result in the return of premium prices for acquisitions. As the economy picks up, we expect banks to return to normalized earnings and begin to trust the credit quality of peer banks, thus paving the way for a return to more traditional standalone M&A activity. This will lead to much higher market multiples as the consolidation premium creeps back into valuation. The best way to capitalize from this expected return to normalcy is to identify strong banks franchises now and begin investing for this prospect.

**“A common investor mistake when there is turmoil and depressed equity prices, as is currently the case, is to wait for the all-clear signal and expect to enter at the precise inflection point to the upside.”**

## **MUTUAL-TO-STOCK CONVERSION OPPORTUNITY:**

- We forecast a pick up in mutual-to stock conversions during the next several years. With regulatory change in the air, this should serve as a solid catalyst for bank management teams and their boards of directors to get off the sidelines and join the majority of their peers as stock companies.

**This opportunity has produced outsized returns over the last 20 years and, given the current depressed pricing environment, we project superior returns in this sub-space going forward.**

### **Conversion Mechanics and Pricing**

- Mutual institutions were formed decades ago as depositors pooled money to earn interest and lend back to their communities. They are similar to community banks, but have no owners and are controlled by their Board of Directors. Their retained earnings have grown over the years, but with no stock, growth is limited by retained earnings and regulatory leverage ratios. The Board may take the mutual public in a regulated process requiring an independent appraisal, followed by a sale of stock. Shares typically are sold at discounts to their market values, creating an opportunity for short- and- long-term investors. Depositors receive first rights to buy in the offering. Further substantial value accrues to shareholders as the mutual leverages new capital, executes stock buybacks, becomes more competitive and, in many cases, sells at a significant premium after being fully public for just three years.
- Mutual thrifts are managed for the benefit of depositors but have no formal owners. Mutual holding companies (MHCs) have a minority of their shares trading publicly, with the balance privately held by the MHC, until or when it conducts a second step and sells the remaining shares to the investing public. There are three conversion types:
  - Standard – The thrift starts as a mutual institution with no owners and sells 100% of the company in a conversion IPO.
  - MHC – The thrift starts as a mutual institution with no owners and sells less than 50% of company in a conversion IPO. Management typically retains substantial control of the company, which legally controls the thrift and the majority of shares, which remain private.
  - Second Step – Following an MHC conversion, many thrifts later convert the private portion of the company to publicly traded shares in a second step conversion.

## **Conversion Opportunities for 2010**

- Regulatory change is in the air, and the threat of regulator consolidation could spur some mutual thrifts to convert to stock form, particularly at a time when many of them could use the capital. As a potential catalyst, it is worth noting that management teams and their boards of directors are able to buy significant amounts of stock in the conversion process at steep discounts to tangible book value; the same holds true for the bank's stock-based compensation plans that typically are awarded within a year or so after the conversion.

## **Current Conversion Valuations – Early 1990s Revisited:**

- In years past, conversion stocks would come public and immediately trade to 80% or more of tangible book value. They would then proceed to trade at premiums to tangible book value one year after conversion.
- Today, we see solid companies converting at 50% to 60% of tangible book value with capital in excess of 15% and above-average credit quality. While not all converted banks are equal, the excess capital gives their managers ample cushion to navigate this tough banking environment.
- The current conversion landscape is a buyers market, where buyers can purchase quality franchises near issue price or at slight premiums that create good entry points for long-term value creation. This reality fits well into the traditional consolidation theme of banking, and we would expect many banks in the space to opt to sell during the next window of opportunity.
- The following table illustrates that a high percentage of thrift conversions opt to sell out after becoming fully public. Note that typically, regulations prohibit thrifts from sale for at least three years after becoming fully public.

**"Aging of the Wine"**  
**Thrift Conversions & Takeouts Since 1990**

Year	Total Conversions*	# Acquired	% Acquired	Avg. Life (Yrs.)
1990	27	24	89%	4.4
1991	23	22	96%	3.2
1992	51	45	88%	4.2
1993	73	62	85%	4.2
1994	74	61	82%	3.5
1995	91	63	69%	4.1
1996	76	54	71%	3.8
1997	42	31	74%	4.6
1998	52	40	77%	4.1
1999	19	11	58%	2.7
2000	13	10	77%	3.3
2001	12	6	50%	3.8
2002 <sup>1)</sup>	9	2	22%	2.5
2003 <sup>2)</sup>	12	5	42%	3.3
2004	8	2	25%	3.2
2005	10	3	30%	3.2
2006	6	0	0%	0.0
2007	15	0	0%	0.0
2008	5	0	0%	NA
2009	5	0	0%	NA
2010	4	0	0%	NA
<b>Totals</b>	<b>627</b>	<b>441</b>	<b>70%</b>	<b>3.7</b>

Sources: SNL Financial LC, Stifel Nicolaus Research & FJ Capital Research

\* Includes standard and 2nd-step conversions to full stock ownership; excludes MHCs

1) HRGB, a state-chartered institution, was acquired less than 2 years from its conversion

2) RFBK, a state-chartered institution, was acquired less than 2 years from its conversion

## **FORCES of CHANGE 2010 & BEYOND:**

### **Regulatory Changes – How Will They Affect the Industry?**

- Regulation – Perhaps Banking’s Biggest Unknown: In the wake of “The Great Recession”, hundreds of fingers point and wag on Capitol Hill and inside the Beltway. The blame game is one of the great opportunities in politics, with stakes high and the chance to re-shape the regulatory landscape for financial institutions.
  - Regulator Consolidation. We believe with a high degree of certainty that bank regulators will be consolidated in some form, with the Office of Thrift Supervision (OTS) most likely to become a part of another bank regulator. Needless to say, consolidating one or more bank regulators would significantly impact the banking landscape. We believe the regulatory uncertainty surrounding the OTS will cause a significant number of mutual thrifts to convert to stock form in the near future, before any regulatory consolidation can occur and cloud their future. As the old adage goes, “Better the devil you know, than the devil you don’t.”
  - Capital Levels. One reason for past and future bank failures is the high level of leverage relative to the risk in banks’ loan books. Much discussion is currently ongoing regarding the appropriate level of capital banks should hold. It is probably a safe bet that capital mandates will increase, creating a need for more capital in the banking industry. We expect the “new normal” capital levels to be 100 to 300 basis points higher than the current minimum levels. This also likely will lead to more consolidation, as the companies lacking access to acceptable capital will opt to sell to those with access.
  - Large vs. Small. Discussions about larger, “too big to fail” banks versus smaller, community banks has taken center stage with the current administration. While most of the Federal programs favored the bigger banks initially, the pendulum seems to be shifting to the smaller community banks. We view this change as marginally positive for community banks.
  - Loan Growth and Regulation. The lack of regulation on exotic lending products was largely responsible for the financial meltdown and the failure of some large institutions. We are mindful that regulation may go too far and limit potential growth at the precise time when the economy needs banks to lend the most.
  - Compliance and Regulatory Cost. Clearly, costs are rising to maintain and navigate the existing and proposed regulatory changes. We see this as a catalyst for smaller companies lacking scale, to realize that their

stockholders would be far better served by a merger, with partners that can effectively spread the cost over a greater asset base.

- Change in the Works. While it is tough to predict the exact regulatory change that will be thrown at the banking industry, one thing is certain: change will come. Our general impression is that this change will lead to higher needs of capital and accelerated consolidation.

## **THE BIG PICTURE:**

- Economic View: We remain somewhat bullish on the economy for the balance of the first half of 2010, as government stimulus efforts remain in effect (i.e., low interest rates, home purchase credits, cash-for-clunkers). We see GDP growth in the 2% to 3% range; however, we are concerned the government cannot maintain this accommodative and counter-cyclical pace. Having said that, to invest in community banks, it is vital to understand the local economies in which they operate.
  - Interest Rates: Consequently, while rates could/should remain low through the end of 2010, the government may begin to rein in its efforts to prop up the economy. During this pullback phase, the consumer may fail to step in with natural demand fully offsetting the demand removed by the government, resulting in slower growth toward the end of 2010 and the beginning of 2011. We expect the Fed will begin to raise interest rates in late 2010 or early 2011, although the current, primary risk still seems more toward deflation, in our view.
  - Mortgage Market/Home Prices. The government has propped up home prices by purchasing mortgage-backed securities. This has had the effect of lowering interest rates, allowing consumers to refinance at historically low rates. The government is about to reduce purchases, which will raise interest rates, potentially slowing the housing recovery of the last several quarters. Additional home foreclosures also could slow the recovery by increasing the already elevated housing inventory.
  - Unemployment: Based on current hiring trends, which appear to be on the upswing, we expect modest job creation, thus causing the unemployment rate to stabilize and drift down slightly. On the local level, unemployment and its relative, job growth, are the two most important factors for banks.
- Market View: We are bullish for the balance of the first half of 2010, as government stimulus remains in place and its effects linger in the market. However, our stance is less enthusiastic toward the latter part of the year, as we believe fiscal concerns will force the government to pull back its spending efforts. Further, the Fed is more likely to raise rates as the economy becomes healthier.
- The broader market currently seems reasonably priced at a P/E of 15.0x vs. the long term averages of 13.9x since the late 1800s and 15.2x since 1990. The 15.0x P/E implies an earnings yield of 6.7% on the S&P 500 Index.
- By comparison, the current 10-Year Treasury yield is 3.67%, due to government stimulus and likely other extraordinary demand for Treasuries distorting prices upward and yields downward. This phenomenon should begin to unwind as the government withdraws stimulus. Eventually, rates may rise to the point the 10-

year yield surpasses the earnings yield on the S&P, which could compress stock multiples. We do not, however, see this as a 2010 event.

- Given such a backdrop, we believe the market will trade in a tight range over the next 12 months. As we articulated in this paper, the relative value in banks is compelling, yet picking the right stocks is crucial given the fundamental picture we see over the duration of this credit cycle.

## **CONCLUSION – UNCERTAINTY CREATES OPPORTUNITY:**

We have discussed many major themes in this white paper. We addressed the current challenges facing small- and- mid-cap banks as the credit cycle continues and credit worsens, which leads to higher provisions and lower earnings. Though many banks are troubled, as we have noted in great detail, there are also a large number of banks on solid ground. Again, all banks are NOT equal. In fact, the banks on solid footing have a generational opportunity to take share from the weaker players through either FDIC-assisted transactions that significantly limit credit risk, or more traditional standalone acquisitions. We discussed timing and the need to invest in the space well before fundamentals fully normalize. This strategy can lead to outsized returns for long-term investors.

In the near-term, banks that stand out as unique are most likely to be valued as such. To date, larger banks have gained much of the attention. Going forward, however, the community banks that have or will execute FDIC-assisted transactions will garner greater attention from the investment community. Those best positioned to win the bidding for FDIC transactions typically have excess capital or the ability to raise it quickly and a track record of successfully executing M&A transactions. Bank conversions also could be unique due to their attention-grabbing IPOs and typically discounted offering prices. Many converted banks will use the excess capital raised to acquire banks either in FDIC-assisted transactions or more traditional standalone M&A transactions.

In summary, the balance of 2010 promises to be very active and potentially very lucrative for investors in the community bank space, driven by FDIC transactions and a changing regulatory landscape. For those straddling the fence waiting for the all-clear signal before entering the community bank space, we again note that historically investors have been rewarded for investing before, not after, the dust has completely settled.

## **About FJ Capital Management, LLC**

This paper was written by FJ Capital CEO and Portfolio Manager, Martin Friedman, and FJ Capital Senior Analyst, Scott Cottrell, who have a combined 30 plus years of capital markets experience, much of this time spent following and analyzing small- and mid-capitalization financial institutions. Prior to founding FJ Capital in 2007, Mr. Friedman served nine years as director of research at Friedman, Billings, Ramsey Group, a major financial services firm publicly traded on the New York Stock exchange, where he built the 13th largest US sell side research organization, with 140 professionals encompassing eight industry sectors. Previously, Mr. Friedman was a senior research analyst focused on the financial services industry covering small and mid cap banks and thrifts. Prior to joining FJ Capital, Mr. Cottrell served as a research analyst at FBR covering small and mid cap banks and thrifts.

FJ Capital is a fundamental investment management firm that was formed to take advantage of the turmoil in financial services sector, with a special focus on under-followed small and midcap banks and thrifts. On the long side, we target institutions with solid credit quality and excess capital that can be used to make FDIC-assisted and standalone acquisitions, buyback stock at steep discounts to tangible book values and pay attractive dividends. On the short side, we target firms with weak credit and low capital levels. We believe the current environment provides banks a generational opportunity to significantly increase their assets with limited credit risk.

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