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3-SIGMA VALUE

# Bank Investing in 2015

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According to the FDIC's Quarterly Banking Profile for the Fourth Quarter 2014, FDIC-insured institutions earned $152.7 billion in 2014, down from the $154.7 billion earned in 2013, with the entire shortfall coming in the fourth quarter. This is the first full-year earnings decline in five years.

| All FDIC-Insured Institutions (1) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 |
| Net Interest Margin (NIM) | 3.14% | 3.26% | 3.42% | 3.60% | 3.76% | 3.49% | 3.16% | 3.29% | 3.31% | 3.47% |
| Return on Assets (ROA) | 1.01% | 1.07% | 1.00% | 0.88% | 0.65% | -0.07% | 0.03% | 0.81% | 1.28% | 1.28% |
| Return on Equity (ROE) | 9.03% | 9.56% | 8.91% | 7.79% | 5.85% | -0.72% | 0.35% | 7.75% | 12.30% | 12.43% |
| Leverage | 8.94x | 8.93x | 8.91x | 8.85x | 9.00x | 10.29x | 11.67x | 9.57x | 9.61x | 9.71x |
| | | | | | | | | | | |
| # of Institutions Reporting | 6,509 | 6,812 | 7,083 | 7,357 | 7,658 | 8,012 | 8,305 | 8,534 | 8,680 | 8,833 |
| # of Problem Institutions | 291 | 467 | 651 | 813 | 884 | 702 | 252 | 76 | 50 | 52 |
| | *-37.7%* | *-28.3%* | *-19.9%* | *-8.0%* | | | | | | |
| Assets of Problem Institutions (in billions) | $87 | $153 | $233 | $319 | $390 | $403 | $159 | $22 | $8 | $7 |
| Nonperforming Assets as a % of Total Assets (2) | 1.20% | 1.63% | 2.20% | 2.60% | 3.11% | 3.37% | 1.91% | 0.95% | 0.54% | 0.50% |
| | | | | | | | | | | |
| # of Failed Institutions | 18 | 24 | 51 | 92 | 157 | 140 | 25 | 3 | 0 | 0 |
| | *-25.0%* | *-52.9%* | *-44.6%* | *-41.4%* | | | | | | |

(1) Data is taken from the FDIC's Fourth Quarter 2014 Banking Profile.
(2) Includes Other Real Estate Owned (OREO).

In 2014, there was divergence in individual bank stock performance due to several factors including the fall in the price of oil which impacts certain geographies disproportionately (e.g. Texas). Loan growth dispersion is wide and skewed with industry-wide loan growth of 1.8%. Some banks, such as portfolio-holding **Customers Bank (CUBI)**, are growing their loan portfolios at 20-plus percent while most banks are barely replacing the loans that are rolling off their balance sheets into a much lower yielding product. With the cost of capital zero-bound, it is asset yield that determines NIM (net interest margin), and as you can see in the chart above, NIM dropped from 3.26% in 2013 to 3.14% in 2014, the lowest level since 2008.

With loan growth offset by NIM compression, average return on assets (ROA) fell to 0.96% from 1.09% in 2013. While this is the first time in two years that average quarterly ROA has fallen below 1.00%, anything above 0.90% is supportive of valuations. As discussed later in this report, a bank that earns 0.90% (the minimum level) is worth at least 1.8x tangible book value (TBV) based on historical M&A data (using data from SNL going back to 1990).

2015 may be marked as the year the Federal Reserve raises its target for short-term interest rates off its floor of 0.00%-0.25%. If this is an inflexion point in monetary policy and the beginning of a sustained process of normalizing rates, rather than a token event, then bank margins will expand, although not equally. However, if the Fed raises rates but once then pauses, then 2015 will follow in the footsteps of 2014 – NIM will remain under pressure, offset in part by pockets of loan growth led by commercial and industrial (C&I) loans, which increased by $42.2 billion (2.5%) last year, and credit cards, which increased by $35.4 billion (5.2%). In an environment of offsetting forces, a diversified beta strategy (e.g. ETFs, index funds) will generate flattish investment performance while a more concentrated alpha strategy offers the opportunity to generate significant outperformance.

## Alpha vs. Beta Investing

Last year I came across an interesting company called **StoneCastle Financial Corp (BANX)**. BANX is a closed-end regulated investment company (RIC) founded in February 2013 to make investments in community banks across the United States. BANX is managed by StoneCastle Asset Management LLC, an SEC-registered investment advisor dedicated to the community banking sector. BANX went public on November 6, 2013 at $25.00 per share, raising ~$115 million of gross proceeds[1]. The portfolio is mainly invested in preferred stock (85.6% of the fair value of the portfolio as of 9/30/14), but also in debt (21.8%), trust preferred (15.6%), and equity (3.6%) securities. The total amount of investments in the BANX portfolio equals 126.6% of net asset value (NAV), meaning there is a little leverage[2].

When I look at the schedule of investments in the BANX portfolio I am struck by the negative asymmetry of risk versus reward – a dangerous and potentially fatal flaw. The upside is capped (sans leverage), with an asset yield that compresses with each roll-over. The original portfolio of preferred stock yields 9.0%, while the more recently invested trust preferred securities, issued by money center banks including Deutsche Bank, JP Morgan, Merrill Lynch, and Morgan Stanley, yield between 6.45% and 8.05%. Assuming a constant cost of funds of 3.0%, net interest margin (NIM) will decline from its current 6% level to somewhere between 3.5% and 5.0%. Without the use of more than 33% leverage, gross return on equity (ROE) will drop to the mid-single digits. While a 6% or 7% barely-levered return is not too shabby in a yield-starved, zero-bound

[1] Includes a partial exercise of the over-allotment equal to an additional 202,000 shares for $5.050 million.

[2] RICs must comply with a statutory limit of debt-to-assets equal to 33.3%.

interest rate world, the marked-to-market risk associated with a stock market-based investment overwhelms its potential return (return = yield). In other words, BANX is a beta investment in banks – an investment that will work in a bull market and fail in a bear.

BANX illustrates the important distinction between **alpha** and **beta** investing. Our investment process at 3-Sigma Value builds on itself every year, such that cumulative learning increases our conviction. We are better bank investors now than ever before. Generating alpha is about finding divergence, and nowhere in the market is there more divergence than in the valuation of banks.

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 equity (ROE) 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/BV and ROE 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 launching 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 equity (ROE), 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 13.8x/13.9x, 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 2014. We apply P/E multiples as a sanity check to the primary analysis based on the relationship between ROE and P/TBV, and adjust accordingly if the results are statistically disparate.

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

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, what we find in 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. Valuations are all over the place. Herein lies the opportunity. Herein lies the alpha.

Building on our analysis in *Bank Investing in 2014*, 3-Sigma Value seeks the following 4 key characteristics in a bank investment:

1. Return on assets (ROA) in excess of 0.90% in 2015 – a bank that earns 0.90% (the minimum level) is worth at least 1.8x tangible book value (TBV) based on historical M&A data (using data from SNL going back to 1990).

2. Franchises that are tightly managed, as reflected in a below-average efficiency ratio[4].

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 1 to 3 years.

**<u>Results</u>**

We identify 5 publicly-traded banks that meet all of our requirements[5]. Each of these banks is an active participant in the consolidation of the U.S. banking industry, either as a ripe consolidation opportunity or as an efficient consolidator. Each of these banks is worth ~twice as much as its current market valuation. This is 3-Sigma Value's 2015 bank portfolio:

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[4] 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.

[5] **First Bank (FRBA)**, based in Hamilton New Jersey, is a deeply undervalued bank with >100% total return to 3-Sigma Value's estimation of fair value, and was featured in 3-Sigma Value's *Bank Investing in 2014*. However, we have since determined that its small size ($57 million market cap) and shallow liquidity (~11k shares traded daily limits allocation) render it too small to make a meaningful contribution to the 3-Sigma Value portfolio.

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**Bank Investing in 2015 - The Portfolio**

| | 12/31/2014 Stock Price | Shares Out | Mkt Cap | 4Q14 Assets | 4Q14 TBV | Mkt Cap / Assets | TCE Ratio | P/TBV | 2014 ROA | 2015E ROA | 2015E ROTCE | 12/31/17 TBV | Take-out Multiple | Target | Plus: 3 yrs Dividend | Equals: Total Return |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fidelity Southern (LION) d.b.a. Fidelity Bank - GA** | 16.11 | 23.5 | 379 | 3,085 | 12.22 | 12.3% | 9.3% | 1.32x | 1.12% | 1.00% | 10.74% | 16.60 | 1.87x | 31.11 | 7.8% | 100.9% |
| **Pulaski Bank (PULB) - St. Louis MO** | 12.33 | 12.1 | 149 | 1,426 | 8.98 | 10.5% | 7.6% | 1.37x | 0.89% | 0.90% | 11.81% | 12.55 | 1.98x | 24.87 | 10.7% | 112.4% |
| **Baylake Bank (BYLK) - Sturgeon Bay WI** | 12.49 | 9.6 | 120 | 1,022 | 10.85 | 11.7% | 10.2% | 1.15x | 0.91% | 0.96% | 9.42% | 14.21 | 1.74x | 24.76 | 9.6% | 107.8% |
| **Northrim Bank (NRIM) - Anchorage AK** | 26.24 | 6.9 | 181 | 1,449 | 20.48 | 12.5% | 9.8% | 1.28x | 1.34% | 1.00% | 10.25% | 27.45 | 1.83x | 50.10 | 9.1% | 100.1% |
| **Customers Bank (CUBI) - PA** | 19.46 | 26.6 | 518 | 6,532 | 16.44 | 7.9% | 6.7% | 1.18x | 0.74% | 0.80% | 11.95% | 23.41 | 1.57x | 36.68 | 0.0% | 88.5% |
| Average | | | | | | 11.0% | 8.7% | | 1.00% | 0.93% | 10.84% | | 1.80x | | 7.46% | 101.9% |

## Bank #1: Fidelity Southern (LION) d.b.a. Fidelity Bank

Fidelity Bank, founded in 1974, is one of the largest community banks in metro Atlanta Georgia with 32 offices, plus one in Jacksonville Florida. With \$3.1 billion assets and \$2.5 billion deposits, LION ranks #7 in deposit market share in the Atlanta MSA and 9th in the state of Georgia. In September 2014, LION closed the acquisition of six branches from CenterState Bank of Florida (CSFL), expanding the bank's presence in Jacksonville and Orlando.

Atlanta is a prosperous MSA with a resumption of 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 giant Too-Big-To-Fail 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.

**Bank Investing in 2015 - The Southeast with a Focus on Atlanta Georgia**

| | 12/31/2014 Stock Price | Shares Out | Mkt Cap | 4Q14 Assets | 4Q14 TBV | Mkt Cap / Assets | TCE Ratio | P/TBV | 2014 ROA | 2015E ROA | 2015E ROTCE | 12/31/17 TBV | Take-out Multiple | Target | Plus: 3 yrs Dividend | Equals: Total Return |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BB&T (BBT) - Winston Salem NC | 38.89 | 728.4 | 28,326.4 | 186,814 | 19.93 | 15.2% | 7.8% | 1.95x | 1.19% | 1.20% | 15.44% | 30.66 | 2.34x | 71.88 | 7.4% | 92.2% |
| SunTrust Banks (STI) - Atlanta GA | 41.90 | 528.0 | 22,121.5 | 190,328 | 29.82 | 11.6% | 8.3% | 1.41x | 0.83% | 0.88% | 10.64% | 40.39 | 1.86x | 75.27 | 5.7% | 85.4% |
| Regions Financial (RF) - Birmingham AL | 10.56 | 1,377.0 | 14,541.1 | 119,679 | 8.26 | 12.2% | 9.5% | 1.28x | 0.96% | 0.95% | 10.00% | 10.99 | 1.80x | 19.78 | 5.8% | 93.1% |
| Synovus Bank (SNV) - Columbus GA | 27.09 | 137.8 | 3,733.8 | 26,202 | 21.42 | 14.3% | 11.3% | 1.26x | 0.82% | 0.80% | 7.10% | 26.31 | 1.51x | 39.73 | 4.4% | 51.1% |
| United Community Banks (UCBI) - Blairsville GA | 18.94 | 60.3 | 1,141.3 | 7,567 | 12.15 | 15.1% | 9.7% | 1.56x | 0.91% | 0.99% | 10.23% | 16.27 | 1.82x | 29.67 | 3.2% | 59.8% |
| Ameris Bank (ABCB) - Moultrie GA | 25.64 | 26.8 | 686.5 | 4,038 | 10.99 | 17.0% | 7.3% | 2.33x | 1.08% | 1.05% | 14.41% | 16.46 | 2.24x | 36.88 | 2.3% | 46.2% |
| State Bank & Trust (STBZ) - Atlanta GA | 19.98 | 33.9 | 678.0 | 2,882 | 13.97 | 23.5% | 16.4% | 1.43x | 1.16% | 1.10% | 6.69% | 16.96 | 1.47x | 24.92 | 3.8% | 28.5% |
| Fidelity Southern (LION) d.b.a. Fidelity Bank - GA | 16.11 | 23.5 | 378.6 | 3,085 | 12.22 | 12.3% | 9.3% | 1.32x | 1.12% | 1.00% | 10.74% | 16.60 | 1.87x | 31.11 | 7.8% | 100.9% |
| Deposits concentrated in Atlanta, expanding into North Florida. 1% ROA / 10%+ROE is sustainable. Take-out target. | | | | | | | | | | | | | | | | |
| Average | | | | | | 15.1% | 9.9% | | 1.01% | 1.00% | 10.66% | | 1.87x | | 5.1% | 69.6% |

The second largest bank based in Georgia is **Synovus Bank (SNV)** with headquarters in Columbus Georgia. Synovus barely survived 2008 and remains an under-performer. **United Community Banks (UCBI)** and **Ameris Bank (ABCB)** are the #7 and #8 banks, respectively. They are both active consolidators in the state.

Which leads us to #9, **Fidelity Bank (LION),** the highest performing under-valued bank in the all-important Atlanta market. LION is a bite-sized $3 billion in assets, giving it enough scale to drive efficiency while rendering it an ideal acquisition target for any consolidator or regional bank. 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 no condos, $7 million of multi-family, and only one strip mall. Non-performing loans are only $36.8 million, out of a total loan portfolio of $2.3 billion, representing a minor 1.7% of total loans[6]. 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-interest income. In 2014, net interest income totaled $90.4 million while non-interest income was $95.3 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 ($5.5 billion total). Add these three sources of income together and total mortgage revenue as a % of mortgage production averages around 3.0%. For example, in Q4 2014, LION earned $15.5 million on mortgage production of $515.7 million. This 3% rate varies quarterly due to volatility in the gain on sales. In 2015, management is guiding to ~$2.5 billion of mortgage production.

2. SBA – LION's Small Business Administration business will generate $125 to $150 million of loans in 2015 according to Bank President Palmer Proctor, while servicing a total of ~$7 billion of loans. 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.

[6] Net of $25.5 million of ALLL (allowance for loan and lease losses).

3. Autos – LION is a leading auto lender in metro Atlanta, generating $150 to $200 million per month in "car paper" that is short in duration (< 2 years) and high in credit quality. The average FICO score is 755 and the delinquency rate is a mere 30 basis points. 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 – Ramped up last year, the wealth management group is not yet a significant contributor to non-interest income.

With a solid organic loan origination program and a diverse set of sources of fee income, 1% ROA / 10%+ ROTCE appear sustainable. What is this worth?

In December 2014, **IBERIABANK (IBKC)** announced the acquisition of $1 billion asset Georgia-Commerce Bancshares, headquartered in Atlanta GA, for $189 million stock, equal to 2.02x TBV. Also in December 2014, **Renesant Bank (RNST)** announced the acquisition of $1.8 billion Heritage Financial Group d.b.a Heritage Bank of the South (HBOS), headquartered in Albany Georgia, for $258 million, equal to 1.69x TBV and 14.6x consensus 2015 EPS. Albany is in the southwestern part of the state, which is not Atlanta, accounting for part of the valuation discount (1.7x vs. 2.0x). The other factor is profitability. HBOS is a recent roll-up of banks that generated an underwhelming 6% ROTCE in 2014 compared to 12% for LION. At a regression-based 1.87x[7] tangible book value (TBV) based on estimated 12/31/17 TBV, **Fidelity Bank (LION) is worth $31.11 per share, representing 100.9% total return including 3 years of dividends**.

**Bank #2: Pulaski Bank (PULB)**

Across the Midwest, we found two banks that meet our requirements for inclusion in the 2015 portfolio. The first, headquartered in St. Louis Missouri, is **Pulaski Bank (PULB),** operator of 13 full-service branch offices in the St. Louis MSA. Founded in 1922, the Pulaski brand is very well-known in the region with long-standing relationships, and the franchise value supports a premium valuation despite a discount in the market. The bank is well-managed, delivering a 65% efficiency ratio in 2014, and consistently generating a ROA in excess of 0.90% (goal is 1.00%) and ROTCE in excess of 10%.

[7] Using historical M&A data going back to 1990 and the correlation between ROA and P/TBV.

Of the 5 banks in 3-Sigma Value's 2015 portfolio, Pulaski Bank is the most-likely take-out candidate. It has a relatively-new management team, hired around the bursting of the credit bubble to repair a balance sheet that had been stretched by the 3rd generation scion of the bank's founder. Led by CEO Gary Douglas who joined in 2008, this is a professional management team who acknowledge being as much a seller as a buyer.

The St. Louis economy is "not dynamic", according to Jim Sullivan, EVP of Corporate Planning and Analysis. 5-6% loan growth is all that can be expected in a "sub-2%" economy. Out of a \$1.2 billion total loan portfolio as of 12/31/14, ~\$500 million is residential and \$700 commercial, 2/3 of which is CRE (commercial real estate) and 1/3 C&I (commercial and industrial). Much like Fidelity Bank (LION) in Atlanta, Pulaski Bank (PULB) is a hybrid commercial-consumer bank; however in this case, it is one focused almost exclusively on the St. Louis MSA[8].

Management believes a large part of Pulaski's valuation discount is due to its low liquidity, and I tend to agree. What offsets this (in part) is the higher likelihood of a take-out. There are numerous suitors for Pulaski, including many that can be found on the list of the top banks in Missouri.

**Top Banks in Missouri - by 2014 Deposit Market Share**

| Institution - Headquarters | # of Branches | Deposits | Market Share |
|---|---|---|---|
| US Bancorp (USB) - Minneapolis MN | 235 | 18,191 | 13.6% |
| Commerce Bank (CBSH) - Kansas City MO | 117 | 13,557 | 10.2% |
| Bank of America (BAC) - Charlotte NC | 82 | 13,159 | 9.9% |
| UMB Financial (UMBF) - Kansas City MO | 58 | 9,045 | 6.8% |
| Central Bancompany (CBCY) - Jefferson City MO | 123 | 7,249 | 5.4% |
| PNC Financial Services (PNC) - Pittsburgh PA | 43 | 2,634 | 2.0% |
| Regions Financial (RF) - Birmingham AL | 66 | 2,074 | 1.6% |
| Great Southern Bancorp (GSBC) - Springfield MO | 64 | 2,021 | 1.5% |
| Enterprise Financial Services (EFSC) d.b.a. Enterprise Bank & Trust - St. Louis MO | 8 | 1,870 | 1.4% |
| National Bank Holdings (NBHC)* - Greenwood Village CO | 33 | 1,852 | 1.4% |
| Other | 1,525 | 61,667 | 46.3% |
| Total All Institutions In Missouri | 2,354 | 133,320 | 100.0% |

* d.b.a. Bank MidWest, Community Banks of Colorado, and Hillcrest Bank.
Other banks with substantial deposit market share in the St,Louis MSA include First Bank (private, Creve Coeur MO), Fifth Third Bank (FITB), Banc Ed Corp (private, Edwardsville IL), and Bank of Montreal (BMO).

[8] The mortgage business extends outside of St. Louis / Kansas City to contiguous areas to Omaha and West Iowa, through Missouri to Central Kansas, with de novo operations in Denver and the Chicago suburbs. There is no plan to expand commercial banking operations outside the St. Louis MSA.

At the top of the list is **U.S. Bancorp (USB)** – who, based in Minneapolis MN with #1 deposit market share in the state of Missouri, trades at a high flying valuation of 2.8x 2014 TBV of $15.96 and loves to use its currency to make accretive transactions.

**Commerce Bank (CBSH)** at 1.92x TBV and **UMB Financial (UMBF)** at 1.86x are the largest banks with headquarters in Missouri ($24.0 billion and $17.5 billion of assets respectively). Both are consolidators based in Kansas City, either one a bidder for Polaski. Most recently, in December 2014, UMB announced the $182 million acquisition of $1.3 billion asset Marquette Financial (private), owned by the Pohlad family[9], equal to 1.57x TBV. Marquette is a holding company for two banks – Meridian Bank based in Phoenix AZ, and Meridian Bank Texas based in Ft. Worth, calling into question the focus of the UMB management team. Whatever the motivation for the Marquette transaction – management expects it to be immediately accretive to tangible book value (TBV) and after cost savings accretive to EPS in 2016 – it illustrates the added risk to investing in a consolidator with an expensive currency (i.e. highly-valued stock) – a tendency towards uneconomical deals in the name of growth and economies of scale. At 1.9x TBV, neither Commerce Bank nor UBM are attractive investment opportunities.

**Central Bancompany (CBCY)** – headquartered in Jefferson City Missouri – is the third largest banking company based in Missouri, although it is actually a "family of 13 affiliate banks", each maintaining their own charters and local management teams. Obviously this structure eliminates economies of scale and is inefficient. Moreover, the stock is un-investable due to low trading liquidity.

**PNC Bank (PNC)** and **Regions Financial (RF)** are regional consolidators that are #6 and #7 respectively in terms of Missouri deposit market share. At 1.6x TBV, PNC is fairly-priced, especially given its huge size; assets = $345 billion. Regions, on the other hand, is 1.3x TBV, and at $14.5 billion in assets is able to grow at a much faster rate than PNC. Both PNC and Regions are well-managed, with mid-to-low 60% efficiency ratios and ~1% ROAs, however, it is the combination of growth and profitability offered by Regions that warrants it a higher valuation multiple. As mentioned in the previous discussion of the metro Atlanta banking market, Regions is based in Birmingham Alabama and a consolidator through the south. At a regression-based 1.80x[10] tangible book value (TBV) based on estimated 12/31/17 TBV, RF is worth $19.78 per

[9] Carl Pohlad was a financier and owner of the Minnesota Twins baseball franchise before passing away in 2009. Carl's son Jim inherited ownership of the franchise.

[10] Using historical M&A data going back to 1990 and the correlation between ROA and P/TBV.

share, representing 93.1% total return including 3 years of dividends. Even though Regions is not in the 2015 portfolio, it is a bank on our watch list.

**Great Southern Bank (GSBC)** – based in Springfield Missouri – is #8 in Missouri with $4.0 billion of assets spread across 108 retail banking centers in Missouri and its neighboring states of Iowa, Minnesota, Nebraska, Kansas, and Arkansas. GSBC has done an admirable job of consolidating five FDIC-assisted acquisitions along with two branch office acquisitions, generating an impressive 66% efficiency ratio and 1%+ ROA. As the acquired loans roll-over it will be critical, however, to not only replace but also grow the loan portfolio in order to earn a full valuation. Moreover, new loans will never be as profitable as loans acquired below their worth – an accounting convention called *bargain purchase gain* that adds accretable yield to the nominal yield of an acquired loan portfolio. With rapidly shrinking net interest margin (NIM) due to rapidly shrinking accretable yield, GSBC trades at a relatively low 1.3x TBV. GSBC is a higher risk medium reward bank that does not meet 3-Sigma Value's requirements for risk versus reward.

**Enterprise Bank & Trust (EFSC)** – based in St. Louis Missouri – is #9 with $3.3 billion of assets across three markets: St. Louis ($1.7 billion of loans at 12/31/14), Kansas City ($583 million), and Phoenix Arizona ($139 million). With a core ROA ~0.80%, which is lower than the 0.90% minimum we require for consideration of inclusion in the 2015 portfolio, EFSC is roughly fairly valued at 1.4x TBV.

**National Bank Holdings (NBHC)** is a holding company for three banks acquired via FDIC-assisted acquisitions[11] with total assets of $4.8 billion: Bank Midwest (Missouri and Kansas), Community Banks of Colorado (self-explanatory), and Hillcrest Bank (2 banking centers, one in Austin Texas and the other in Dallas Texas). Efficiency ratio is bloated at 86% and ROA sub-standard at 0.26% in 2014, although projected to improve going forward. At 1.0x TBV, there appears little risk to the downside, however, with an inherently inefficient structure dampening potential returns there appears little return to the upside, rendering NBHC an unattractive investment opportunity.

Which leads us back to **Pulaski Bank (PULB)**. Not yet cracking the Top 10 in Missouri market share and unlikely to ever do so, Pulaski is more target than acquirer. The best, most recent comparable M&A transaction is **BB&T's (BBT)** September 2014 announced acquisition of The Bank of Kentucky (BKYF) for $363 million, equal to 2.14x TBV. On $1.9 billion of assets,

[11] Four acquisitions have been made, three of which were FDIC-assisted.

Bank of Kentucky is expected to earn a 1.0% ROA and 11% ROTCE in 2015. At a regression-based 1.98x[12] tangible book value (TBV) based on estimated 12/31/17 TBV, **Pulaski Bank (PULB) is worth $24.87 per share, representing 112.4% total return including 3 years of dividends**.

**Bank #3: Baylake Bank (BYLK),** headquartered in Sturgeon Bay Wisconsin, is the second of two midwest banks in the 2015 portfolio. Founded in 1876, Baylake Bank operates 21 full-service financial centers in Northeast Wisconsin with core strength in and around the Green Bay market. Like Pulaski, Baylake is a solid brand name in an industrial region. Corporate relationships go back decades and the bank generates a consistent 0.9%+ ROA (short-term target = 1.0%; long-term target = 1.1%).

In 2006, Robert "Bob" Cera, CEO of the former $1.7 billion asset State Financial Bank, sold the bank he had built over years to Associated Bank (ASBC) for 2.36x TBV. By the time Bob Cera joined Baylake Bank later that year, the music was playing and the bankers were dancing[13]. Baylake had been family run for generations and its loan portfolio was littered with construction loans and non-owner & occupied (O&O) CRE, hallmarks of the credit bubble.

At the end of 2014, non-performing assets (loans + OREO) had steadily declined to below $20 million, representing 2% of assets. This is a prime example of a well-restructured bank. When Baylake was run by its founding family it was known for its "client relations". Now it is known for its tight expense management. Efficiency ratio of 67% in 2014 is targeted to drop to 65% near-term with a longer-term goal in the "low 60s".

Wisconsin is a fragmented banking market with 245 community banks and a few large regional players led by Associated Bank (ASBC) with #1 market share in the Green Bay MSA.

[12] Using historical M&A data going back to 1990 and the correlation between ROA and P/TBV.

[13] In 2007, Chuck Price, CEO of Citigroup, famously said about Citigroup's commitment to finance leveraged buy-out deals in spite of the bursting of the credit bubble: "As long as the music is playing, you've got to get up and dance."

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| Top Banks in Wisconsin - by 2014 Deposit Market Share | | | |
|---|---|---|---|
| Institution - Headquarters | # of Branches | Deposits | Market Share |
| US Bancorp (USB) - Minneapolis MN | 130 | 29,386 | 21.7% |
| Bank of Montreal (BMO) - in 2010, acquired Marshall & Isley based in Milwaukee, WI | 230 | 18,561 | 13.7% |
| Associated Banc-Corp (ASBC) - Green Bay, WI | 169 | 12,224 | 9.0% |
| JP Morgan Chase (JPM) - NY | 75 | 8,473 | 6.3% |
| Wells Fargo (WFC) - CA | 57 | 4,368 | 3.2% |
| Johnson Financial Group, d.b.a Johnson Bank (private) - Racine WI | 47 | 3,014 | 2.2% |
| Anchor BanCorp Wisonsin (ABCW) - Madison WI - 10/14 IPO @ $26 | 53 | 1,864 | 1.4% |
| Bank Mutual Corp (BKMU) - Milwaukee WI | 76 | 1,744 | 1.3% |
| North Shore Bank (private) - Milwaukee WI | 46 | 1,402 | 1.0% |
| Wintrust Financial Corp - IL | 24 | 1,364 | 1.0% |
| Other | 1,287 | 52,959 | 39.1% |
| Total All Institutions In Missouri | 2,194 | 135,357 | 100.0% |
| | | | |
| Green Bay MSA only | # of Branches | Deposits | Market Share |
| Associated Banc-Corp (ASBC) - Green Bay, WI | 15 | 1,805 | 28.4% |
| Bank of Montreal (BMO) - in 2010, acquired Marshall & Isley based in Milwaukee, WI | 13 | 927 | 14.6% |
| Nicolet Bankshares (NCBS) d.b.a. Nicolet National Bank - Green Bay, WI | 6 | 514 | 8.1% |
| Wells Fargo (WFC) - CA | 7 | 473 | 7.4% |
| JP Morgan Chase (JPM) - NY | 6 | 323 | 5.1% |
| **Baylake Bank (BYLK) - Sturgeon Bay, WI** | **11** | 288 | **4.5%** |
| FirstMerit (FMER) - OH | 10 | 281 | 4.4% |
| Denmark Bancshares (private) d.b.a. Denmark State Bank - WI | 2 | 267 | 4.2% |
| Bank Mutual Corp (BKMU) - Milwaukee WI | 8 | 248 | 3.9% |
| Luxemburg Bancshares (private) d.b.a. Bank of Luxemburg - WI | 7 | 215 | 3.4% |
| Other | 30 | 1,023 | 16.1% |
| Total All Institutions In Green Bay | 115 | 6,363.3 | 100.0% |

Wisconsin's economy is manufacturing-based, built upon the backs of metal fabricators, auto part producers, truck companies, defense contractors, shipbuilders and paper/tissue manufacturers. CEO Bob Cera says that his goal is to increase assets from the current $1 billion to $1.5 to $2.0 billion, a level at which the bank can drive economies of scale and its efficiency ratio down to the low 60s.

With projected loan growth in the "mid-single digits", according to CEO Bob Cera, the only way he can achieve his goal of $1.5+ billion in assets is via M&A. Baylake is well-capitalized at 10.2% TCE ratio, a level at which there is substantial capacity for M&A. Unfortunately, with a low valuation of 1.15x P/TBV, many prospective acquisitions would be dilutive.

Ultimately, Baylake Bank will be sold. CEO Bob Cera is following the same playbook that led to his sale of State Financial to Associated for 2.36x TBV. However, for an investment in Baylake to be successful it doesn't take such a lofty valuation (Upside case). At a regression-based 1.74x[14] tangible book value (TBV) based on estimated 12/31/17 TBV, **Baylake Bank (PULB) is worth $24.76 per share, representing 107.8% total return including 3 years of dividends**

[14] Using historical M&A data going back to 1990 and the correlation between ROA and P/TBV.

One final note about Baylake Bank – it owns a 49.6% stake in data processor "United Financial Services" (UFS)[15]. UFS licenses Fiserve technology to other banks who outsource their processing business. In effect, UFS is a customer and competitor of Fiserve (FISV). UFS processes for 42 other banks in Wisconsin, and 13 in adjacent states where the business was acquired via acquisition. The reason UFS wins against Fiserve direct is better and personalized customer service. UFS generated $1.4 million of after-tax contribution to Baylake. This asset is hidden inside, a gem just like the bank itself.

**Bank #4: Northrim Bank (NRIM)**

The fourth bank that meets our criteria for inclusion in the 2015 portfolio is found in the northwest corner of the country. Founded in 1990 and headquartered in Anchorage Alaska, Northrim Bank (NRIM) is the second largest bank based in Alaska behind First National Bank Alaska[16]. Northrim's stock price was crushed at the end of the year in connection with the price of oil despite minimal direct oil exposure. Only 8% of NRIM's $925 million loan portfolio[17] is loans to companies that support and service oil companies, and none to exploration and production (E&P) companies.

Alaska is an island economy that in general is less correlated to oil then popularly perceived. One-third of the economy is derived from the U.S. government (transportation, defense, preservation, etc.), and one-third from oil[18], however oil only employs 10% of the Alaskan workforce – jobs that are high-paying. The final third consists of everything else including fishing, mining, and tourism. What is critical to understand about the oil industry in Alaska is that production is not based on shale basins / fracking with high upfront costs and accelerated decline rates but on conventional oil wells with lower cash costs. Furthermore, Alaska's oil country (the North Slope[19]) is not a frontier for wildcatters but government owned and leased to the major oil companies led by the "Big 3" of BP Shell (BP), Exxon Mobile (XOM), and Conoco Phillips (COP). As a result, even if the price of oil were to remain in a sub-$50 per bbl or lower range, oil production in Alaska will not be shut in.

[15] Bank First owns 49.6%.

[16] Wells Fargo (WFC) is number one in Alaska with 50% deposit market share and $6 billion of assets.

[17] At 12/31/14.

[18] Specifically oil, and not oil <u>and</u> gas.

[19] The largest oil field in North America is Prudhoe Bay on Alaska's North Slope.

Northrim Bank's management team led by CEO Joe Beedle (a charter employee of the bank) targets 5% loan growth in a flattish Alaskan economy, and a minimum 1% ROA. Northrim is a business bank with only 7% of its loans to consumers. The majority of the loan portfolio is CRE (50%) and C&I (33%), geographically concentrated in greater south-central Alaska centered around Anchorage where the bank is headquartered. While 92% of the loan portfolio is in Alaska and 8% elsewhere in the U.S., there is no strategy to expand outside of Alaska. According to Joe Beedle, NRIM has two goals: (1) to generate double-digit total returns (including dividends) and (2) to become a $3 billion asset bank, at which level the bank can improve its margins via economies of scale. In the meantime, **we believe fair value for NRIM is $50.10 per share, 100.1% above its year-end price of $26.24.**

**Bank #5: Customers Bank (CUBI)**

Introduced in 3-Sigma Value's *Bank Investing in 2013*, Customer's Bank (CUBI) is a tightly-managed operation generating double-digit earnings growth and accretion in book value. For background on CUBI, including the all-important fact that the bank was founded by CEO Jay Sidhu, former CEO of Sovereign Bank, please read the 2013 report.

Since then, Jay has delivered (albeit a year late) on expectation of $2.00 per share in annual EPS. Going forward, the path to $2.50 appears straight. The question is what is this stream of earnings worth? Conventional wisdom teaches a direct relationship between Price-to-EPS (P/E) and earnings per share (EPS) growth. Often this relationship is reflected in a PEG ratio, which is equal to P/E divided by the EPS growth rate. A PEG >1 signifies potential over-valuation while a PEG < 1.0 signifies potential value. However, this basic relationship is lacking in substance and ultimately fundamentally-flawed. The missing ingredient is the return on equity (ROE), which in conjunction with PEG may or may not signify value. For example, two companies are growing EPS at the same rate (e.g. 20%); however one of the companies is a huge bureaucracy with a return on equity in the mid-single digits. The other is an efficient operation with higher margins and ROE in excess of 10%. Clearly, the company with EPS growth <u>and</u> high ROE is worth more than a company with the same EPS growth but lower ROE. Customers Bank earns a 12+% ROTCE yet trades at a mere 1.18x TBV, a level significantly below its peer group. CUBI should trade at a premium (or at least in line), not at a discount, given its superior ROE driven by superior cost management (54.9% efficiency ratio in 4Q 2014). CUBI is one of the most profitable banks in the U.S. and has minimal credit risk.

## CUBI Valuation Summary

| | Upside | Base | Downside |
|---|---|---|---|
| 2017E Tangible Book Value per share | $24.00 | $23.41 | $22.83 |
| Multiple of 2017 TBV | 1.88x | 1.57x | 1.25x |
| Target Price | $45.21 | $36.68 | $28.53 |
| % Upside (Downside)* | 132.3% | 88.5% | 46.6% |
| | | | |
| 2017E EPS | $2.57 | $2.53 | $2.49 |
| Multiple of 2017 EPS | 18.84x | 15.67x | 12.50x |
| Target Price | $48.49 | $39.66 | $31.12 |
| % Upside (Downside)* | 149.2% | 103.8% | 59.9% |
| | | | |
| Average of TBV & EPS-based Valuations | $46.85 | $38.17 | $29.82 |
| % Upside (Downside)* | 140.7% | 96.2% | 53.3% |

* Price at 12/31/14 = $19.46

One final note about Customers Bank – Jay hired a team to build a proprietary mobile banking platform, called "Bank Mobile". The strategy is based on attracting millennials via affinity relationships including both non-profit and profit generating organizations. Examples include USAA & Veterans, Bancorp Bank and T-Mobile, and a plan to target alumni associations, foundations, charities, advocacy groups, and religious groups. Bank Mobile is a solid product but not unique. There is a company called Q2 Holdings (QTWO) that went public in March 2014 @ $13 per share. QTWO sells online and mobile banking platforms to community banks, competing mainly against the large core processor platform providers: Fiserv, Jack Henry, and FIS. EBITDA is negative and the margin structure is weak. Gross margin is a lousy 40%, exposing the lack of IP. While it is true banks are buyers and outsourcers of technology, not builders, and therefore QTWO's and CUBI's mobile banking platforms makes sense, the problem is two-fold; first, the large and profitable banks are served by the core processors, and second, the small, less-profitable community banks are limited in the amount they can spend. Therefore, prices for technology will be driven down as high end platforms are stripped down to service the community banks that can afford it.

Regardless of the outlook for Q2 Holdings (QTWO), Customer Bank's Bank Mobile platform is a hidden asset. Nothing from the core processors is cutting edge; these companies are not technology companies. This opens a huge opportunity for innovators to take share. Foot traffic count in Wisconsin is down 35% over the past five years yet the banking business grows. The migration online is now and banks such as Consumers Bank (CUBI) and Baylake Bank (BYLK) are at the vanguard.

**Final Thoughts**

At the start of this analysis, we established a framework for investing in banks, a framework governed by 4 key characteristics:

1. Return on assets (ROA) in excess of 0.90% in 2015 – a bank that earns 0.90% (the minimum level) is worth at least 1.8x tangible book value (TBV) based on historical M&A data (using data from SNL going back to 1990).

2. Franchises that are tightly managed, as reflected in a below-average efficiency ratio.

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 1 to 3 years.

The fourth characteristic – a catalyst – is often the most elusive, and in the case of these five banks the catalysts are multi-faceted:

1. **Fidelity Southern (LION)** – the first catalyst is Atlanta – as the local economy continues to strengthen in the long aftermath of the credit bubble LION continues to become more profitable; the second catalyst is ROA > 1% in 2015/2016, which would prove profit durability; and third is M&A in either direction.

2. **Pulaski Bank (PULB)** – the most likely take-out candidate; ROA > 1%.

3. **Baylake Bank (BYLK)** – economies of scale drive ROA > 1%; growth and/or monetization of its 49.6% stake in data processor "United Financial Services" (UFS); M&A in either direction.

4. **Northrim Bank (NRIM)** – the first catalyst is a rebound in the price of oil; the second is growth to $3 billion in assets driving economies of scale; and the third catalyst is M&A in either direction.

5. **Customers Bank (CUBI)** – $2.00 EPS becomes a new base-line leading to $2.50 in 2017; CUBI's proprietary mobile banking platform "Bank Mobile" is successful in attracting millennials using an affinity strategy.

Without a catalyst, none of these banks 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 the stock. What all five 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.

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