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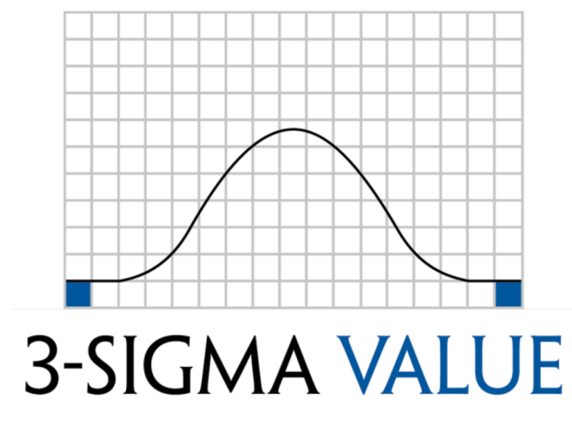

Bank Investing in 2014

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Bank Investing in 2014

According to the FDIC's *Quarterly Banking Profile* for the Fourth Quarter 2013, FDIC-insured institutions earned $154.7 million, a 10% increase from the $141.3 billion in earnings that the industry reported in 2012, and the highest annual profit **ever** reported, topping the $145.2 billion earned in 2006.

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

(1) Data is taken from the FDIC's Fourth Quarter 2013 Banking Profile.
(2) Includes Other Real Estate Owned (OREO).

However, 2014 is an inauspicious time for bank stocks that have risen strongly from the ashes of 2008. Earnings are set to stagger or fall in the swirl of the following headwinds:

1. Net Interest Margin (NIM) Compression
2. Mortgage Lending Under Pressure
3. Declining Gains from Lower Credit Provisioning

Combine these three fundamental headwinds with valuations that are inflated across the board and it becomes very difficult to find banks stocks that meet 3-Sigma Value's requirements for total expected return (50%) and risk versus reward (asymmetrical).

At first blush, a yield curve that steepened in 2013 – in response to the Federal Reserve's announcement of the tapering of quantitative easing (QE)[1] – should benefit net interest margin as loan portfolios reset at higher interest rates. Unfortunately, that's not what is happening as margins across the banking industry continue to trend down.

1. NIM Compression

After five years of robust net interest margin (NIM), this core measure of earnings for the banking industry fell below its long-term average in 2013. The main reason for the margin pressure is the continuing descent of average loan yields – from 5.2% in the first quarter of 2013 to below 5% at year end.

With deposit costs already at generational lows, the fact that they continue to shrink a few basis points at a time – from 0.44% in the first quarter of 2013 to 0.37% in the fourth quarter – only partially offsets the decline in loan yields. The net result is margin erosion that will compress NIM to historically low levels approaching 3% in 2014.

Despite the NIM compression, average return on assets (ROA) for the industry rose to 1.07% in 2013, the highest annual average since 2006. Upon closer inspection, though, the improvement in earnings from 1.00% to 1.07% was mainly attributable to a $22.6 billion reduction in loan-loss reserves (down 16.2%), a noble but unsustainable way of boosting returns. Nonperforming assets (NPAs)[2] as a % of total assets fell dramatically in 2013, from 2.20% to 1.63%, the lowest level since 2007, implying credit quality has returned to pre-crisis levels. Whether or not this reported improvement in credit quality is real or perceived (an important question we seek to answer in a separate analysis), it is enabling the release of tens of billions in loan-loss reserves.

There is a direct correlation between the absolute level of interest rates and NIM. Deposit costs can barely go any lower, while the 10-year rate is under pressure and loan yields along with it. At this point in time, banks need higher rates in order to generate a higher NIM; it is not simply a matter of the yield curve[3].

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[1] Quantitative easing (QE) refers to the Federal Reserve's systematic purchase of fixed income securities in order to suppress interest rates and maintain its zero-bound interest rate policy.

[2] Nonperforming assets (NPAs) are equal to nonperforming loans (NPLs) plus other real estate owned (OREO).

[3] For the month of May 2014, the slope of the yield curve as measured by the difference between the 3-month and the 10-year Treasury yields was +241 basis points, above the 20-year average of 180 basis points for the 13th month

When interest rates are ZIRP[4], securities yields are low, and as a result banks will hold more cash. In fact, cash levels today are much higher than historical levels. More cash on the balance sheet coupled with lower yielding securities (mostly MBS, municipals – state & local, and some government and government-sponsored agencies) translates to lower net interest margin.

2. Mortgage Lending Under Pressure

Another major factor pressuring bank profits in 2014 is a significantly reduced level of mortgage activity. In the first quarter of 2014, lenders originated $235 billion in mortgage loans, down 50% from the same period a year ago and down 23% from the fourth quarter of 2013 – representing the lowest level in 14 years. Mortgage revenue could easily decline in 2014 by half or more.

		Total Mortgage Originations (in $B) *									Mkt Share	**% Growth**
Rank	Lender	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	1Q14	**1Q14 vs 1Q13**
1	Wells Fargo (WFC)	130	131	141	126	110	114	82	51	37	15.9%	**-66.0%**
2	JP Morgan (JPM)	41	47	50	54	56	53	45	26	19	8.1%	**-66.0%**
3	Quicken Loans (private)	11	14	20	25	26	24	17	13	11	4.8%	**-56.6%**
4	Bank of America (BAC)	16	19	21	22	25	27	24	14	11	4.6%	**-56.8%**
5	US Bancorp (USB)	20	23	23	23	22	19	16	9	7	2.9%	**-69.0%**
6	PHH Corp (PHH) - private label	14	13	14	14	13	15	15	10	6	2.7%	**-51.2%**
7	Citigroup (C)	16	14	17	19	19	19	17	9	6	2.7%	**-66.6%**
8	Flagstar Bank (FBC)	11	13	15	15	12	11	8	6	5	2.1%	**-58.9%**
9	PennyMac (PFSI)	2	3	6	10	9	9	8	6	5	2.1%	**-45.2%**
10	Nationstar Mortgage (NSM)	1	2	2	3	3	7	8	6	4	1.9%	**48.8%**
11	Walter Investment Mgmt (WAC)	NA	NA	NA	0	0	5	6	5	4	1.6%	**NM**
12	Freedom Mortgage (private)	NA	NA	NA	5	6	4	3	3	4	1.6%	**-37.3%**
13	BB&T Corp (BBT)	8	8	8	9	9	9	8	5	4	1.6%	**-58.2%**
14	SunTrust Bank (STI)	8	8	8	8	9	9	8	4	3	1.3%	**-66.1%**
15	Franklin American Mortgage (private)	5	5	6	6	6	6	5	4	3	1.3%	**-49.1%**
	Other Lenders									105	44.8%	
	Total									235	100.0%	
	Average Decline in Originations											**-49.9%**

* Data from Goldman Sachs.

The average 30-year fixed-rate mortgage is hovering around 4.5%, up from a 30-year low of 3.35% last May when the Fed introduced the idea of tapering the amount of quantitative easing (QE). While loans for home purchases were basically flat in the first quarter of 2013 compared to a year earlier, refinancing dropped 75%. As a result, the share of refinancing, which has constituted approximately 40% of all mortgage lending (since 2000), fell to 50% of mortgage lending in the first quarter of 2014 versus 78% a year earlier.

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in a row going back to when the Federal Reserve introduced the concept on tapering, or gradually lowering the amount of monthly quantitative easing (QE).

[4] Zero interest rate policy.

For the full year 2014, the Mortgage Bankers Association (MBA) expects lenders to originate $1.046 trillion in single-family loans in 2014, down 40% from 2013. A large part of the problem is the ugly fact that ~20 million U.S. households (~38% of U.S. homeowners with a mortgage) are either underwater[5] or have too little equity to cover the expenses of selling their home. The inability of these homeowners to sell has caused inventory to remain tight, driving up pricing to levels that subdue demand. This is a dangerous cycle, and one that is paradoxical. Demand is low yet prices are high. Typically, low demand begets low prices, and vice versa. Today's economic environment bears no resemblance to anything I have witnessed or studied. The idea of a natural equilibrium is lost, replaced and warped by the government's hand replacing Adam Smith's.

In addition to the headline drop in single-family mortgage demand, the mix shift to purchases, which are more time intensive than refinancing, will translate to lower margins in 2014. The mortgage industry is facing a reckoning that will squeeze lenders that can't survive on thinner margins.

"This change is much more structural and will be longer lasting," said David Stevens, chief executive of the Mortgage Bankers Association. "It's a classic supply-and-demand scenario. We have an excess supply of lenders and a lack of demand."

3. Declining Gains from Lower Credit Provisioning

The largest positive contribution to the year-over-year change in earnings came from reduced loan-loss provisions. Net charge offs (NCOs) declined a whopping 36.7% year-over-year in 2013 as non-performing assets (NPAs) continue to decline in aggregate and as a percentage of total assets to the lowest level since 2007. Forty-two percent of all banks reduced their loss provisions.

In the parlance of our time, the tailwind (of lower provisioning) is about to become a headwind. Earnings growth will arrest and probably decline across the universe of U.S banks in 2014 (vs. 2013) without another $22.6 billion release of loan loss reserves, an impossible scenario. And while, we, as long-term[6] value investors look though the confusion wrought by this near term challenge to a more normal environment (in 2015?), the reality of 2014 is a tough comparison.

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[5] Underwater means the home is worth less than the mortgage.

[6] 3-Sigma Value uses a one to three year time horizon when analyzing investment opportunities.

4. Valuations are Inflated

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[7] 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 thus far. 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.

In 2014, it doesn't matter whether a bank is too big to fail or too small to achieve economies of scale. It doesn't matter whether a bank is a consolidator in the southeast, northeast, or west coast. Across the United States, valuations are full and in many cases inflating rapidly in the face of little-to-no earnings growth. However, it would be wrong to paint the industry with such a broad brush, and therefore in order to find investment opportunities, we discriminate between over-performing and under-performing banks within each of the four sectors of our banking universe: (1) Too-Big-To-Fail, (2) Northeast/MidAtlantic, (3) South/Southeast, (4) West/Midwest.

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

1. **Too-Big-To-Fail Banks**[8]. The six banks that fall into this category must be separated from all the rest because their analysis is substantially different. These banks have open-ended, unlimited liability stemming from abuses during and since the credit bubble that are unresolved. They are virtually controlled by the government. They waste tens of billions of dollars every year with no accountability because the government expects them to spend tens of billions on shiny new branches and Hollywood marketing. The government manages these banks like government agencies rather than free-market corporations. They hire armies of lawyers and politicians. Trading is dead. Which means risk-taking is dead. Moreover, all except for Wells Fargo (WFC) are insolvent on a marked-to-market basis in a normalized interest rate environment. In sum, the Too-Big-To-Fail banks are univestable using a long-term time horizon. Maybe there is a trade in these banks every now and again, but no one should conflate trading and investing. They are two completely different strategies requiring two completely different skill sets.

2. **Northeast/Mid-Atlantic Banks** – recent M&A transactions in the Northeast/Mid-Atlantic region display little in terms of the consolidation trend evident in the South/Southeast. As described in ***Bank Investing in 2013***, the markets in and around Washington DC are attractive when viewed through the lens of return on equity (ROE) and its relationship to tangible book value (TBV)[9]. Recently, **EagleBank (EGBN)**, announced the acquisition of $900 million asset Virginia Heritage Bank (VGBK) for $183 million, equal to a full 210% of TBV and 18.5x TTM[10] EPS. On the other hand, **United Bankshares (UBSI)**, an aggressive consolidator in the region paid a fair 1.8x TBV for Virginia Commerce Bank (VCBI) while **Union First Market Bank (STEL)** paid a reasonable 1.4x TBV for the well-capitalized StellarOne Bank (STEL). In each of these cases, the relationship between ROE and P/TBV holds – the higher the ROE, the higher the P/TBV.

Moving north up the I-85 finds little in terms of meaningful consolidation. In fact, **Valley National Bank (VLY)** recently announced the acquisition of $1.7 billion asset **1st United Bank (FUBC)**, based in Boca Raton, for $305.5 million, equal to 1.8x TBV. Rather than expand its footprint and take advantage of the geographic synergies in the Tri-State area (NY, NJ, CT), Valley National Bank chose to enter Florida, the market that along with Georgia produced the most bank failures and continues to support the highest number of zombie banks (defined as

[8] The six Too-Big-To-Fail banks are JP Morgan (JPM), Bank of America (BAC), Citigroup (C), Wells Fargo (WFC), Goldman Sachs (GS), and Morgan Stanley (MS).

[9] Regressing price-to-tangible-book value (P/TBV) versus return on tangible common equity (ROTCE) generates an R-squared of 75%+ depending on asset size, geography, and other factors.

[10] Trailing twelve months.

banks with greater than 100% Texas Ratio[11]). The implication is clear – there are better opportunities for bank investors in the South/Southeast.

3. **West/Midwest Banks** – the Westcoast banking market is consolidating, in part along ethnic lines. With a substantial Asian population on the Westcoast, banks that cater to Koreans and Chinese have rapidly formed banking oligopolies. Specifically, the Korean market has consolidated into three major banking groups: **Hamni Bank (HAFC)**, **BBCN Bank (BBCN)**, and **Wilshire State Bank (WIBC)**[12]. While the Chinese market has consolidated into **East West Bank (EWBC)**, who recently acquired MetroCap Bank (MCBI) for 1.67x TBV, and **Cathay Bank (CATY)**. As discussed in ***Bank Investing in 2012***, 3-Sigma Value invested in Hamni Bank in 2011 as part of its *second* recapitalization. We exited the position after two winning years.

Valuations across the West and the Midwest have expanded over the past two years, at a rate faster than the rate of increase in earnings[13]. Price-to-tangible book value ratios (P/TBV) remain highly correlated to ROE, however at an elevated level of valuation. For example, the highest ROE banks – **PacWest Bancorp (PACW)**[14] d.b.a. Pacific Western Bank, **Westamerica Bank (WABC)** and **Western Alliance Bank (WAL)**[15] – trade at north of 3x TBV. Meanwhile, the bulk of banks across the West and Midwest earning an ROA of 0.80% to 1.0% trade in a tight range around 1.5x – with plenty of outliers.

4. **South/Southeast Banks** – The first challenge is finding a bank that is not fully-valued relative to its ability to earn. Price-to-tangible book value (P/TBV) is over 2x on average for southern consolidators, and over 3x for the highest ROE banks including **Home Bancshares (HOMB) d.b.a. Centennial Bank** at 3.7x TBV and **Bank of the Ozarks (OZRK)** at 3.5x, both based in Arkansas. On the other end of the spectrum, banks that continue to struggle are valued in excess of 1x TBV. There are no solvent banks to buy below tangible book value[16]. In other words, there are no great discounts.

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[11] Texas Ratio is a simple, straightforward statistic to evaluate the health of a bank; Texas Ratio = Non-Performing Assets divided by Tangible Equity + Loan Loss Reserves**.** In normal times, Texas Ratios approach zero. A 50% ratio is considered very sick (~50/50 chance of survival). A 100% Texas Ratio means the bank is a zombie bank.

[12] Other large Korean Banks in the U.S. include Woori American Bank (NY) and Shinhan Bank America (NY).

[13] Represented as earnings per share (EPS) and return on equity (ROE).

[14] July 2013, PacWest (PACW) announced the acquisition of CapitalSource (CSE) for $2.3 billion.

[15] In addition to Western Alliance Bank, WAL owns Bank of Nevada and Torrey Pines Bank.

[16] With the minimum trading liquidity required for inclusion in 3-Sigma Value, LP.

The Texas market is an attractive banking market from an economic standpoint. Demographics are favorable and there is a culture of conservatism. Banks in Texas did not gorge themselves during the credit bubble, and as a result emerged relatively unscathed. Furthermore, the banking market in Texas is consolidating swiftly. In the past year, **Cullen/Frost (CFR)** acquired $1.4 billion asset West Texas-based WNB Bancshares for $220 million, equal to a rich 2.9x TBV[17], **Prosperity Bank (PB)** paid 1.9x TBV for $2.4 billion asset F&M Bancorporation (FMBC), and **Southside Bank (SBSI)** recently announced the acquisition of $1.4 billion asset OmiAmerican Bank (OABC), based in Ft. Worth TX, for $311.6 million, equal to 1.5x TBV. While banks in Texas are not on sale *per se*, the opportunity to invest in healthy banks in a consolidating market warrants deeper inspection. Following is a list of the largest banks in Texas by deposit market share.

Texas Market Analysis*

		Home	Deposits ($B)		Price as of	Shares	Market	Q1 2014						
		State	in market - 2013	Market Share	3/31/14	Out	Capitalization	Deposits	Assets	TCE / TA	TCE	P/TBV	ROA	ROTCE
1	JPMorgan Chase (JPM)	NY	125,918	22.5%	60.71	3,824	232,131	1,282,705	2,476,986	6.4%	159,559	1.5x	0.89%	13.82%
2	Bank of America (BAC)	NC	81,601	14.6%	17.20	10,561	181,641	1,133,650	2,149,851	6.8%	145,841	1.2x	NM	NM
3	Wells Fargo (WFC)	CA	60,386	10.8%	49.74	5,353	266,273	1,094,576	1,546,707	9.8%	150,832	1.8x	1.57%	16.10%
4	Cullen/Frost Bankers (CFR)	TX	20,363	3.6%	77.53	62	4,775	20,511	24,007	8.4%	2,011	2.4x	1.00%	11.94%
5	Prosperity Bank (PB)	TX	13,982	2.5%	66.15	66	4,384	15,460	18,913	6.6%	1,241	3.5x	1.43%	21.80%
6	Capital One (COF)	VA	10,410	1.9%	77.16	580	44,776	208,324	290,500	9.9%	28,827	1.6x	1.61%	16.22%
7	Zions Bank (ZION)	UT	10,358	1.9%	30.98	185	5,735	46,532	56,081	9.9%	5,539	1.3x	0.74%	7.49%
8	**Comerica (CMA)**	**TX**	**9,870**	**1.8%**	**51.80**	**187**	**9,687**	**53,750**	**65,681**	**10.4%**	**6,826**	**1.4x**	**0.86%**	**8.28%**
9	Texas Capital Bancshares (TCBI)	TX	7,721	1.4%	64.94	43	2,807	9,729	12,143	10.0%	1,209	2.3x	1.01%	10.14%
10	**International Bank of Commerce (IBOC)**	**TX**	**6,981**	**1.2%**	**25.08**	**67**	**1,687**	**8,436**	**12,144**	**9.7%**	**1,181**	**1.4x**	**1.37%**	**14.09%**
11	BOK Financial (BOKF)	OK	4,866	0.9%	69.05	68	4,726	20,390	27,365	9.9%	2,714	1.7x	1.14%	11.50%
12	First Financial Bankshares (FFIN)	TX	3,965	0.7%	61.79	32	1,984	4,234	5,281	9.8%	519	3.8x	1.74%	17.70%
13	Southside Bank (SBSI)	TX	2,528	0.5%	31.38	19	593	2,528	3,434	7.3%	249	2.4x	0.96%	13.23%
14	Independent Bank Group (IBTX)	TX	2,698	0.5%	58.75	13	745	1,891	2,354	9.2%	206	3.6x	0.84%	9.12%
15	ViewPoint Bank (VPFG)	TX	2,369	0.4%	28.85	38	1,097	2,369	3,604	14.4%	520	2.1x	0.92%	6.37%
	Other		195,122	34.9%										
	Total		559,137	100.0%										

* Publicly-traded, U.S. domiciled banks only. Excluded banks with market share in Texas include Banco Bilbao Vizcaya Argentaria, S.A. (BBVA) of Spain, #4 in market share with over $30 billion of deposits, Grupo Financiero Banamex (Mexico), Citigroup (C), Regions Financial (RF), PlainsCapital Bank - a subsidiary of Hilltop Holdings (HTH), and dozens of privately-held banks.

Excluding the Too-Big-To-Fail banks (JPM, BAC, WFC), and any other bank that is based outside of Texas, leaves us with a sub-list of Texas banks. While most Texas banks are fully valued, there are two that stand out as candidates potentially undervalued by 50% or more. They are **International Bank of Commerce (IBOC)** and **Comerica (CMA)**.

International Bank of Commerce (IBOC) – Despite $12 billion of assets, IBOC is underfollowed by Wall Street which likely accounts for a portion of its substantial valuation discount. Regression analysis suggests its P/TBV should be 3x, rather than 1.4x. Management virtually ignores investors. There is no investor relations page on its website, only a corporate profile with links to SEC filings, annual reports, and corporate governance guidelines.

[17] Cullen/Frost (CFR) is trading around 2.4x TBV.

IBOC is a model of efficiency, generating 1.37% ROA in Q1 2014, and 1.07% for the full year 2013. With 215 branches in Texas (83% of deposits) and Oklahoma (17%), operations are clustered strategically in south Texas, with branches along the Mexican border. Expenses are managed professionally with a 55% Efficiency ratio[18]. The only challenge here is identifying a catalyst to unlock value. Given management's virtual disregard for investors, it is unlikely they can be counted on to enhance shareholder value. Because management is the predominant factor in any bank investment, we must wait for IBOC to signal a change in corporate communications before serious consideration.

Comerica (CMA) – while not a Texas bank in the sense that only 18% of its deposits are domiciled in Texas, we include CMA here because of its unique characteristics. CMA's cost of capital is the lowest in our universe due to one of the highest levels of non-interest bearing deposits (45% of total deposits) and one of the lowest average cost of deposits (0.15% in Q1 2014). On the asset side of the equation, CMA has one of the highest levels of variable loans (85% variable). This asset sensitivity offers investors a natural hedge against rising interest rates.

CMA is concentrated in three markets: (1) Michigan – $21 billion of deposits, (2) California – $15 billion; and Texas – $10 billion; and as a result its operations are less centralized and more expensive than single-market banks including IBOC. Efficiency ratio is elevated at 66%, with a long-term goal "below 60%". In 2011, CMA overpaid for Sterling Bank, based in Dallas – 2.3x TBV for a decentralized, underperforming franchise that continues to weigh on profitability[19]. Given CMA's structural cost-disadvantage compared to pure Texas banks it is no surprise that it trades at a valuation discount. However, at 1.4x TBV, the discount is too great.

The parts are worth more than the whole, and CMA should separate into three regional powerhouses that can pursue M&A transactions independently. Corporate expense levels would be cut along with efficiency ratios. The Texas bank is worth at least 2x TBV. Michigan and California are worth at least 1.5x. Combined, the pieces are worth $75 per share.

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[18] Efficiency ratio is a key measure of expense control. It equals non-interest expense divided by (net interest income before provision for credit losses plus total non-interest income). Non-interest expenses include salaries and employee benefits, occupancy and equipment expenses, other real estate (OREO) and troubled asset resolution related expenses, professional services, and other.

[19] Q1 2014 ROA = 0.86%; long-term goal = 1.30%.

Strategy

Because change defines the banking industry, investors must constantly re-evaluate and change the fundamental parameters when buying and selling bank stocks. In 2014, with net interest margins contracting and the regulatory screws continuing to tighten, it becomes more important than ever to focus on low cost providers.

3-Sigma Value seeks the following five key characteristics in a bank investment:

1. Franchises with low-cost deposits.
2. Franchises that are tightly managed, as reflected in a below-average efficiency ratio.
3. A catalyst to unlock value.
4. **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.
5. 50% upside to 3-Sigma Value's scenario-based target price, and asymmetrical risk versus reward.

In 3-Sigma Value's ***2013 Review / 2014 Outlook***, we introduced the idea of **The Great IPO Flood of 2013**, a flood that actually began in 2012[20] and flows unabated into 2014. In this analysis of initial public offerings, we largely focused on technology-based IPOs, and to a lesser extent the YieldCo phenomenon (MLPs, BDC's, REITs). In contrast, the number of banks that have gone public recently I can count on two hands.

It is quality not quantity, isn't that what they say. Too many or too few, quality doesn't discriminate. Quality exists on its own volition. Quality can live in a vacuum or be overwhelmed by the law of large numbers. There is no pattern to quality despite the machines. Quality is never as obvious as we think because quality is not superficial. Quality is unaware of time, timeless, a survivor in all markets. Quality is a well-managed community bank that went public on November 15, 2013 at $6 per share.

[20] Two events opened the flood gates: (1) implementation of the JOBS Act (Jumpstart Our Business Startups), and (2) the carnival surrounding the Facebook IPO.

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First Bank (FRBA) (the "Bank") began operations April 2007 in Hamilton **New Jersey**. An investor group led by Patrick M. Ryan, former CEO of Yardville National Bank from 1991 through its sale to PNC Bank in 2007, and Les Goodman, current Vice Chairman of Anchor Commercial Bank in Palm Beach County, FL, recapitalized the Bank in October 2008 with an investment of $19 million.

Patrick M. Ryan's son, Patrick L. Ryan ("Pat"), is the CEO of First Bank and an apprentice with an excellent mentor. Yes, daddy bought him a bank, but that hardly disqualifies someone from being worthy. Pat worked at Goldman and Bain before joining his dad at Yardville National. He's smart enough, and maybe very smart. I love the fact that his father is invested and looking over his shoulder. My father was my mentor in business and I wish he were still alive today so that I could bounce investment ideas off of him and listen to his fifty years of market wisdom.

First Bank went public on NASDAQ on November 15, 2014 at $6 per share. Net proceeds were $20.9 million after deducting $2.1 million in fees. In addition to supporting the acquisition of $133.4 million asset Heritage Community Bank (closed 3/7/14, paid for with stock), the stock offering was used to create a currency for additional M&A. Heritage had two branches that along with two de novo branches, doubles First Bank's branch network from four at the time of its IPO to eight.

First Bank (FRBA)		
Share Price at 11/15/14 IPO		$6.00
Share Price at 3/31/14		$6.00
x FD Shares Out.		8.8
= Market Capitalization		**53.0**
Tangible Book Value (TBV)		**61.0**
P / TBV		**0.87x**
	2014	2015
Tangible Book Value (TBV)	64.3	70.8
P / TBV	**0.82x**	**0.75x**
EPS - Base Case: Scenario 1	0.71	0.66
P/E	**8.5x**	**9.1x**
ROE	**10.2%**	**10.7%**

To project the future performance of First Bank (FRBA), or any bank for that matter, we focus on the underlying assumptions that drive net income. Net income is the principal metric by which we determine a bank's valuation – the higher the net income as reflected in ROE, the higher the price investors will pay as a percentage of tangible book value (P/TBV).

We begin with the basic formula:

Net Income = Net Interest Income plus Non Interest Income minus Non Interest Expense

Net Interest Income: NIM averaged 3.61% in Q1 2014, after averaging 3.50% in 2013. Longer-term, Pat Ryan expects flattish to eroding NIM – assuming interest rates remain zero-bound. Loan pricing is competitive as the economy limps along and banks chase the same commercial and industrial (C&I) and owner-occupied (O&O) commercial real estate (CRE) loans. First Bank is primarily a commercial bank: 85% of its loan portfolio is commercial (C&I, O&O, and investor-owned CRE) and 15% consumer, comprised of residential mortgages originated in conjunction with a New Jersey-based lender, Aurora Financial. The consumer business is more of an accommodation to commercial customers than a core business.

Organically, First Bank is growing its loan portfolio by $5 million to $6 million (net) per month. On a $450 million loan portfolio as of March 31, 2014, $60-$80 million of annual growth represents a hard-working 20% increase. On the subject of credit risk, there appears little to none as loan vintage is post-credit bubble and allowance for loan losses (ALL) is 140% of nonaccrual loans. As far as the loans acquired from Heritage Community Bank, in addition to writing them down to current market value, an additional 7-10% yield mark was added for extra cushion. CEO Pat Ryan is very confident in the marking of the loan portfolio and believes hidden gains are far more likely than hidden losses.

On the liability side of the Bank's balance sheet, funding costs continue to decline as high cost CDs (1.29% average cost in Q1 2014) re-price around 0.75%. In addition, savings and money market deposit accounts re-priced lower yet again in Q2 2014. As long as short-term interest rates remain anchored to zero, First Bank's cost of capital will remain relatively stable with limited sensitivity to interest rates.

Non-Interest Income – fees are depressed because interest rates are zero-bound. Longer-term, management targets non-interest income as a percentage of assets to expand from its negligible

0.13%, however for the foreseeable future it will remain negligible. CEO Pat Ryan says the Bank is a "spread bank" not a "fee bank', and that is not a rationalization but an accurate reflection of the current business.

Non-Interest Expense – the Bank's efficiency ratio of 74.2%[21] in Q1 2014 is elevated because of additional expenses related to the acquisition of Heritage Community Bank that closed in March. This is in contrast to 2012 and 2013, when efficiency was tighter at 68%. CEO Pat Ryan expects operational efficiency to improve to below 60% in the short-to-medium term, reflecting interest expense as a percentage of average assets below 2.5%. Investors can expect a new branch every 12 to 18 months, supported by opportunistic acquisitions. Pat's goal is to exceed $1 billion in assets "in the next few years", a statement disproportionately impacted by the pace of M&A.

Financial Summary - First Bank (FRBA)	**2011**	**2012**	**2013**	**1Q14**	**2Q14**	**3Q14**	**4Q14**	**2014**	**2015**
Assets (avg balances)									
Investment Securities	23,789	37,618	59,118	79,624	78,886	78,886	78,886	79,071	78,886
% avg rate	*2.11%*	*1.94%*	*1.95%*	*2.31%*	*2.31%*	*2.31%*	*2.31%*	*2.31%*	*2.31%*
Loans (See Loan Portfolio for Detail)	182,809	233,194	294,751	395,201	463,569	487,145	508,013	463,482	560,183
% avg rate	*5.97%*	*5.71%*	*5.20%*	*5.13%*	*5.06%*	*4.99%*	*4.92%*	*5.03%*	*4.92%*
Fed Funds and Bank Deposits	22,690	20,871	21,861	22,590	22,590	22,590	22,590	22,590	22,590
% avg rate	*0.53%*	*0.32%*	*0.28%*	*0.41%*	*0.41%*	*0.41%*	*0.41%*	*0.41%*	*0.41%*
Restricted Invetment in Bank Stocks	491	598	997	1,188	1,344	1,344	1,344	1,305	1,344
% avg rate	*4.07%*	*4.01%*	*3.41%*	*4.78%*	*4.78%*	*4.78%*	*4.78%*	*4.78%*	*4.78%*
Other Investments	535	69	78	5,000	5,000	5,000	5,000	5,000	5,000
% avg rate	*2.06%*	*1.38%*	*1.56%*	*1.78%*	*1.78%*	*1.78%*	*1.78%*	*1.78%*	*1.78%*
Total Interest Earning Assets	**230,314**	**297,283**	**381,727**	**503,603**	**571,389**	**594,965**	**615,833**	**571,447**	**668,003**
% avg rate	***5.02%***	***4.76%***	***4.34%***	***4.44%***	***4.47%***	***4.43%***	***4.39%***	***4.44%***	***4.44%***
Allowance for Loan Losses (ALL)	-2,808	-3,738	-4,405	-4,702	-4,867	-5,115	-5,334	-5,004	-5,881
as a % of Loans	*1.54%*	*1.60%*	*1.49%*	*1.19%*	*1.05%*	*1.05%*	*1.05%*	*1.08%*	*1.05%*
Non-Interest Earnings Assets	10,083	18,264	19,652	25,926	29,416	30,630	31,704	29,419	34,390
as a % of Earning Assets	*4.4%*	*6.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*	*5.1%*
Total Assets	**237,589**	**311,809**	**396,974**	**524,827**	**595,938**	**620,480**	**642,204**	**595,862**	**696,512**
Interest Income	**11,567**	**14,137**	**16,576**	**5,152**	**6,381**	**6,594**	**6,766**	**24,893**	**29,629**
Liabilities (avg balances)									
Interest Bearing Demand Deposits	6,103	9,290	11,556	13,531	16,695	17,544	18,295	16,516	20,174
% avg rate	*0.82%*	*0.56%*	*0.35%*	*0.33%*	*0.33%*	*0.33%*	*0.33%*	*0.33%*	*0.33%*
Money Market Deposits	62,180	73,707	71,134	79,302	97,843	102,820	107,224	96,797	118,236
% avg rate	*1.01%*	*0.65%*	*0.69%*	*0.61%*	*0.53%*	*0.53%*	*0.53%*	*0.55%*	*0.53%*
Savings Deposits	20,059	56,781	87,471	103,428	127,610	134,101	139,845	126,246	154,206
% avg rate	*1.23%*	*1.26%*	*0.77%*	*0.71%*	*0.65%*	*0.65%*	*0.65%*	*0.67%*	*0.65%*
Time Deposits	104,250	115,248	140,669	177,762	219,324	230,479	240,352	216,979	265,035
% avg rate	*1.82%*	*1.64%*	*1.43%*	*1.29%*	*1.15%*	*1.01%*	*0.87%*	*1.08%*	*0.87%*
Total Interest Bearing Deposits	192,592	255,026	310,830	374,023	461,472	484,943	505,717	456,539	557,651
% avg rate	*1.47%*	*1.23%*	*1.03%*	*0.95%*	*0.85%*	*0.78%*	*0.72%*	*0.83%*	*0.72%*
Non-Interest Bearing Deposits	18,335	24,174	39,030	60,950	75,865	79,724	83,139	74,919	91,677
as a % of Total Deposits	*8.69%*	*8.66%*	*11.16%*	*14.01%*	*14.12%*	*14.12%*	*14.12%*	*14.10%*	*14.12%*
Total Deposits	**210,927**	**279,200**	**349,860**	**434,973**	**537,337**	**564,667**	**588,855**	**531,458**	**649,327**
% avg rate	*1.34%*	*1.12%*	*0.92%*	*0.82%*	*0.73%*	*0.67%*	*0.62%*	*0.71%*	*0.62%*
Other Interest Bearing Liabilities / Borrowings	4,257	5,622	11,843	14,000	14,000	14,000	14,000	14,000	14,000
% avg rate				*1.56%*	*1.56%*	*1.56%*	*1.56%*	*1.56%*	*1.56%*
Other Non-Interest Bearing Liabilities	545	639	1,164	1,415	1,657	1,657	1,657	1,596	1,657
Total Liabilities	215,729	285,461	362,867	450,388	552,994	580,324	604,512	547,054	664,984
Stockholders' Equity	**21,860**	**26,348**	**34,107**	**74,440**	**75,414**	**76,515**	**77,703**	**84,190**	**90,469**
Total Liabilities + SHE	**237,589**	**311,809**	**396,974**	**524,827**	**595,938**	**620,480**	**642,204**	**595,862**	**696,512**
Interest Expense	**2,822**	**3,137**	**3,216**	**944**	**1,036**	**1,005**	**962**	**3,946**	**4,220**
Net Interest Income	**8,745**	**11,000**	**13,360**	**4,208**	**5,345**	**5,589**	**5,804**	**20,946**	**25,409**
Net Interest Margin (NIM) = net int inc / avg total	**3.80%**	**3.70%**	**3.50%**	**3.34%**	**3.74%**	**3.76%**	**3.77%**	**3.67%**	**3.80%**
Provision for Loan Losses		-1,366	-1,543	-178	-276	-219	-219	-892	-876
Non-Interest Income		461	532	2,739	200	208	215	3,362	933
as a % of avg assets		*0.1%*	*0.1%*	*2.1%*	*0.1%*	*0.1%*	*0.1%*	*0.6%*	*0.1%*
Non-Interest Expense		7,769	9,427	3,221	3,771	3,884	3,973	14,848	15,806
as a % of avg assets		*2.5%*	*2.4%*	*2.5%*	*2.5%*	*2.5%*	*2.5%*	*2.5%*	*2.3%*
Efficiency Ratio	*75.9%*	*67.8%*	*67.9%*	*74.2%*	*68.0%*	*67.0%*	*66.0%*	*68.8%*	*60.0%*
Pre-tax Income				3,548	1,498	1,694	1,827	8,568	9,661
Pre-tax Return on Average Assets	**0.89%**	**0.83%**	**0.43%**	**2.70%**	**1.01%**	**1.09%**	**1.14%**	**1.44%**	**1.39%**
Pre-tax Return on Average Equity	**9.62%**	**9.82%**	**5.01%**	**19.07%**	**7.95%**	**8.86%**	**9.41%**	**10.18%**	**10.68%**
Taxes				324	524	593	640	2,081	3,381
% rate				*9.1%*	*35.0%*	*35.0%*	*35.0%*	*24.3%*	*35.0%*
Net Income				3,224	974	1,101	1,188	6,487	6,279
FD Shares Outstanding				8,839	9,490	9,490	9,490	9,155	9,490
EPS				**0.36**	**0.10**	**0.12**	**0.13**	**0.71**	**0.66**

[21] Adjusted for $2.606 million gain on acquisition of Heritage Community Bank.

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Valuation

What is a well-run, well-capitalized[22] bank, albeit a small bank, worth in today's marketplace? Earning ~1% return on assets and ~10% return on equity, consistently, warrants at least 1.5x TBV, and at least 2x in a sale. This is not an undercapitalized bank. It's not losing money. It's not mismanaged. I've met Pat Ryan and I don't understand why I am able to buy his bank at below tangible book value. The stock is relatively illiquid, but not illiquid. I can buy or sell it every day.

First Bank (FRBA) - Balance Sheet Statistics:	**12/31/2013**	**3/31/2014**	**6/30/2014**	**9/30/2014**	**12/31/2014**	**12/31/2015**
Cash & equivalents	23,714	38,120	39,094	40,195	41,383	47,662
Interest-bearing time deposits with banks	4,903	5,339	5,339	5,339	5,339	5,339
Securities, available for sale	65,017	63,506	63,506	63,506	63,506	63,506
Securities, held to maturity	15,414	15,380	15,380	15,380	15,380	15,380
Restricted investment in bank stocks	1,131	1,344	1,344	1,344	1,344	1,344
Other investments	5,000	5,000	5,000	5,000	5,000	5,000
Loans - receivable	**339,975**	**450,424**	**476,711**	**497,579**	**518,447**	**601,919**
Net loan growth - sequential		110,449	26,287	20,868	20,868	83,472
% Growth		*32.5%*	*5.8%*	*4.4%*	*4.2%*	*16.1%*
LESS: Allowance for loan and lease losses	-4,675	-4,729	-5,005	-5,224	-5,443	-6,320
% Coverage	*1.4%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*	*1.0%*
Premises and fixed assets	1,787	3,382	3,382	3,382	3,382	3,382
Other real estate owned (OREO)	1,664	2,266	2,266	2,266	2,266	2,266
Accrued interest receivable	1,232	1,356	1,356	1,356	1,356	1,356
Bank-Owned Life Insurance (BOLI)	8,805	8,868	8,868	8,868	8,868	8,868
Intangibles	0	413	413	413	413	413
Deferred income taxes	2,352	7,442	7,442	7,442	7,442	7,442
Other assets	473	1,101	1,101	1,101	1,101	1,101
Total assets	**466,792**	**599,212**	**626,197**	**647,947**	**669,784**	**758,659**
Deposits:						
Noninterest-Bearing	48,186	73,714	78,016	81,431	84,846	98,507
% of deposits paying no interest	*12.1%*	*14.1%*	*14.1%*	*14.1%*	*14.1%*	*14.1%*
Interest-Bearing	350,927	448,388	474,556	495,330	516,103	599,198
Total Deposits	399,113	522,102	552,572	576,761	600,950	697,705
Loan-to-Deposit Ratio	*85.2%*	*86.3%*	*86.3%*	*86.3%*	*86.3%*	*86.3%*
Long-term borrowings (FHLB advances)	14,000	14,000	14,000	14,000	14,000	14,000
Accrued interest payable	156	364	364	364	364	364
Other liabilities	1,016	1,293	1,293	1,293	1,293	1,293
Total liabilties	414,285	537,759	568,229	592,418	616,607	713,362
Total equity capital	**52,507**	**61,453**	**62,427**	**63,528**	**64,716**	**71,203**
Total liabilties and equity capital	**466,792**	**599,212**	**626,197**	**647,947**	**669,784**	**758,659**
TCE / TA	***11.25%***	***10.19%***	***9.90%***	***9.74%***	***9.60%***	***9.33%***
Fully-diluted shares outstanding		8,839	8,839	8,839	8,839	8,839
Tangible Book Value (TBV)	**52,507**	**61,040**	**62,014**	**63,115**	**64,303**	**70,790**
per share		**6.91**	**7.02**	**7.14**	**7.27**	**8.01**
Price / TBV @ Current Market Price		**0.87x**	**0.86x**	**0.84x**	**0.82x**	**0.75x**

Valuation is Based on FYE 2015 Tangible Book Value					
Multiple Range	**1.00x**	**1.25x**	**1.50x**	**1.75x**	**2.00x**
Implied Market Valuation	**70,790**	**88,487**	**106,185**	**123,882**	**141,580**
per share	**8.01**	**10.01**	**12.01**	**14.01**	**16.02**
% Profit (Loss)	**33.5%**	**66.8%**	**100.2%**	**133.6%**	**167.0%**

[22] 10.2% TCE (tangible common equity) as of March 31, 2014.

At 1.5x 2015E TBV, First Bank's stock is worth $12.01, representing a gain of 100% over its $6.00 share price on June 30, 2014.

Final Thoughts

We are market-cap agnostic here at 3-Sigma Value. The limiting factor is liquidity not size. In the case of First Bank (FRBA), a position must be built slowly and systematically over time, and the position must never represent a significant percentage of our portfolio; nevertheless, when you are walking down the street and you see a quarter, do you not stop and pick it up?

On the opposite end of the size spectrum is $54 billion asset Comerica (CMA), which as discussed earlier is perfectly constructed for a rising interest rate environment. Given the basic assumption that short term rates are zero-bound for the foreseeable future, Comerica is a defensive investment compared to other banks, a hedge. In a bull market, it's worth 50% more than its current market cap. In a bear market, its value is already reflected. Taken together, the reward-to-risk ratio is highly asymmetrical – 5:1 based on valuations derived from 3-Sigma Value's Upside Case operating scenarios compared to valuations derived from the Downside Case scenarios. This scenario-based approach to valuation is integral to the objective application of 3-Sigma Value's investment strategy.

Intellectual honesty. It is the cornerstone of any analytical construct. Success in investing necessitates it. We are fixated, dare I say obsessed with the pursuit of intellectual honesty, specifically in the application of scenario analysis. The assumptions underlying any model determine the model's usefulness. It is not the answer that matters. It is the identification of the assumptions that drive valuation. It is the awareness of biases. The rejection of heuristics. The necessity of data. The power of skepticism. And finally, it is the capacity to buy <u>and</u> sell short, one way and/or the other that opens the possibility to profit in any market environment. We are never forcing conclusions. Never rationalizing. The flexibility inherent in the long/short hedge fund model enables us to research industries without bias. We don't have to be long. We don't have to be short. We don't have to be anything other than intellectually honest.

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