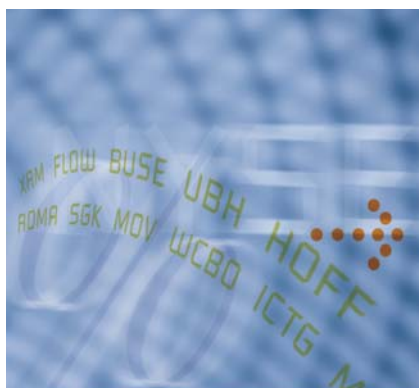

EarningsQuality ANALYTICS™ EQA

Issue Commentary

Analyst: Michael Williams (PhDs in Accounting and Economics)

25 June 2009

Revisiting Earnings Quality and Valuation in the Banking Sector

Over the past two years, we have highlighted significant problems at a number of banks with under-accruals for loan losses and other earnings- and asset-quality problems. On average those banks have experienced substantial multiple compression. In late 2008 we expanded the analysis with an earnings-quality-based bank valuation model. As share values were down sharply at the time, we first used the model to identify five banks that we believed were undervalued at the time. On average, the five banks have outperformed the overall sector by 19% since the publication of our report.

In this *Issue Commentary*, we develop a more detailed model based on regulatory filing data. We use the enhanced model to highlight four banks that appear relatively undervalued and four that appear relatively overvalued. We stress, however, that the model focuses on relative valuation and we take no position on how the sector as a whole is likely to perform.

Company / Commentary	Page / Scale +/-
Citigroup (C)	*Page 11*
Among U.S. banks, we believe that Citibank ranks toward the very bottom in terms of earnings quality and see little hope that it can produce value for shareholders.	–
Commerce Bancshares (CBSH)	*Page 12*
CBSH has seen rapid deterioration in its loan portfolio since our last analysis. We also have concerns about its accounting for securities.	–
Cullen/Frost Bankers (CFR)	*Page 13*
CFR has also seen a significant decline in loan quality this year, yet its share price does not appear to reflect the full extent of deterioration.	–
Valley National Bancorp (VLY)	*Page 14*
Valuation appears excessive given VLY's loan-quality problems and its accounting for securities, which appears at odds with economic reality.	–
Bank of America (BAC)	*Page 15*
Despite a weak balance sheet and exceptionally poor decision-making in the past year (or more), core earnings are strong, and the price is relatively low.	+
JPMorgan Chase (JPM)	*Page 16*
Earnings- and balance-sheet quality are much better than peers. Even with its relatively higher multiple, JPM still appears attractively priced.	+
First Citizens Bancshares (FCNC.A)	*Page 17*
Perhaps the safest, most conservative bank in America. The upside potential is limited but the risk is much lower than that of peers.	+
Marshall & Ilsley (MI)	*Page 18*
Though it has struggled over the past two years, for those willing to take on additional risk, MI appears to offer significant upside potential.	+
EARNINGS QUALITY VIEW	*Scale +/-*

14614 N. Kierland Blvd., Suite S-260
Scottsdale, Arizona 85254
Tel 480.998.8585 Fax 480.998.4747

GRADIENT

products@gradientanalytics.com
www.earningsquality.com
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Model of Bank Stock Prices

OVERVIEW OF MODEL

Our objective is to identify banks that we believe are over- or undervalued given their specific economic situations. To that end, we model the two key drivers of value: net asset value of the business and sustainable earnings. In today's environment, where capital adequacy and solvency are especially salient in the banking industry, we still expect balance-sheet quality to be particularly important. That said, for any going concern business, sustainable earnings are the key long-term driver of firm value.

Considering the above, our modeling approach involves constructing measures of both adjusted book value and sustainable earnings. These variables are combined with other value-relevant variables that do not easily fit into an estimate of sustainable earnings or adjusted book value. Specifically, we account for both the growth of the bank over the last year (generally negative) and the composition of their securities portfolios (a source of asset-quality concern that is difficult to quantify as a book value adjustment). The model is based on accounting measures taken from regulatory filings (call reports) and estimated using a multi-step regression analysis to derive an relative value estimate for each of the 145 largest bank holding companies in the U.S. (by market value) with continuous regulatory data since 2007.[1]

These relative value estimates are then compared to actual stock prices to assess over- and undervaluation of the sample banks on a relative basis. We subsequently use this comparison as a starting point in selecting a subset for a qualitative (i.e., analyst) review. The final review led to the selection of eight banks which we highlight in more detail at the end of the report.

REVISITING GRADIENT'S OCTOBER 2008 *ISSUE COMMENTARY*

Last fall we developed a similar model and published a related *Issue Commentary* on 10/18/08. That report focused on five regional banks that we believed to be undervalued on a relative basis. The five banks (BKMU, BXS, EWBC, FMER, and STEL) have outperformed the S&P 1500 regional bank index by approximately 19% in the subsequent period.[2]

With the addition of new data and more time to expand on the analysis, we have now deepened the model significantly. The principal differences are due to the use of regulatory accounting reports (known as call reports) filed quarterly with their regulatory agencies. These reports are highly detailed and completely uniform across banks (unlike financial statements prepared for shareholders), and thus allow superior comparability at a very granular level. Additionally, the original model treated all loans as identical and ignored securities portfolios. The new model breaks loans into nine categories and analyzes each type separately.

[1] This excludes recent bank holding company conversions, such as Goldman Sachs. The original sample had 150 banks, but five of them were dropped because of data limitations.
[2] An alternative benchmark would include regional bank ETFs. Our banks beat the IAT, KRE, and RKH funds by an average of 11%.

The new model also accounts for details of a bank's securities portfolio. These improvements have increased the model's explanatory power (R^2) with respect to cross-sectional variation in bank stock prices from 65% (old model) to 83% (new model).

STRUCTURE OF THE MODEL

The model involves four steps. In the first step, we develop a charge-off forecasting model for each of the nine loan categories (using linear regression). We then forecast charge-offs for all sample banks and use that to determine our estimates of the sustainable loan-loss allowance and loan-loss provision.

In the next step, we construct measures of book equity value and sustainable earnings by making several adjustments to as-reported values. These adjustments include the loan-loss estimates in Step 1 as well as other adjustments to eliminate intangibles and most gains and losses included in income.

In Step 3, we fit stock prices to our book value and earnings figures from Step 2 to derive coefficients (i.e., "multiples") for the two sources of value (using linear regression). This provides our initial estimate of (relative) intrinsic firm value and thus an estimate for each bank of its over- or undervaluation.

In Step 4, we explain the initial over-valuation measure using a set of variables for both growth and securities portfolio composition (using a log-linear regression). This allows us to construct a refinement to the intrinsic value measure that significantly improves its fit to observed stock prices.

STEP 1: CHARGE-OFF FORECASTING

Two of the key areas of asset quality we've focused on in prior bank earnings quality reports are the allowance for loan losses (ALL) and the loan-loss provision (LLP). In this report, we are expanding on our prior ALL analysis with a detailed statistical model of charge-off activity. In this regard, it is important to understand that the purpose of the ALL is to anticipate charge-offs that will likely be needed at any point in the future, for all loans currently outstanding. Since 2007 we have recommended that the ALL should be equal to approximately two years (eight quarters) of forecasted charge-offs to be reasonably conservative. However, that rule of thumb was intended to be employed during a period of rapidly rising charge-offs when the trend could be anticipated to continue for several more quarters, but the slope of that trend line was more uncertain. Hopefully as of Q2 2009, charge-off levels are nearing a peak, given the expectation that the U.S. recession will end later this year. Assuming that the temporarily elevated levels of charge-offs should begin to moderate, this time we employ a rule that the ALL as of Q1 2009 should be seven times the forecasted charge-offs for Q2 2009.

Since individual banks vary widely in their actual ALL levels, for our modeling purposes we feel it is necessary to put them all on equal footing by imposing an

ALL equal to seven quarters of forecasted charge-offs. With this in mind, we estimate a linear regression of the following model for the last four quarters:

$$\frac{CO_t}{TL_t} = \alpha + \beta_1 \frac{CO_{t-1}}{TL_{t-1}} + \beta_2 \frac{NAL_{t-1}}{TL_{t-1}} + \beta_3 \frac{L_{t-1}}{TL_{t-1}}.$$

This model is estimated separately in each of nine loan categories (described below). Charge-offs (CO) in each quarter are predicted by charge-offs, non-accruing loans (NAL), and loans (L) in the prior quarter. To ensure that banks that make very few loans in a given category have less weight in the estimation process, we scale all variables by total loans (across all categories, TL). The three explanatory variables predict anywhere from 19% (other loans) to 97% (credit cards) of the variation in charge-offs (the R^2).

The categories include:

- Domestic 1-4 family residential mortgages
- Domestic home equity loans
- Domestic construction loans
- Other real estate loans
- Commercial loans
- Credit cards
- Other consumer loans
- Leases
- Other loans

Using the linear-regression estimates, we then forecast charge-offs for each bank in Q2 2009 (by summing up forecasted charge-offs in each category). In turn, we estimate an appropriate ALL as seven times the forecasted level of Q2 charge-offs. On average, our ALL estimate is 24.9% higher than the ALL reported by each bank in Q1 2009 (median excess is 19.4%). Thus, even after banks have significantly increased their ALL in the past year, our view is that most banks still may not have accrued enough of a reserve.[3]

STEP 2: ADJUSTED BOOK VALUE AND SUSTAINABLE EARNINGS

The next step in the modeling process is to estimate the true economic value of bank equity and sustainable earnings. There are numerous adjustments that could be made in a bank-by-bank analysis, but for large-scale modeling purposes such as this one, we limit ourselves to a few key adjustments.

Adjusted book value (ABV) is calculated as:

ABV = Book value of common equity as of March 31, 2009

[3] The most under-provisioned bank according to the model is Republic Bancorp (RBCA.A) with only $17.9 million in allowance versus the $79.7 million suggested by the model.

+ ALL as recorded by the bank
- ALL as estimated by Gradient
- Intangible assets, including goodwill
- Cumulative gains from fair value of financial liabilities
+ Cumulate unrealized gains(losses) on held to maturity securities
+/- Adjustment for deferred taxes on above adjustments.

In today's environment, the value of acquired intangibles is questionable at best. Certainly, these assets provide no benefit in terms of solvency and regulatory capital adequacy. Further, they are likely to be impaired at this point given the diminished earnings expectations for the sector. Thus, we remove all intangibles from book value.

We also do not regard fair value as the proper measure of a liability since the bank owes the full face value to creditors regardless of fair value. As a result, we remove any fair-value marks on liabilities.

On the other hand, we maintain that fair value is the best way to measure financial assets. Accordingly, we mark held to maturity securities to market.

Finally, the deferred tax adjustment on the above changes applies an effective tax rate of 30% across the board to all banks.[4]

After determining adjusted book value, the next step is to estimate sustainable earnings (SE). We do this on a quarterly basis and then sum the last four quarters (Q2 2008–Q1 2009) for a TTM figure. We deem losses as inherently unsustainable so any negative values for SE are set to zero.

The formula for SE is as follows:

SE = Pre-tax income
+ LLP as recorded by the bank for those quarters
- LLP as estimated by Gradient for those quarters
+ Amortization/impairment of intangible assets
- Realized gains (losses)
+ Sustainable gains on AFS securities (see below)
- Taxes at 30%
- Preferred stock dividends and minority interest

For sustainable earnings, we recognize that the LLP (i.e., loan-loss provision) consists of two components, the necessary provisions for new loans and a catch-up provision for previously inadequate provisions on old loans that are being charged off at a higher rate than previously assumed. The latter is a consequence of two things: (1) many banks were overly optimistic in prior periods and accrued less than was prudent and (2) loan quality has deteriorated over the last

[4] It would be inappropriate to apply each bank's effective tax rate given that many banks have losses, and effective tax rates can be quite bizarre in the case of losses (since the amount of earnings is the denominator in the effective tax rate calculation).

two years to an apparently unexpected extent. As a consequence, many banks have taken huge catch-up provisions in the past year. But we cannot necessarily expect the same level of charges to be required on a sustainable basis. Ideally, sustainable earnings should only count the provisions needed for the current period's lending activities and fully exclude the catch-up component. We estimate the LLP as the ALL we've calculated spread over a four-year period (thus 1/16 of the allowance is taken as sustainable expense each quarter).

The add-back for amortization is necessary because we don't want to penalize banks that have been forthright in taking appropriate impairment charges, and in any case it would be unfair to remove the benefit of the asset in determining adjusted book value and not remove the expense as well.

Realized gains or losses are arbitrarily based on a bank's strategy for selling its assets and its impairment policy which seems to vary considerably across banks. We do not want to penalize banks with aggressive impairment charges (i.e., conservatively stated earnings). However, we do think that unrealized losses should be reflected in sustainable earnings as they will need to be recognized eventually. Thus, we take the combination of realized and unrealized gains or losses on available-for-sale (AFS) securities and amortize it over five years (thus each quarter's sustainable earnings includes 5% of the total net gains).

STEP 3 : EXPLAINING STOCK PRICES, BASIC MODEL

The next step in the modeling process is a linear regression of the following equation:

$$\frac{MV}{TA} = \beta_1 \frac{ABV}{TA} + \beta_2 \frac{SE}{TA}.$$

The purpose of the regression is to explain the market value (MV) of each bank at the current time. To predict market value, we use our estimates of adjusted book value and sustainable earnings. All variables are scaled by total assets (TA) to adjust for size differences across banks.

In essence the model is combining simple pricing multiples to adjusted book value and sustainable earnings as we measure them. The multiple on book value is 0.64 and the multiple on earnings is 5.70. Thus, if two firms have exactly the same book value, the firm with \$1 more in earnings should have a stock price that is \$5.70 higher.

Compared to our model from last fall, the marginal value of book equity has declined (it was 1.44 on average), as we would expect given that liquidity-related concerns have moderated somewhat. On the other hand, the marginal value of earnings has increased (it was 2.73 on average). This result is also consistent with expectations, given that we would expect the market to begin to focus more on future earnings now that liquidity-related risks are beginning to moderate. Notwithstanding the foregoing, we should also note that changes in model

design could also explain some or all of the shifts in both multiples. Still, the current model's parameter estimates are closer to theoretical values.[5]

Next we compare this predicted market value to each bank's actual market value to construct a measure of over- or undervaluation. However, not all relevant values have been taken into account yet, so this over-valuation measure is analyzed further in the final stage.

STEP 4: SUPPLEMENTAL VALUE MODELING

This step uses two types of variables to explain why some firms are richly (poorly) priced relative to their adjusted book value and sustainable earnings. We consider growth rates since theoretically they should affect valuation multiples. We also consider securities portfolio variables given our concerns that many banks may have materially mispriced securities that effectively distort book value.

We considered the following growth rates:

- Year over year (YOY) change in net income/assets (profitability growth)
- YOY change in adjusted book value
- YOY change in total assets

These growth measures are highly correlated and we ultimately used just the best fitting of the three, which was the YOY change in ABV.

We also considered the following securities portfolio variables (all of them scaled by total assets):

- Value of AFS securities (total) at cost
- Fair-value markdown on AFS securities
- Value of HTM securities (total) at cost
- Fair-value markdown on HTM securities
- Value of MBS securities at cost (mortgage-backed)
- Fair-value markdown on MBS securities
- Value of ABS securities at cost (asset-backed)
- Fair-value markdown on ABS securities
- Trading assets at fair value

Of these, six variables proved useful in explaining valuation, AFS at cost and markdown, HTM at cost, MBS at cost, ABS at cost, and trading assets.

Thus, the final model is estimated using a linear regression on the following:

[5] The October *Issue Commentary* stated that "in theory, the first value [multiple on ABV] should be less than $1 and the second [multiple on SE] should be higher than it is (1/cost of capital). The current values suggest that the market is very concerned right now with survival, and less with earnings prospects." That appears to have changed.

$$\ln\left(\frac{MV}{IV}\right) = \alpha + \beta_1 \frac{ABV_{Q1\,2009}}{ABV_{Q1\,2008}} + \beta_2 \frac{AFS}{TA} + \beta_3 \frac{AFS_{mark-down}}{TA} + \beta_4 \frac{HTM}{TA} + \beta_5 \frac{MBS}{TA} + \beta_6 \frac{ABS}{TA} + \beta_7 \frac{Trading}{TA}.$$

MV is market value and IV is intrinsic value as estimated by the Stage 3 model. By taking the log of the overvalue measure, we ensure that the factors considered at this stage affect valuation proportionally. This guarantees that our estimate of value cannot be negative (which is impossible for common stock because of limited liability). All of the variables are statistically significant.

As-expected growth is a positive factor, while MBS and ABS holdings are negative factors. High holdings of other security types (such as U.S. government bonds) are a positive factor. Of note, large fair-value markdowns have a positive valuation. This could mean either the market is rewarding banks that mark down aggressively (and are thus more conservative than their counterparts) or that the market expects the markdowns to mean revert eventually.

We can use this final model to adjust our intrinsic value estimates. Then, by comparing the final intrinsic values to market prices, we derive our quantitative scores for every bank.

With regard to our final scores, we expect that any bank that has a market price higher than the model's estimate is more likely to decline in value than the average bank over the next year. In contrast, banks with stock prices below our intrinsic value estimate are more likely to increase in value relative to the sector as a whole.

The overall fit of our model is very good. As indicated earlier, we explain 83% of the variation in market values (as a ratio of total assets). Our view is that the 17% we can't explain is at least in part due to mispricing that will mean revert with the passage of time.

Using the Model to Identify Banks Likely to Outperform or Underperform the Sector

SUMMARY OF OUR FINDINGS

We use our statistical model of bank value to estimate what we'd expect each bank's stock price to be, then compare it to the current price. This provides an estimate of under or over-valuation for each of the 145 sample banks. However, there is clearly a limited amount of information accounted for by the model. For example, an extreme valuation could result as a result of a mismeasurement in the financial statements that we have not corrected for or material post-reporting-period events. Thus, we have used the model as a screening device to identify potential under and over-valuation candidates. We then conducted a bank-by-bank review to ensure that the banks we highlight in this report do indeed appear to have good (bad) earnings and asset quality, based on management's disclosures, and are, in our view, likely to outperform

(underperform) the sector going forward. Based on our review, we have identified four banks at each end of the spectrum that appear to have stock prices too high or low to be justified by their financial condition.

Below we provide a high level summary of our findings. In the final section of the document, we provide a more detailed analysis of each of the eight banks selected for review.

POTENTIALLY OVER-VALUED

Citigroup (C) is the most over-valued bank according to our model. In fact, the estimated over-valuation is 262%. When we last covered the firm recently, we had assigned our lowest grade (F). With shares collapsing shortly after that final downgrade and the government clearly communicating its intent to backstop the remaining large banks, we discontinued coverage on 01/20/09. Still our view of the company's earnings quality is that it remains abysmal. In other words, absent the backstop, shares would be worth next to nothing. From the perspective of our model, C appears massively overpriced even at $3.04 a share. However, the Federal backstop effectively truncates what would otherwise have been the firm's true downside risk. This backstop may be worth some premium over our theoretical price (although it depends on whether further government funding to prop up Citigroup will spare the shareholders or dilute them to irrelevance; the backstop of GM saved the company but did little for investors). In any case, we would not want to invest in C with the intent of capitalizing on future share-price appreciation or dividends. It could take a very long time for that to occur.

Commerce Bancshares (CBSH) is an example of a regional bank that largely escaped the subprime crisis only to be ensnared by a broader credit crisis this year. In this regard, the balance sheet appears to be declining in quality, but the market has yet to reflect this shift. We are particularly dismayed by a large income-statement-skipping "impairment" of securities that took advantage of a recent FASB rule change. By our estimate, shares are overpriced by 50% relative to the banking sector as a whole.

Cullen/Frost Bankers (CFR) is in a similar situation as CBSH, but without the dubious securities "impairment." It is also not quite as overpriced, but at a 35% premium to our estimate of intrinsic value (which does not reflect these qualitative observations), it also may be materially overvalued.

Finally, Valley National Bancorp (VLY) has reported some questionable accounting for large securities positions, including more than $100 million in losses on trust preferred that have been completely unrecognized as well as a large transfer of lower-quality securities to Level 3 valuation in Q1 2009. Despite these issues (which could not be evaluated by the model), VLY is priced at 30% above our intrinsic value estimate.

POTENTIALLY UNDERVALUED

With one exception (FCNC.A), this category includes some companies with serious blemishes. However, in our view, the stock market may have imposed an excessive penalty for these shortcomings within the past year. To this point, you aren't likely to find bargains in this market without taking some risks, as the sterling high-asset-quality banks generally trade at a substantial premium. Our picks as potentially undervalued banks include the following:

Bank of America (BAC) ranks at the top of our list, with an estimated undervaluation of 54%. The stock has been crushed in the past year (down to $12.35 from a 52-week high of $39.50). Admittedly, the balance sheet is very weak, but the bank should have the earnings power to repair it over time. While the company has made some terrible deals in the last year, of all the large banks, we see BAC as having the best upside potential going forward. As noted earlier, however, this upside potential comes with a degree of additional risk.

JPMorgan Chase (JPM) is a somewhat safer version of BAC. In addition, management has been much more prudent with respect to deals made in the last year. Its valuation is also nearly as attractive, with an undervaluation of 38% by our model. Considering that the model probably penalizes JPM unfairly for its loans acquired from WM in September (loans which we believe actually may be undervalued as a part of the acquisition process but with an offset in the form of an extraordinary gain which our model reverses out), the true discount on the shares is likely to be even larger.

First Citizens Bancshares (FCNC.A) is the lowest risk pick amongst those we view as potentially undervalued. With a loan portfolio with few non-performing assets and a securities portfolio consisting of Treasuries, the bank has a lower potential reward than the other banks in this *Commentary*. But on a risk-adjusted basis, the discount to estimated intrinsic value of 14% may still be attractive. Thus, we see it as one of the better investment choices in the sector for those who are more risk averse.

Finally, Marshall & Ilsley (MI) has had a rough year as shares have fallen approximately 70% over the last 12 months to less than $5. In our view the company appears likely to be turning the corner with respect to loan-portfolio deterioration. Thus, while it remains a relatively weak company, the stock is sufficiently cheap and the risk of insolvency so small that we see mostly upside. The model estimates that shares are underpriced by 50%.

On the following pages are more detailed discussions of each of the eight banks highlighted in this report.

06.25.09

Issue Commentary

Citigroup Inc.
399 Park Avenue
New York, NY 10043
(212) 519-1000
www.citigroup.com

Money Center Bank	INDUSTRY
16.76 billion	MARKET CAPITALIZATION
$3.04	RECENT CLOSING PRICE
NA	PRICE-EARNINGS RATIO
23.1%	SHORT INTEREST
VIEW	NEG

Scale +/-

WE'VE COVERED CITI PREVIOUSLY, WITH AN F GRADE

On 10/17/08, we issued a *Bulletin* on Citigroup (C) initiating an Earnings Quality Grade of F. The key reasons for concern were questions regarding valuation of a large pool of potentially impaired Level 3 assets, adequacy of loan-loss reserves, and distortions caused by fair valuation of long-term debt.

Following that report, C dropped from $15.90 to $2.80 on 01/20/09, at which time Gradient discontinued coverage. Importantly, the reason for discontinuation was not any discernable improvement in earnings or asset quality, but simply the huge decline in stock price. Indeed, our discontinuation *Note* states "as a result of hubris, greed, and mismanagement, there is simply nothing of tangible value left for common shareholders."

ON EARNINGS QUALITY, CITI IS IN A CLASS ALL ITS OWN

In the five months since discontinuation, nothing has changed in our assessment of Citigroup. Indeed, singularly among all the 145 banks we analyzed for this *Commentary*, C really does appear to have essentially no tangible value left. Our model estimates its adjusted book value of common equity at 0.5% of assets. The median of all banks in the sample is 6.6%. The second worst bank with at least $1 billion market value is Wells Fargo (WFC) with a much better ratio of adjusted equity to assets of 2.6%. Another grim stat for C is an estimated allowance shortfall of $31.7 billion (92% of the allowance). The median deficiency is 19%.

Citigroup's horrible balance sheet might not be so troublesome if there was serious hope of earning its way out of the deep hole it is in. Unfortunately, by our estimate Citigroup is one of the few banks with no sustainable earnings. Net income available to common shareholders as reported has been negative for six consecutive quarters. Worse, the losses cannot simply be attributed to one-time impairments and other unsustainable events. While Citigroup has had plenty of those, our model suggests that trailing 12-month earnings after adjustment for unsustainable components is a loss of $4.3 billion (79 cents per share). A handful of other banks in the sample had negative adjusted earnings, but every one of them had market value less than $300 million. Citigroup is the only bank in the U.S. of any meaningful size that appears to have been losing money on a core basis over the last year. It should be noted that C did generate positive sustainable earnings in Q1 2009, but that quarter was wildly profitable for most banks in the country.

Given the full suite of problems at Citigroup (we haven't even mentioned the company's massive pension deficiencies), it is no wonder that the firm is by far the most over-valued bank in our sample. The model estimates intrinsic value at 84 cents per share—less than a third of the current stock price. Our qualitative assessment of the bank leads us to see 84 cents as an appropriate estimate of value.

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Commerce Bancshares Inc.
1000 Walnut
Kansas City, MO 64141-6248
(816) 234-2000
www.commercebank.com

Regional Bank	INDUSTRY
2.37 billion	MARKET CAPITALIZATION
$31.06	RECENT CLOSING PRICE
15.23	PRICE-EARNINGS RATIO
2.2%	SHORT INTEREST
VIEW	NEG

Scale +/-

2008 WAS A RELATIVELY CALM YEAR FOR CBSH

Commerce Bancshares (CBSH) is a regional bank operating in the Central U.S. While the average bank earned a -6.0% stock return in 2008, CBSH actually gained 0.3%. Moreover, it largely avoided the wild price swings in the past 12 months that most banks experienced. This is largely due to the fact that CBSH's region did not see the severe real estate bubble that characterized other parts of the country, and in any case CBSH did not engage in subprime lending (in fact, residential mortgages are only 15.5% on its loan portfolio versus the median of 19.9% for all banks).

EARNINGS AND ASSET QUALITY APPEARS TO BE DECLINING

A year ago, we would have seen CBSH as a generally strong firm from an earnings-quality perspective. Indeed, by our model, CBSH appears to have had an excess allowance throughout 2007 and only a minor deficit through most of 2008. That is no longer the case. From Q3 2008 to Q1 2009, our estimate of the required allowance jumped 65.9% while the allowance on CBSH's balance sheet increased just 15.9%. As a result, the firm seems to be short by 62.8% at the end of Q1 2009. Unfortunately, the bank has not maintained an adequate provision level as its loan portfolio has deteriorated, meaning that a significant catch up will probably be required later this year, which will weigh heavily on 2009 earnings.

What seems to have happened is that CBSH largely avoided the first wave of credit defaults (mortgages, especially subprime) only to get hit squarely by a second wave involving other loan categories. CBSH's commercial and consumer loans (including credit cards) comprise 47.5% of its total loan portfolio, compared to just 20.4% at the median bank. These are the categories that have come under the most stress in recent quarters as the national economy has soured. This is reflected in a 164% (61.2%) increase in non-accrual (90 day past due) loans over the last two quarters. Charge-offs have jumped 70.2% over the same six-month period.

Another major earnings-quality concern is CBSH's securities portfolio. It consists largely of mortgage-backed and asset-backed securities (they are 18.9% of total assets, compared to a median of 10.3%). In March, the bank impaired some of these securities, taking a write-down of $21.9 million, but chose to classify just $553,000 of the impairment as part of net income. The other $21.3 million in impairment was included in other comprehensive income based on the claim that the impairment is due to non-credit issues (even though the firm acknowledges the decline in value as other than temporary). In our view, this treatment (allowed under FSP FAS 124-2) misses the entire point of impairment. The firm, by its own assertion (in claiming an other-than-temporary loss), expects to eventually recognize the $21.3 million loss in net income but has merely postponed the day of reckoning. The amount is highly material, representing 48% of Q1 pre-tax income as reported. We also find it convenient that the bank waited until FSP FAS 124-2 was available before recognizing the impairment. Had the impairment been recorded one month earlier, the entire amount would

Issue Commentary

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have been included in determination of net income.

Given our concerns, valuation appears rich

As noted above, CBSH largely escaped the market panic of 2008. Considering that its asset quality is now declining rapidly, we expect that it won't escape a price correction in 2009. Our model estimates the bank's intrinsic price to be $20.72 and our qualitative assessment concurs with that. The current price of $31.06 has a considerable ways to fall to hit that target.

Cullen/Frost Bankers Inc.
100 W Houston St.
San Antonio, TX 78205
(210) 220-5578
www.frostbank.com

Regional Bank	Industry
2.68 billion	Market Capitalization
$45.02	Recent Closing Price
13.40	Price-Earnings Ratio
9.3%	Short Interest
VIEW	NEG

Scale +/-

2008 was a good year for CFR

Cullen/Frost Bankers (CFR) is a regional bank operating in Texas. CFR's story is very similar to Commerce Bancshares. While the average bank earned a -6.0% stock return in 2008, CFR actually gained 3.1%. The bank benefitted in 2008 from having very few residential mortgages. As a consequence, loan performance remained solid overall during the year.

Earnings and asset quality appears to be declining

A year ago, we would have seen CFR as a generally strong firm from an earnings quality perspective. Indeed, by our model, CFR appears to have had an excess allowance through Q4 2008. However, just as with CBSH, while the residential mortgage crash didn't hit CFR, a second credit-quality wave has. CFR's major problem is its commercial loans, which are 73.6% of total loans when commercial mortgages and leases are included. Commercial loans saw a 98.4% increase in non-accrual amounts just from Q4 2008 to Q1 2009. This sudden increase in loan difficulties explains why our model raised its target allowance by 50.0% this past quarter. Unfortunately, the bank only raised its allowance by 3.9%. As a result, the bank is now well short (by 35.2%) of where we believe they should be.

Bank is still reasonably solid, but valuation is steep

The allowance deficiency is not yet at a highly concerning level, and capital remains adequate (adjusted book is 9.0% of assets). Nevertheless, CFR is carrying a valuation premium to the sector that may no longer be justified (1.92x adjusted book value versus 1.22 median and 12.3x sustainable earnings versus 9.2 median). Overall, our model estimates intrinsic value for CFR at $33.43. Given that the current price is $45.02, we see more downside than upside for this stock.

Issue Commentary

Valley National Bancorp
1444 Valley Road
Wayne, NJ 07470
(973) 305-8800
www.valleynationalbank.com

Regional Bank	INDUSTRY
1.55 billion	MARKET CAPITALIZATION
$10.95	RECENT CLOSING PRICE
16.39	PRICE-EARNINGS RATIO
11.1%	SHORT INTEREST
VIEW	NEG

Scale +/-

2008 WAS A DIFFICULT YEAR, BUT STOCK HAD 17% RETURN

Valley National Bancorp (VLY) is a regional bank operating in New Jersey and New York City. VLY is an oddity in that its stock performed even better than CBSH and CFR in 2008. Unlike those banks, VLY actually had a difficult year operationally, due to its concentration in real estate lending (67.4% of total loans), including an above-average proportion of residential mortgages (24.3% of total loans). VLY's real estate loans rose 111% YOY in 90 days-past-due amounts in 2008. The bank's difficulties were enough to compel the company to accept $300 million in TARP funds. Why the stock did so well in 2008 is an interesting question.

ALL ADEQUATE BUT CUSHION FALLING

VLY entered the credit crisis with a fairly strong allowance. As of Q1 2007, VLY's allowance was 41% higher than our model estimates was necessary. Over time, that cushion has been steadily drawn down to just 18% in Q1 2009. This fact enabled VLY to avoid the catch up provisions that many other banks found necessary in recent quarters, providing on a relative basis a boost to earnings.

CONCERNS ABOUT SECURITIES PORTFOLIO

Two issues regarding VLY's securities portfolio worry us. First, the bank has a $104 million fair-value loss on trust-preferred securities that are classified as held to maturity. Because of the classification, the loss has not been recognized in any way on the face of the financial statements. Trust preferred is essentially a form of preferred stock (albeit with a long finite life and different tax characteristics). Such a large decline in value (36.7% of carrying value) is presumably due to severe credit risk for the issuer of the securities. That suggests to us a high likelihood that VLY will never recover the loss regardless of its intent to hold to maturity and raises the question of why this loss has not been recognized as an impairment.[6]

Our second concern is a reclassification of $149.6 million of securities from Level 2 to Level 3 valuation in Q1 2009. The securities in question are trust-preferred securities and private-label MBSs. These are precisely the riskiest securities in their portfolio. The transfer to Level 3 is troublesome as it substitutes the bank's judgment for the market's judgment in valuing the securities.

2009 SAW A MARKET CORRECTION, BUT WAS IT ENOUGH?

VLY did finally see a rapid price decline in early 2009 before rebounding along with the whole sector in March. For 2009 as a whole, VLY has lost 41.2%. Even so, valuation seems high to us. The stock is currently at 1.88x adjusted book value and 10.5x sustainable earnings, both multiples well above the median. The model estimates intrinsic value at $8.45, and given our concerns, that figure seems reasonable. Thus the current price of $10.95 seems a bit high.

[6] There is also an unrealized loss of $33.6 million on AFS trust preferred (58.6% of cost). We question why this amount has not been impaired as well given the severity of value decline.

14614 N. Kierland Blvd., Suite S-260
Scottsdale, Arizona 85254
Tel 480.998.8585 Fax 480.998.4747

products@gradientanalytics.com
www.earningsquality.com
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Issue Commentary

06.25.09

Bank of America Corp.

100 N Tryon Street
Charlotte. NC 28255
(704) 386-6699
www.bankofamerica.com

Money Center Bank	INDUSTRY
79.08 billion	MARKET CAPITALIZATION
$12.35	RECENT CLOSING PRICE
14.50	PRICE-EARNINGS RATIO
1.9%	SHORT INTEREST
VIEW	POS

Scale +/-

RECENT PERIODS HAVE BEEN A DISASTER, BUT WE SEE SIGNS OF HOPE

Bank of America (BAC) has been one of the most newsworthy banks in recent years. Its acquisitions of Countrywide and Merrill Lynch were ill-advised at best. The bank was hit almost as hard as anybody by the subprime implosion. The company's balance sheet has become a disaster, with virtually all value destroyed in the last two years. Even so we like the firm.

The key difference between BAC and C is core earnings power. C has destroyed its balance sheet and dug a deep hole that we doubt it can earn its way out of. BAC also dug a hole (not nearly as deep), but the company has retained fantastic sustainable earnings even as it has generated huge realized and unrealized losses on its portfolio. Thus, we expect BAC can earn its way out of near insolvency in a couple of years.

Meanwhile, the market has certainly punished BAC for its missteps. The stock has had a -51.4% return over the last 12 months (dividends included) compared to the 26.8% loss for the median bank. We feel that the bad news has been fully impounded and perhaps over-impounded.

THE BALANCE SHEET IS HORRIBLE

BAC faces huge rates of non-performance on its loan portfolio, with non-accruals at 2.8% of total loans. In addition, 2.3% of accruing loans are 90 days past due. These are extremely high levels. Consequently, our measure of BAC's target allowance is $52.5 billion, second only to C and 61% more than third-place JPM. Since BAC only has $29.0 billion in allowances, it falls well short. Combined with $1.9 billion in unrealized losses hidden from the balance sheet for held-to-maturity securities, it is apparent that the true net worth of the bank is less than the number on the balance sheet. By our model estimate, adjusted book value is just 2.9% of assets, well below the median of 6.6%. With $81.5 billion in Level 3 assets (excluding derivatives) whose market value may be significantly less than reported "fair value," it is plausible that the liquidation value of BAC is near zero.

SUSTAINABLE EARNINGS ARE GREAT

Obviously, the balance-sheet situation is abysmal. But despite the problems there, core income appears very strong. Despite many realized losses and massive catch-up provisions (for under-accruals in earlier years), trailing 12-month EPS is $0.85. When we remove those unsustainable elements, BAC earned $4.28 per share. We expect that more cleaning up of the balance sheet will suppress reported earnings in 2009, but ultimately BAC should emerge in 2010 with really strong numbers.

The key to our recommendation is the fact that price to sustainable earnings is just 2.9. A multiple that low cannot last. Overall, our model suggests BAC is worth $27.08 per share—well above the current price of $12.35. The only risk is insolvency, but it is clear that the Federal government won't allow that, so BAC will have the time it needs to earn its way to full solvency. We see the overall risk-reward proposition to be favorable, even if the risk is high.

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Issue Commentary

06.25.09

JPMorgan Chase & Co.
270 Park Avenue
New York, NY 10017
(212) 270-6000
www.jpmorganchase.com

Money Center Bank	INDUSTRY
125.78 billion	MARKET CAPITALIZATION
$33.46	RECENT CLOSING PRICE
29.66	PRICE-EARNINGS RATIO
1.5%	SHORT INTEREST
VIEW	POS

Scale +/-

BALANCE SHEET IN SOLID CONDITION

JPMorgan (JPM) has seemingly weathered the storm better than most banks despite a high concentration in residential mortgages and consumer debt (60.2% of total loans, including home-equity loans and credit cards in that amount). This is in large part due to the company being more pro-active than most large banks in ramping up its provision as needed. The company has maintained a close match of its actual allowance to the target set by our model. Thus, no nasty surprise catch-up provisions have been or likely will be necessary.

As of Q1 2009, our model sets a target allowance of $32.7 billion, but this is almost certainly too high. The reason is that a significant portion of JPM's loans were acquired in September from Washington Mutual (WM). Those loans are generally poor (which is why WM failed) and would require large allowances if the loans were carried on the books at cost. But they are carried at fair value (at the date of acquisition) and so really don't require much if any allowance (it is built into the $31 billion fair-value write-down in September). Considering that, the true allowance target for JPM should be substantially less than $32.7 billion. JPM has a $27.4 billion allowance, so in our view the company is on target.

Even without an adjustment for WM loans, the model estimates JPM's adjusted equity as 4.2% of assets. While not as large as we would prefer, it is among the strongest of the money center banks. Indeed, JPM is so confident of its financial strength, it has paid back the TARP loan forced on it by the government.

STRONG EARNINGS AND GROWTH

By our estimate, sustainable earnings are $3.72 per share. While this is down slightly over the last year, it is better earnings stability than most other money center banks. The level of sustainable earnings implies a PE of 9.0, lower than the average bank. Moreover, JPM is rare among banks in actually growing its adjusted book value over the past year (by 9.4%). Moreover, we feel the growth has been smart. Snatching Washington Mutual's massive branch network for almost nothing at the bottom of the market seems to have been a shrewd deal.

BEST VALUE AMONG THE LARGE BANKS

The model estimates JPM to be worth $54.26 per share even as it undervalues the WM piece (as discussed above). Since the current price is $33.46, JPM seems like a real bargain, and relative to BAC it entails significantly less risk.

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Issue Commentary

First Citizens Bancshares Inc.
4300 Six Forks Road
Raleigh, NC 27608
(919) 716-7000
www.firstcitizens.com

Regional Bank	INDUSTRY
1.33 billion	MARKET CAPITALIZATION
$127.72	RECENT CLOSING PRICE
19.79	PRICE-EARNINGS RATIO
1.0%	SHORT INTEREST
VIEW	POS

Scale +/-

AN ISLAND OF STABILITY IN A TURBULENT MARKET

First Citizens Bancshares (FCNC.A) is a regional bank based in North Carolina but spread across several states. First Citizens has avoided the volatility that characterized the stock market in the last year, and the stock has a 12-month return of -11.3% (versus a median of -26.8%).

CONSERVATIVE BALANCE SHEET

First Citizens is principally a commercial lender (53.3% of total loans, including commercial mortgages). It appears to choose its loans very carefully, as evidenced by the fact that only 0.7% of all loans are either non-accruing or 90 days past due in Q1 2009, an extremely low level. Moreover, the firm has conservatively maintained a high allowance for a long time and increased it further. By our estimate, the allowance is currently 35.0% higher than needed.

The balance-sheet conservatism is also apparent from the securities portfolio. Remarkably, 91% of First Citizens' securities are U.S. Treasuries. If anything, this bank takes safety too seriously in its asset allocation. Nevertheless, it has clearly served the company well in the last year.[7]

Unsurprisingly, given the bank's careful behavior, it has a very large capital cushion. By our measure, adjusted book value is 8.1% of assets—well above the median of 6.6%.

EARNINGS HAVE NOT BEEN AS STRONG

The company has continued to produce solid earnings but at a diminished rate. This is perhaps unsurprising given that commercial loans have been lagging in performance of late. Moreover, while most banks have seen great Q1s earnings-wise, it is largely due to recovery from 2008 losses. Since First Citizens never had those losses, it has received no bounce-back. That said, the firm is poised to produce steady earnings in a good economy or bad.

THE ANTI-BAC

First Citizens is the opposite of BAC in many ways. It has a safe, solid balance sheet but mediocre earnings. We like both, but in different ways. BAC will perform really well if the economy rebounds strongly, while FCNC.A will maintain value if the recession deepens. In general, we view the current price of $127.72 as a bargain compared to the estimated intrinsic value of $148.92.

[7] One risk is a loss of value on Treasuries in Q2 2009, when interest rates increased substantially. This risk is mitigated by the relatively short duration of the bonds, with none more than five years to maturity and nearly half less than one year.

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Issue Commentary

Marshall & Ilsley Corp.
770 N Water Street
Milwaukee, WI 53202
(414) 765-7801
www.micorp.com

Regional Bank	INDUSTRY
1.26 billion	MARKET CAPITALIZATION
$4.76	RECENT CLOSING PRICE
NA	PRICE-EARNINGS RATIO
6.5%	SHORT INTEREST
VIEW	POS

Scale +/-

BEATEN DOWN STOCK MIGHT BE A BARGAIN

Marshall & Ilsley (MI) is a regional bank based in Wisconsin but spread out as far as Arizona. MI has been battered by the market, with a -70.2% return over the last 12 months. At just $4.76 a share, our question is whether the stock is attractively priced at this level.

HOW BAD IS IT?

There is no mystery why the stock has performed so poorly. The wreck of the Arizona real estate market has caused a surge in non-performing loans (15.2% of Arizona loans are non-performing compared to 3.5% for the bank's non-Arizona loans). Overall, non-accruing loans increased 168% YOY in Q1 2009. This required a massive increase in provisions to keep up with the decline in loan quality. Along with huge goodwill impairments, this caused MI to record a $2.1 billion net loss in 2008. The firm's difficulties led it to take $1.7 billion in TARP funds. Q1 2009 was little better with a net loss for common shareholders of $117 million.

THERE IS A SILVER LINING

2008 was a nightmare year for MI, but there are positive signs in 2009. The loan portfolio has turned a corner. While non-accruals continue to rise, our forecasted charge-offs show a predicted decline going forward. Meanwhile, the bank has been ramping up its allowance. After falling way behind in 2008 (an estimated deficit of 87.7% at year end), it has started catching up and is only short by 52.5% of our target for the allowance. That isn't great, but it shows clear improvement in the situation.

While the loan portfolio quality did fall rapidly, the bank's overall capital level is not really that bad. We estimate that adjusted book value is 5.8% of assets, not far below the median of 6.6%. There are many banks in worse shape than MI, but not as many with stock prices so beaten down.

ANYTHING IS ATTRACTIVE AT THE RIGHT PRICE

Well not Citigroup, but MI is a long, long way from that. On a sustainable basis, MI generates $1.47 in EPS. Given the stock price of $4.76, that implies a PE of 3.2. Even more remarkable, adjusted book value is $11.71 per share even after adjusting for the recent stock offering, 2.5 times the stock price. If we thought MI had a serious risk of insolvency, we might be deterred. But since we don't, the valuation appears extraordinary. Overall, our model estimates MI's intrinsic value to be $9.54, perhaps making this stock the biggest bargain in the banking sector.

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14614 N. Kierland Blvd., Suite S-260
Scottsdale, Arizona 85254
Tel 480.998.8585 Fax 480.998.4747

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