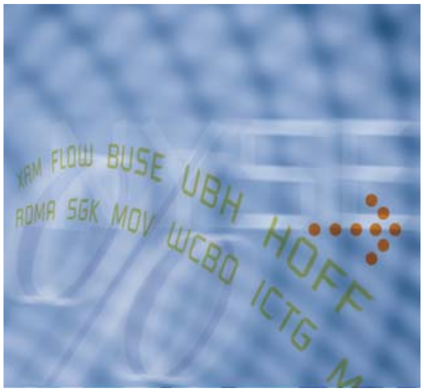

EarningsQuality ANALYTICS™ EQA

Issue Commentary

Analyst: Michael Williams (PhDs in Accounting and Economics)

15 March 2010

Revisiting Earnings Quality and Valuation in the Banking Sector

In three prior *Issue Commentaries*, we have utilized our earnings-quality-based, bank valuation model—supplemented by analyst review of company financial statements—to identify banks that may be relatively overvalued or undervalued relative to peers. Our recommendations have consistently provided positive excess returns (in 15 of 21 cases, with an overall average excess return of 9.3%). (Note: Returns for negatively rated stocks have been sign adjusted.)

Based on the model's evaluation of Q4 2009 data, we have identified several banks that we believe may be mispriced. Specifically, we provide four positive and four negative recommendations. It should be noted that our model is focused on relative valuation and, as before in these *Issue Commentaries*, we do not attempt to assess whether the sector as a whole is overvalued or undervalued.

US Bancorp (USB)	*Page 9*
2009 income included numerous unsustainable items. Loan-portfolio quality also appears to be declining rapidly.	**–**
PNC Financial Services Group (PNC)	*Page 10*
We have serious qualms about acquisition accounting that appears to have given a large boost to 2009 earnings but is less likely to help in 2010.	**–**
BB&T Corp. (BBT)	*Page 12*
Seemingly one-time items comprised 72% of 2009 earnings. The bank has also begun accruing interest on 90-day past-due construction loans.	**–**
M&T Bank Corp. (MTB)	*Page 13*
The stock price continues to soar even as the bank's loan portfolio is showing signs of rapid decay.	**–**
Regions Financial Corp. (RF)	*Page 14*
Huge catch-up provisions and securities losses hurt 2009 earnings. But all signs suggest 2010 results will be substantially better.	**+**
Marshall & Ilsley (MI)	*Page 15*
A recent stock-price decline has returned the bank to an attractive valuation. The loan portfolio is improving at a swift pace.	**+**
Zions Bancorp (ZION)	*Page 16*
Last year's results were dragged down by catch-up provisions. However, earnings should recover in 2010 now that reserves are more substantial.	**+**
East West Bancorp (EWBC)	*Page 17*
Despite its recent stock-price increase, we feel it is an attractive prospect because of the likelihood of significant 2010 profits from a recent acquisition.	**+**
EARNINGS QUALITY VIEW	*Scale +/-*

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Issue Commentary

Model of Bank Stock Prices

BRIEF OVERVIEW OF MODEL

We are using the latest iteration of the same model used in our earlier *Issue Commentaries* of 06/25/09 and 09/29/09. Please refer to the earlier reports for a full specification of the model (before the changes discussed in more detail previously).

The model's objective is to identify banks that may be overvalued or undervalued, relative to peers, given their own specific economic situations. To that end, we model two key drivers of value: net asset value of the business 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 and the composition of its securities portfolios.

The model is based on accounting measures taken from regulatory filings (call reports) and estimated using a multistep regression analysis to derive a relative value estimate for each of the 139 largest commercial bank holding companies in the United States (by market value) with continuous regulatory data since 2007.[1]

The resulting intrinsic value estimates from the model are then compared to actual stock prices to assess overvaluation and undervaluation of the sample banks on a relative basis. We subsequently use this comparison as a starting point in selecting a subset for an analyst review.

CHANGES TO THE MODEL SINCE OUR LAST PUBLICATION

Fundamentally, the model is similar to what we have used in the past.[2] However, we have made one important change. Previously we predicted charge-offs by loan category one quarter ahead, then set our estimate of the ideal loan-loss allowance equal to seven times total forecasted charge-offs. (Note: This ideal allowance is used to adjust both net asset value and earnings). With more data now available in the financial crisis period, we have decided to extend the charge-off forecast to two quarters ahead.

When predicting two-quarters-forward charge-offs, we use additional variables. Previously, we only considered historic charge-offs and nonaccrual loans. In making projections for two quarters ahead, we also consider past-due and accruing loans (both 90 days+ and 30–89 days). For some loan categories (such as residential mortgages), past-due amounts don't matter statistically for two quarters because the charge-off process proceeds at a slower pace. In contrast, past-due amounts are very important for predicting charge-offs on home equity loans, especially in the 30–89-day category (and even more important for credit cards). This change highlights one of the key advantages of our model—that the

[1] This excludes recent bank holding company conversions, such as Goldman Sachs. The original sample from last year had 150 banks, but some of them were dropped due to their disappearance or data limitations.
[2] We have also added two additional quarters of data and re-estimated all of the statistical parameters.

loan-portfolio analysis is conducted on a disaggregated basis, allowing differences in the nature of various loan types to be taken into account.

One final change to the model is that the ideal loan-loss allowance is now estimated as three times our estimated charge-offs for the next two quarters (Q1 and Q2 2010). Thus, we are now assuming that banks should have a total of six quarters of future charge-offs accrued. That is down from seven quarters in 2009 and eight quarters in 2008. As the credit crisis nears its peak and the rate of charge-off growth slows, the prudent level of allowances should decline on a relative basis, and to be fair to the banks in our sample, we need to adjust our allowance recommendations accordingly.

REVISITING GRADIENT'S SEPTEMBER 2009 *ISSUE COMMENTARY*

We highlighted eight banks in our last report, four that we felt were likely to be relatively overvalued and four that were relatively undervalued. In the intervening five-plus months, bank stocks have moved up slightly, with the SPDR KBW Bank ETF up 6.7% since our publication on 09/29/09. Both our positive and negative picks are up overall, but the positives have outperformed the negatives by 7.0% in five months (see Table 1 for details).

Overall, the results are good and in line with even stronger results in the two prior *Issue Commentaries*, although we are disappointed by the strong showing of three of the negative picks. In particular, U.S. Bank (USB, up 15.5%), PNC Financial Services (PNC, up 24.6%), and M&T Bank (MTB, up 29.0%) all had unexpectedly high returns. On the other hand, we remain steadfast in our view that these banks are overvalued. And given that the model once again ranked these three firms near the top of the list of potentially overvalued banks, all three are once again included in our *Issue Commentary*.

On the positive side, Fifth Third (FITB, up 33.9%), Prosperity (PRSP, up 15.9%), and Susquehanna (SUSQ, up 37.3%) have all done very well. The one relative laggard, Regions Financial (RF, up just 11.6%) continues to rate as significantly undervalued according to the model. It, too, is included again in our *Issue Commentary*.

When we combine the most recent *Issue Commentary's* performance with the prior two,[3] we have made a total of 21 picks, of which 15 provided positive (sign-adjusted[4]) excess returns. Overall, the 21 stocks had an average excess return (relative to the banking sector overall) of 9.3%. Our positive picks have been especially solid, with 11 out of 13 providing positive excess returns, averaging 16.0% overall.

[3] The performance of the 13 earlier picks is disclosed in the last two *Issue Commentaries*. In each case, performance is measured over the period between consecutive commentary publications.

[4] By "sign-adjusted" we mean that negative excess returns on banks that we believed to be overvalued are multiplied by -1 to allow us to combine returns for positively and negatively rated banks.

Table 1: Stock Returns for September *Issue Commentary* Picks
(Excess return is relative to the KBE bank ETF return of 6.7%)

	Return	Excess return	Current price	Percent Difference Between Current Share Price and Estimated Intrinsic Value
Positive picks:				
FITB	33.9%	27.2%	13.15	-8.8%
RF	11.8%	5.1%	7.34	-30.4%
PRSP	15.9%	9.2%	40.77	4.1%
SUSQ	37.3%	30.6%	8.32	-41.0%
Average	24.7%	18.0%		
Negative picks:				
USB	15.5%	-8.8%	25.67	46.7%
PNC	24.6%	-17.9%	57.86	24.0%
MTB	29.0%	-22.4%	80	38.5%
FHN	1.7%	5.0%	13.39	18.2%
Average	17.7%	-11.0%		
Spread between positive and negative	7.0%			

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 intrinsic value for each firm, then compare it to the current share price. This provides an estimate of undervaluation or overvaluation for each of the 139 sample banks. Using the model output supplemented by a qualitative earnings-quality review, we have identified four banks that we believe are likely to be overvalued and four likely to be undervalued. In compiling the list, we did not consider any banks currently under coverage by Gradient (Wells Fargo, WFC, with an F grade, initiated 02/08/10, and Citigroup, C, with a B grade, initiated 01/21/10), but we did reconsider banks covered in the last *Issue Commentary*. Our primary screening metric was absolute difference between market value and estimated intrinsic value (to focus on larger banks), with a requirement that the estimated mispricing be at least 15%.[5]

We summarize the model findings in Tables 2 and 3 for the following banks: the eight banks we are rating in this report (USB, PNC, BB&T, BBT, MTB, RF, MI, ZION, and EWBC), the four largest U.S. banks (JPM, BAC, WFC, and C), and STI (which we recently discontinued). Tables 2 and 3 provide the following information for these banks as well as the median bank in our sample:

[5] Mispricing is defined as (stock price – intrinsic value per share) / max(stock price, intrinsic value per share). The denominator is chosen to avoid extreme values when either of the prices is close to zero. The 15% threshold is applied on an absolute-value basis.

- Current stock price and the model's estimate of intrinsic stock value;
- Absolute dollar and percentage-estimated mispricing;
- Estimated allowance for loan-loss deficiency or surplus; and
- Trend in overall loan quality as measured by growth in nonaccruing loans, past-due loans, and charge-offs

As Table 3 demonstrates, there is good news for the banking industry as a whole with stabilizing loan-quality statistics overall. Indeed, past-due amounts are generally declining after many consecutive quarters of rapid growth. Nevertheless, some individual banks continue to have loan-quality problems, and many banks have growing problems in areas such as commercial real estate. Particularly when these banks with deteriorating loan portfolios have relatively low allowances, there is the potential for high provision expenses in 2010 that will suppress reported earnings. In contrast, banks that have built up plentiful allowances and now have stabilizing loan quality are likely to benefit from significant decreases in their provision expenses in 2010, with a corresponding boost to their reported profitability.

Before proceeding to the eight banks highlighted in this *Commentary*, we will briefly discuss the other five banks of interest.

- We covered JPM in our 06/25/09 *Issue Commentary* with a positive view. JPM still looks good, with one of the most adequately built-up allowances in the country. While nonaccruing loans are still growing at a fast rate (7.3% QOQ), 30–89 days past-due loans are down 5.2% QOQ, which is a good sign going forward. (Note: Total loans fell just 2.6% QOQ). We expect that JPM will be able to cuts its provision costs in 2010, and we are moderately positive on JPM for the longer term. That said, the current stock price appears to impound these expectations, so we remain neutral on its current valuation.

- We also covered BAC in our 06/25/09 *Issue Commentary* with a positive view. Since then, trends have not proven as favorable as we had hoped. The bank's loan-loss allowance is in line with the overall industry median, but loan-quality metrics have deteriorated. Nonaccruing loans (up 7.4% QOQ) and 90 days past-due and accruing (up 48.7% QOQ) are both troubling. We are particularly worried about the 90 day past-due amounts. The rapid growth in this category suggests that BAC may have become less conservative in determining when to stop accruing interest on past-due loans. Thus, overall we are moderately negative in our view of BAC, and we will continue to monitor it closely.

- On 02/08/10, we published an *Alert* initiating coverage of WFC with an F earnings quality grade. The latest run from the model confirms our judgment in that report, with an estimated overvaluation of $46 billion (29.8%). Whereas as recently as three quarters ago, WFC's allowance was adequate according to our model, it has now degenerated to an estimated deficiency of 25.2% at 12/31/09. Additionally, trends going forward are not encouraging, as nonaccruing loans jumped 17.0% QOQ while total loans shrank 1.6% QOQ. WFC has the nation's largest pool of 90+ days past-due and accruing loans, at 4.63% of its portfolio (versus an industry median of 0.12%). This suggests less conservative accounting than peers (many of whom stop accruing interest on all loans after 90 days) and is a growing concern.

- On 01/21/10, we published an *Alert* initiating coverage of C with a B earnings quality grade. The latest model output also confirms our judgment in that report, with an estimated undervaluation of $31 billion (21.5%) even after a strong recent run-up. C has done much in the past year to build up its loan-loss allowance, which is now above the industry median. Nonaccruing loans (down 5.4% QOQ) and 30–89 days past-due loans (down 7.2% QOQ) are also showing mildly favorable trends (total loans fell 4.8% QOQ), reinforcing our thesis that C should be able to significantly cut its provision expense in 2010.

- On 02/26/10, we discontinued coverage of STI, removing our prior grade of D. While there are still substantial negatives, notably an estimated 43.0% deficiency in the loan-loss allowance (highest among the top 10 U.S. banks), there are also signs of improvement. Nonaccruing loans declined in Q4 2009 and 30–89 day past-due loans dropped 12.3% QOQ (total loans fell 2.2% QOQ so the past-due decline is impressive). At this point, we are completely neutral on STI.

In the following section, we provide a detailed analysis of each of the eight banks selected for coverage in this *Issue Commentary*.

Table 2: Model Evaluation of 13 Banks Covered in This Report

Ticker (Gradient view):	Stock Price on 03/12/10	Estimated Intrinsic value[6]	Estimated Mispricing ($ in millions)[7]	Estimated Mispricing (%)[8]
BAC (moderately -)	16.85	14.34	25,142	14.87%
JPM (moderately +)	43.15	47.10	(15,692)	-8.39%
WFC (grade F)	29.63	20.80	45,749	29.80%
C (grade B)	3.97	5.06	(30,936)	-21.49%
USB (-)	25.67	13.68	22,933	46.69%
PNC (-)	57.86	44.00	6,391	23.95%
BBT (-)	30.70	23.35	5,079	23.95%
STI (neutral)	26.86	28.46	(799)	-5.62%
MTB (-)	80.00	49.23	3,652	38.47%
RF (+)	7.34	10.54	(3,816)	-30.36%
MI (+)	7.72	9.08	(719)	-15.02%
ZION (+)	20.99	34.45	(2,025)	-39.07%
EWBC (+)	17.64	22.84	(574)	-22.75%

[6] Per share, as estimated by our model. The model is designed so that, by construction, the average bank's intrinsic value equals its market value.
[7] Mispricing is the difference between market value and the model's estimate of intrinsic value. A positive value means the stock appears overvalued and a negative value means the stock appears undervalued.
[8] Mispricing is defined as (stock price – intrinsic value per share)/max(stock price, intrinsic value per share). The denominator is chosen to avoid extreme values when either of the prices is close to zero. The 15% threshold is applied on an absolute value basis.

Table 3: Model Evaluation of 13 Banks Covered in This Report[11]

Ticker (Gradient view):	Allowance deficiency[9]	QOQ growth: non-accruing loans	QOQ growth: 90 days past due[10]	QOQ growth: 30–89 days past due	QOQ growth: net charge offs
BAC (moderately -)	21.28%	7.35%	48.68%	-0.15%	-12.50%
JPM (moderately +)	13.66%	7.31%	10.73%	-5.21%	-3.08%
WFC (grade F)	25.24%	17.01%	11.81%	-5.70%	5.91%
C (grade B)	16.31%	-5.40%	8.50%	-7.22%	-10.47%
USB (-)	31.34%	30.10%	12.84%	29.85%	6.63%
PNC (-)	23.94%	7.41%	-0.20%	-0.24%	28.51%
BBT (-)	24.57%	5.66%	34.01%	-7.93%	9.62%
STI (neutral)	43.02%	-0.77%	-0.58%	-12.32%	-18.43%
MTB (-)	30.34%	8.41%	13.86%	-11.11%	-4.69%
RF (+)	24.17%	5.81%	8.86%	-0.71%	1.64%
MI (+)	42.13%	-9.12%	-33.09%	-19.15%	7.43%
ZION (+)	27.60%	8.38%	-25.05%	-27.54%	-22.78%
EWBC (+)	NM	NM	NM	NM	-13.61%
Median (139 banks)	18.33%	5.04%	-3.21%	-2.75%	7.43%

[9] This is the model's estimate of the shortfall of the loan loss allowance compares to 3x forecasted net charge-offs over the next six months. This is expressed as a percentage of the recommended allowance.
[10] These include only those loans still accruing interest.
[11] Calculations are based on Call Report figures as reported by SNL Financial. These figures may differ from figures provided by the banks in nonregulatory disclosures.

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INDUSTRY	*Regional — Midwest Banks*
MARKET CAP.	*49.12 billion*
PRICE	*$25.67 (03/12/10)*
P-E RATIO	*26.46*
SHORT INTEREST	*2.6%*
VIEW	NEG

Scale Pos./Neg.

POTENTIALLY INADEQUATE ALLOWANCE FOR LOAN LOSSES WITH DETERIORATING LOAN PORTFOLIO

Our model identifies USB as potentially overvalued by 47%. Of course, that was true six months ago as well, and the stock has continued to perform well as discussed earlier. In our view, however, time is running out for USB, and a correction is coming. The signs are, in fact, even worse now than before.

There are three key problems we see at USB. First, we believe that the quality of 2009 earnings compares unfavorably to peers as a result of unsustainable benefits and, in our view, an inadequate loan-loss provision. Second, the quality of the loan portfolio appears to be rapidly declining. Third, the market seems to have been oblivious to these signs of trouble and elevated the stock to what we believe to be an extremely rich valuation.

In our September 2009 *Issue Commentary*, we noted that the loan-loss provision had fallen behind the growth in charge-offs and nonaccruing loans in the first half of 2009. That trend actually accelerated in the second half of 2009. In fact, despite an increase in the overall loan portfolio (by 5.7% QOQ), skyrocketing nonaccruing loans (up 30.1% QOQ) and a surge in 30–89 days past-due loans (up 29.9% QOQ), USB still reduced its Q4 2009 provision by 4.7% QOQ.[12] This explains why the bank's allowance for loan losses (ALL) has progressively become more deficient according to our model. And, at 31.3% under the recommended level (the industry median), the ALL falls well short of the median bank. As a result, we fully expect to see USB record a substantial increase its provision expense this year while most banks are likely to cut their provisions.

USB's earnings also enjoyed other one-time advantages in 2009. As discussed in the September 2009 *Issue Commentary*, USB took advantage of recent accounting rule changes to avoid recognizing impairment costs for available-for-sale (AFS) securities, even though the bank acknowledges the likelihood of permanent loss on them. For the year, this allowed USB to reverse $402 million of losses out of its income statement (nearly all of these losses were on nonagency mortgage-backed securities). At some point in the future, those losses will need to be recognized, barring a major improvement in the quality of those securities.[13]

USB also benefitted from a near quadrupling of mortgage banking revenue in 2009 from prior years. According to the 10K, "fair value changes related to the MSRs [mortgage servicing rights] and the futures, forwards and options, as well as servicing and other related fees, are recorded in mortgage banking revenue." While it is unclear exactly why this line on the income statement grew so much in 2009, much of it was due to net gains on the sale of loans, which totaled $710

[12] The growth in total loans is due to a minor acquisition in Q4 of First Bank of Oak Park. The acquisition undoubtedly explains part of the growth in nonperforming and past-due loans but cannot explain most of it because of the transaction's small size.
[13] That seems unlikely given that the bank acknowledges the losses as other than temporary, and given that the losses persist even after the market for most securities recovered strongly in 2009. Only the really low quality assets are included in this group.

million, up from $220 million in 2008 and $163 million in 2007. None of the components in the mortgage banking revenue line suggest that the 2009 amount is sustainable. The YOY increase in this revenue was $765 million, providing 29.1% of pretax income for the year.

If we remove the impairment reversal and YOY increase in mortgage banking income from pretax income, then apply a 30% effective tax rate (lower than in any year before 2008), and remove minority interest and preferred-stock dividends, we get an adjusted earnings figure of $592 million for 2009, implying EPS of 32 cents for a PE of 80. We regard that valuation as extremely rich. Moreover, an analysis based on adjusted book value suggests an excessive valuation.

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INDUSTRY	*Money Center Banks*
MARKET CAP.	*26.73 billion*
PRICE	*$57.86 (03/12/10)*
P-E RATIO	*13.14*
SHORT INTEREST	*1.7%*
VIEW	NEG

Scale Pos./Neg.

MARKET CONTINUES TO IGNORE WARNING SIGNS AT PNC

Though PNC defied the predictions made in our September 2009 *Issue Commentary*, our model currently estimates that PNC may be overvalued by 24%. Our view is that the concerns identified in the earlier *Issue Commentary* report have yet to be reflected in share price. However, we expect that many of our concerns may weigh on earnings in 2010, and may lead to a share-price correction.

Our concerns two quarters ago were based on rapidly falling loan quality unmatched by increases in the provision during H1 2009 and questions regarding PNC's accounting for the acquisition of National City at the end of 2008. The latter issue, in particular, may explain why the company's share price has not yet responded to the decline in loan quality and need for additional provisions.

The estimated allowance deficiency cited two quarters ago has gotten no worse since September. Moreover, the rate of deterioration in loan quality is slowing somewhat. Nonaccruing loans are up 7.4% QOQ. Past dues are also down (0.2% QOQ for both 90 days+ and 30–89 days), but given that total loans fell 2.5% QOQ, the slight decline in past-due loans is less than encouraging. On the plus side, PNC increased its provision expense in Q4 by 18.7%, which was clearly necessary given that the bank's allowance had been falling behind earlier in the year. We would not be surprised, however, if the company continues to report increases in the provision during at least H1 2010.

NATIONAL CITY MERGER ACCOUNTING RAISES QUESTIONS

On 12/31/08 PNC acquired National City in a stock-for-stock deal valued at $6.1 billion. As expected, PNC imposed significant fair-value marks to the National City loan portfolio (write-down of $7.2 billion or 7% of net loans acquired).

In our September 2009 *Issue Commentary*, we raised concerns about the prospect that the firm's purchase accounting assumptions may have been overly pessimistic in valuing acquired assets, especially purchase credit impaired (PCI) loans. In theory, excess write-downs provide the acquirer with built-in earnings for a period of several quarters. Moreover, the use of post-acquisition adjustments allows for the possibility of selective avoidance of losses on loans that go bad after the acquisition occurs (PNC added $2.6 billion of PCI loans after 12/31/08 but claimed they were impaired as of the acquisition date, thereby avoiding any earnings cost on the $1.8 billion write-down). See our recent *Alert* on WFC (02/08/10) for a detailed analysis of this issue with regard to bank acquisitions at the end of 2008.After an additional six months, we see further evidence that the National City acquisition may have provided a temporary earnings boost to PNC in 2009. If so, however, that the benefit will soon run out.

With regard to loans, a major advantage of PCI accounting is the ability to ignore expense recognition if loans continue to deteriorate, making these loans a virtually guaranteed source of profit. In contrast, loans originated in-house are always at risk of losing money. However, this works only so long as the nonaccretable reserve holds up. If, as in 2009, loan quality declines long enough (especially for commercial and commercial real estate loans), the nonaccretable reserve could eventually prove inadequate and suddenly the bank will need to start recognizing losses on the income statement for PCI loans. According to the recently filed 10K, PNC recorded provision expense of $646 million on PCI loans during 2009. However, we expect that 2010 is likely to see much greater provision expenses on PCI loans than 2009.

Another apparent source of unsustainable income in 2009 from the National City acquisition accounting involves Residential Mortgage Banking income. This line of business was acquired at the start of the year (so it historically provided no income). It was immediately profitable, generating $364 million in pretax profit in Q1 2009. However, with each successive quarter, the profit fell, reaching just $41 million in Q4. The large profits in early 2009 were due to mortgage-servicing rights, hedging gains, and loan sales revenue. These are unsustainable earnings sources that suggest the value of these assets may have been underestimated in the initial purchase-price allocation (certainly relative to what they proved to be worth within just one quarter). Strip out these revenue lines and mortgage banking actually lost $90 million in 2009, compared to the $700 million pretax profit included on PNC's income statement (21.1% of total pretax profit for the company). We do not expect PNC to earn any material net profit on this line of business in 2010.

If we strip out the mortgage banking profits and the one-time gain on the BlackRock/BGI transaction ($1.1 billion pretax), PNC's net income attributable to shareholders in 2009 was $881 million, or $1.94 per share, implying a PE of 29.8, which is rather high, and that is without making any adjustment for the PCI loan portfolio. We do not see such a rich valuation holding up in 2010.

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INDUSTRY	*Regional — Mid-Atlantic Banks*
MARKET CAP.	*21.20 billion*
PRICE	*$30.70 (03/12/10)*
P-E RATIO	*26.77*
SHORT INTEREST	*3.7%*
VIEW	NEG

Scale Pos./Neg.

SURGING PAST-DUE LOANS AND UNSUSTAINABLE EARNINGS ARE WORRYING

We estimate BBT to be overvalued by 24%, in part as a result of an allowance that we estimate to be 25% short of its ideal level. In reviewing the company, we see some other reasons for concern: a high proportion of 90 days+ past-due and accruing loans that is growing very rapidly (34.0% QOQ), net gains on AFS securities due to advantageous accounting for impairments, and an unusual surge in mortgage banking income in 2009 that we believe is likely to be unsustainable.

The growth in loans 90 days past due and accruing at BBT is the highest of any bank we are rating in this report. Given that these loans account for 1.9% of the portfolio it is a highly material concern as the accrual of interest on these loans can provide an unsustainable boost to earnings that will need to be reversed if the loans ultimately prove to be uncollectible. Moreover, while past due and accruing loans can be reasonable and customary for residential mortgages, it is less appropriate for other categories. When we consider those banks (18 of them including all the largest banks) with material 90 day past due amounts (at least 0.5% of total loans) and material domestic residential mortgages (at least 20% of total loans), we find that 66.6% of the median bank's 90 day past due portfolio consists of residential mortgages.[14] At BBT, only 32.6% of the accruing past due loans are residential mortgages. A larger share consists of construction loans, which are a riskier group in general. Up to Q2 2009, these loans almost never would have accrued interest (just $7.3 million in Q2). Two quarters later, BBT has elected to accrue interest on $800 million of construction loans at least 90 days in arrears, a jump of 109 fold in six months.[15] Our view is that this change is unlikely to prove sustainable.

When reviewing BBT's income statement for 2009, two things jump out. First, the bank recognized net gains of $199 million on securities. However, BBT has a securities portfolio with $363 million in net losses.[16] The key is that the bank disproportionately liquidated its winners to provide positive realized gains. The bank did record $172 million in impairment on securities but elected to exclude $131 million of those impairments (76% of the impairments) from its income statement. Eventually, those losses will need to be realized.

The other notable line on the income statement is mortgage-banking income of $658 million, up 139% YOY. We've discussed this same line item for USB and PNC. Mortgage-service fees were just $190 million, up 31% YOY. The bulk of the income was on loan sales (gains of $357 million, up 358% YOY) and revaluation of MSRs (a gain of $190 million compared to losses in the prior two years). Clearly, with a majority of mortgage banking income coming from loan sales and revaluations on MSRs, the profit reported in 2009 is likely to be unsustainable.

[14] To be precise, domestic 1–4 family mortgages excluding home equity lines.
[15] For comparison, nonaccrual construction loans increased 28.5% in the same six-month period. If BBT counted all 90 day past-due loans as nonaccrual, the growth in nonaccrual construction loans would have been 111.4%.
[16] $317 million of the net losses are on non-agency mortgage-based securities.

Issue Commentary

Together the net securities gains, gains on loan sales, and MSR revaluation gains provided 72.0% of BBT's pretax income in 2009. If we remove them, EPS would have been just 18 cents.[17] That implies a PE of 171, which we view as excessive.

M&T Bank Corp.
One M&T Place
Buffalo, NY 14203
(716) 842-5445
www.mandtbank.com

INDUSTRY	*Regional — Northeast Banks*
MARKET CAP.	*9.49 billion*
PRICE	*$80.00 (03/12/10)*
P-E RATIO	*27.65*
SHORT INTEREST	*20.0%*
VIEW	NEG

Scale Pos./Neg.

PROVISION CUT EVEN AS THE ALL IS SUBSTANTIALLY BELOW PEERS

We featured MTB in our last *Issue Commentary* as potentially overvalued. Since then, the stock has performed well. We fail to see much justification for this, as the concerns we previously had are still salient. Consequently, our model estimates that MTB is overvalued by 38%.

We estimate that MTB has developed a substantial allowance deficiency of approximately 30.3%. The loan portfolio has also continued its rapid deterioration, with nonaccruing loans up 8.4% QOQ and 90 days past-due up 13.9% QOQ. The silver lining is a drop in 30–89 days past due of 11.1% QOQ. That is good news, but we question whether it is sufficient to justify a 5.8% QOQ cut in provisions that we previously considered to be on the low side.

Modest provisioning in 2009 resulted in an allowance that grew just 11.4% YOY even though nonaccruing loans jumped 76.3% YOY. The nonaccrual growth was in line with the industry median of 76.3%, but the median bank built up its allowance much better, growing by 29.9% YOY. MTB's failure to build up as much allowed it to report significantly less provision expense than its peers. If the allowance had grown at the median rate, it would have cut pretax income by $146 million (28%).

One of our concerns about MTB expressed in the September 2009 *Issue Commentary* was the firm's failure to recognize substantial securities losses on its income statement. In H1 2009, the bank had taken just $57 million of $139 million in AFS impairments into net income. Moreover, the bank had a much larger pool of securities losses not reflected in any impairment. In H2, this was somewhat mitigated as an additional $125 million in impairments were taken with $81 million running through the income statement. However, with regard to non-agency MBS, the bank still has $381 million in unrealized losses on AFS and $151 million in unrealized losses on held to maturity. For a bank with just $332 million in net income available to common shareholders, that is a significant overhang of potential losses.

[17] This is based on reducing net income before dividends to preferred stock by 72%.

Issue Commentary

EQA

Regions Financial Corp.

1900 Fifth Ave. North
Birmingham, AL 35203
(205) 944-1300
www.regions.com

INDUSTRY	*Regional — Southeast Banks*
MARKET CAP.	*8.75 billion*
PRICE	*$7.34 (03/12/10)*
P-E RATIO	*NA*
SHORT INTEREST	*0.6%*
VIEW	POS

Scale Pos./Neg.

BANK STILL APPEARS TO HAVE A BARGAIN PRICE

RF is the only bank highlighted in our last *Issue Commentary* as undervalued to make the grade again this time. The main reason is that, while the situation at the bank is largely unchanged, so is the stock price, so the bargain remains. As shown in Table 1, RF has the lowest return of all the former positives at 11.8%. Consequently, RF still appears undervalued, by 30%.

As discussed last time, this bank has faced serious difficulties during the recession, with severe loan-quality problems leading to capital erosion that required substantial dilution of the common stock to keep the bank afloat. However, 2009 has seen signs of a turnaround.

Over the course of the year, nonaccruing loans exploded by 158%, the most of any bank covered in this report (except EWBC which is an artifact of its recent acquisition). Fortunately, the growth is subsiding, with just 5.8% QOQ in Q4. RF entered 2009 with a seriously inadequate allowance so the explosion in problem loans forced the bank to make major catch-up provisions that have crushed RF's earnings. RF is one of the rare banks to report a loss in 2009 ($1.26 billion net loss to common shareholders) with an especially large loss in Q4 ($606 million to common shareholders).

Is there an end to these losses in sight? We think so. 2009 provision expenses were unusually large and should prove unsustainable. In Q4, RF expensed 1.70x net charge-offs, compared to 1.25x at the median bank. This is a much higher level than at any of our other featured banks besides ZION (which is 1.73), and it reflected a need to catch up from a position of serious underaccrual of the allowance account in prior periods. But now our model estimates the deficiency at just 24.2%, or close to the median deficiency level. Therefore, with the loan portfolio stabilizing, RF's provision could drop dramatically in 2010.

RF also took a $96 million loss on securities in Q4. As of the year end, however, the bank is in the favorable position of carrying a $431 million net unrealized gain on its securities portfolio with immaterial holdings of non-agency MBSs or other high-risk debt securities. Thus, we are not concerned that the bank will need to recognize further losses in 2010. To the contrary, it may begin reporting gains.

RF is certainly one of the higher risk propositions in the banking sector, but in our opinion the stock remains attractively priced. If the bank keeps its loan losses from increasing and is thus able to slash its provision expense and report a profit in 2010, the stock should rebound from its current level of $7.34.

Issue Commentary

EQA

Marshall & Isley Corp.
770 N Water St.
Milwaukee, WI 53202
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INDUSTRY	*Regional — Midwest Banks*
MARKET CAP.	*4.07 billion*
PRICE	*$7.72 (03/12/10)*
P-E RATIO	*NA*
SHORT INTEREST	*7.4%*
VIEW	POS

Scale Pos./Neg.

LOW-PRICED BANK RETURNS TO OUR RECOMMENDATIONS

We covered MI in our 06/25/09 *Issue Commentary* as a formerly troubled bank that was attractive due to a very low price. The stock proceeded to generate a 78% return over the next three months so we excluded it from our September recommendations. The stock price has fallen since then, but our optimism for the firm's prospects has not. At present, our model rates MI as undervalued by 15%.

First, we must acknowledge as we did last year that MI's allowance has not kept up with the problems in its loan portfolio and stands at a troubling 42.1% deficiency according to our model. That is, however, a lot better than the 87.7% deficiency we estimated a year ago. The bank has improved the situation through very heavy provisioning, resulting in a net loss to common shareholders of $859 million in 2009.

The good news is that the loan portfolio is improving, with nonaccruals up just 33.9% YOY (versus 76.3% for the median bank) and down in Q4 by 9.1% QOQ. Past-due amounts are also trending favorably, down 19.2% QOQ for 30–89 days (the bank has immaterial 90+ days loans as it stops accruing interest on almost all of them at that point). The explanation for this is that MI was heavily involved in Arizona real estate, which was on the leading edge of the credit crisis. MI got hit hardest early on, and now things are getting better while many other banks are still seeing their problems build.

We foresee a drastic reduction in MI's provision costs in 2010, as charge-offs are likely to come down and catch-ups will no longer be required. That will enable a return to profitability that may drive the stock back up.

Zions Bancorp
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Salt Lake City, UT 84133
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INDUSTRY	*Regional — Pacific Banks*
MARKET CAP.	*3.16 billion*
PRICE	*$20.99 (03/12/10)*
P-E RATIO	*NA*
SHORT INTEREST	*29.0%*
VIEW	POS

Scale Pos./Neg.

ANOTHER TROUBLED BANK APPEARS TO BE TURNING A CORNER

ZION fits the same pattern as other banks we have selected as positives this quarter. It got hit hard early on during the crisis but is now showing signs of an improvement that may not yet be reflected in its share price. 2009 saw a spectacular $1.23 billion net loss to common shareholders. The loss can be traced to a long overdue catch-up provision (it grew 211% YOY in 2009 to $2.02 billion, an order of magnitude more growth than at most banks) as well as serious impairments on securities ($280 million on the income statement). Altogether, gains, losses, and impairments netted to a loss of $343 million.[18]

With respect to the securities portfolio, there may still be trouble ahead, as the held-to-maturity portfolio has just $68 million in net unrealized losses but the AFS portfolio has $736 million in unrealized losses, which is very high. The biggest problem is trust-preferred securities (CDOs), with a net unrealized loss of $751 million overall. This is certainly an area of concern.

On the plus side, the loan situation is bound to improve. Last year was a disaster because ZION had fallen so far behind. To catch up, ZION incurred an expense of $1.73 in 2009 for every $1 of net charge-offs, a ratio well in excess of most banks that entered 2009 in better shape (this is similar to RF's situation). Most of the catch-up was in Q2, when ZION recorded $763 million in provisions, which dropped to $566 million in Q3 and $391 million in Q4. The result of the catch-up is that ZION is now just 27.6% short of its ideal allowance according to our model—not too far from the median bank.

We have reason to expect further drops in the provision expense in 2010, with the likely result of the cost being just half of what it was in 2009 for the full year. The key reasons are that past-due amounts are dropping rapidly (25.0% QOQ for 90+ days and 27.5% QOQ for 30–89 days) although nonaccrual amounts are still growing (8.4% QOQ).

With the prospect of more securities losses in 2010, we are not confident of strong earnings performance in the near term. The main attraction to us is the low price ($20.98) relative to our estimate of adjusted tangible book value ($19.69 per share). In this regard, the stock seems to be enough of a bargain to justify the risk.

[18] This includes gains on fair value of derivatives, subordinated debt modification, and acquisition-related gains, offset by realized losses on equity and debt securities, impairments of securities, losses on securities purchased, and goodwill impairment.

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7th Floor
Pasadena, CA 91101
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INDUSTRY	*Regional — Pacific Banks*
MARKET CAP.	*1.94 billion*
PRICE	*$17.64 (03/12/10)*
P-E RATIO	*54.11*
SHORT INTEREST	*11.7%*
VIEW	POS

Scale Pos./Neg.

THE RETURN OF A 2008 PICK THAT IS SUDDENLY HOT

We recommended EWBC as one of five positive picks in our October 2008 *Issue Commentary*, the first one based on our valuation model. EWBC was the only one of the five to underperform the banking sector in the six months following that report. However, in the last few months, the bank has skyrocketed, up from $8.65 on 11/06/09 to $17.64 currently. In our view, the market's optimism is warranted. Our model suggests the value of the bank is $22.84 per share.

The impetus for the November stock price increase was EWBC's acquisition of failed rival United Commercial Bank (UCB) from the FDIC on 11/06/09 in a very favorable deal that included a loss-sharing agreement covering at least 80% of losses on the $5.7 billion in covered assets. Moreover, aside from assuming some of the acquired bank's liabilities, EWBC essentially paid the FDIC a negative price in the transaction of $174 million. Even after a 23% fair-value markdown of the loan portfolio ($1.80 billion, but just $651 million net of the FDIC's share of those anticipated losses), EWBC booked a pretax gain of $471 million.

We don't doubt that EWBC has received some low-quality loans from UCB, but it took a huge haircut on them. Moreover, even if they do perform badly, the FDIC covers 80% of the loss. Since they only booked a receivable from the FDIC equal to 64% of the asset write-down, it seems that they can't possibly take a loss on these loans. However bad they do, the FDIC should pay them more than they anticipated and that will provide a gain. Combine that with the built-in revenue stream from the accretable yield process, and we expect a high return on investment (in terms of recorded earnings) in 2010. In the longer run, the earnings impact might not be as favorable, but we think it will be a strong driver of earnings this year with the potential to drive the stock price up even further.

But for the UCB acquisition, 2009 would have been a dreary year for EWBC. The bank took $108 million in securities impairments on the income statement (and only $14 million off it, a more conservative approach than many other banks). Its provision expense rose 134% YOY. Even with the UCB gain, the bank reported just $27.5 million in net income to common shareholders (35 cents per share).

The good news is that the UCB purchase should add hundreds of millions in profit to 2010 with little downside risk this year. Provision costs for legacy EWBC should also come down somewhat, although it is difficult to assess Q4 given the mix-in of acquired assets that quarter.[19] In addition, the securities portfolio has been cleaned up and now has a net gain of $1.0 million, so more impairment losses are unlikely.

Our positive grade on this bank is certainly speculative, and the market has

[19] This explains why the model assessed the bank as so severely deficient in its loan-loss allowance in Q4 (72.5%). The acquired loans were nearly as large as EWBC's legacy loans (before fair value write-down) but required no allowance. The model cannot distinguish the acquired loans from legacy ones and assesses an expected allowance for them as well.

already impounded a lot of value from the UCB acquisition. Nevertheless, before November the stock had performed so poorly that even with the recent run-up, the valuation is not especially rich.

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