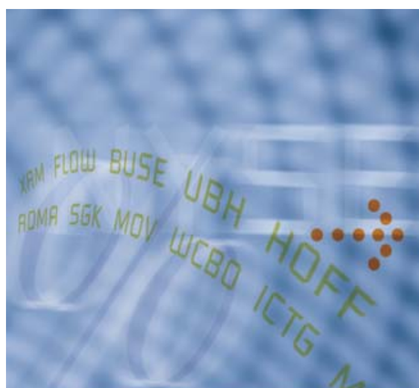

Earnings Quality
EQA ANALYTICS™

Issue Commentary

Analysts: Dr. Michael Williams & Jeff LaFrance

02 June 2010

Quarterly Review of Earnings Quality and Valuation in the Banking Sector

In four prior *Issue Commentaries*, we have used our earnings quality-based, bank-valuation model—supplemented by analyst review of company financial statements—to identify banks that may be overvalued or undervalued relative to peers. Our recommendations have consistently provided positive excess returns, with outperformance in 19 of 29 cases, and an overall average excess return of 7.2% over the ensuing two to three months.

Based on the model's evaluation of Q1 2010 Call Report 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 8*
Deteriorating loan-quality metrics, relatively low provisioning, and large unrealized losses continue to trouble USB.	–
M&T Bank Corp. (MTB)	*Page 9*
We continue to believe the bank is insufficiently reserved, while its unrealized loss overhang remains a threat to earnings.	–
West America Bancorp (WABC)	*Page 11*
Loan-quality metrics have deteriorated compared to peer levels, while the bank has underprovisioned relative to the median bank for 16 quarters.	–
Cullen/Frost Bankers (CFR)	*Page 10*
Valuation premium seems unjustified in light of higher-risk loans, which we believe will cause continuing need for elevated provisioning.	–
Capital One Financial (COF)	*Page 12*
Uncertainties and recent changes in credit card industry have led to what we believe may be a significant undervaluation.	+
Regions Financial Corp. (RF)	*Page 13*
Loan-quality metric improvement, drastically improved reserve, and substantial unrealized gains may bode well going forward.	+
Marshall & Ilsley (MI)	*Page 14*
Bank continues to see loan-quality metrics trend favorably, and we see drastic improvement in estimated reserve deficiency.	+
First Citizens Bancshares (FCNC.A)	*Page 15*
A historically conservative reserve, PCI acquisition accounting, and conservative income recognition make FCNC.A the most undervalued bank according to our model.	+
EARNINGS QUALITY VIEW	*Scale +/-*

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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, 09/29/09, and 03/15/10 to assess quality of earnings and valuation in the domestic banking industry. 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 136 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 analyst review.

No changes of note were made to the model since the 03/15/10 *Issue* Commentary, and specifics on model specification can be found in that and earlier publications. As with the prior model, the ideal loan-loss allowance is now estimated as three times our estimated charge-offs for the next two quarters (Q2 and Q3 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 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. While it could be argued that we are overestimating the ideal level of reserves, it will not affect the model's rankings because (1) the model's output is an estimate of relative valuation and (2) the ideal reserve is measured identically (in a relative sense) for all banks in the sample.

> Note: Please refer to our earlier reports for a full specification of the model, including changes made to the model over time.

REVISITING GRADIENT'S MARCH 2010 *ISSUE COMMENTARY*

We highlighted eight banks in our last report, four that we felt were likely to be relatively overvalued and four that we believed were relatively undervalued. Since publication on 03/15/10 bank stocks surged nearly 15% by 04/23/10, and then pulled back to a net loss, with the SPDR KBW Bank ETF down 3.2% between

[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 the disappearance of the banks or data limitations.

03/15/10 and 06/01/10. Our positive picks are slightly up (1.0%), while our negative picks are slightly down (-2.0%). Thus, the positives have outperformed the negatives by 3.2% in the two-plus months since publication (see Table 1 for details). This is a decent spread on an annualized basis, but less impressive than our prior bank-model-based *Issue Commentaries*. We have yet to publish one of these *Commentaries* without a favorable long-short spread.

Overall, the results are good, but we are disappointed by the adverse performance of two of our picks (one long and one short). In particular, PNC Financial Services (PNC, up 5.9%) had unexpectedly high returns, while East West Bank Corp (EWBC, down 7.8%) had negative returns over the period of coverage. On the other hand, we remain steadfast in our views on four of the banks from the last *Issue Commentary*, as our model and subsequent analysis indicate these banks remain far from intrinsic valuation. We continue to believe RF and MI are undervalued at the current share price, while all the short picks from the last *Issue Commentary* remain overvalued at the current share price. Of particular note, Zions Bancorp (ZION, up 10.3%) and U.S. Bancorp (USB, down 9.1%) have generated the best long and short excess return.

When we combine the most recent *Issue Commentary's* performance with the prior three,[2] we have made a total of 29 picks, of which 19 provided positive (sign-adjusted[3]) excess returns. Overall, the 29 stocks had an average excess return (relative to the banking sector overall) of 7.2%. Our positive picks have been especially solid, with 14 out of 17 providing positive excess returns, averaging 13.3% overall.

As further evidence on the predictive value of the model, we have conducted a regression predicting returns since our last *Issue Commentary* using overvaluation percentage for all the banks in our sample (138 last time). Each percentage point of overvaluation predicts -0.16% less return in the subsequent two and a half months with a t-value of 3.9, indicating strong statistical significance. Note that the median absolute overvaluation percentage was 18.5%, suggesting a predictable excess return for the median bank of 3.0% over two and a half months.

(See table, **Stock Returns for March *Issue Commentary* Picks**, *next page*)

[2] The performance of the 21 earlier picks is disclosed in the last three *Issue Commentaries*. In each case, performance is measured over the period between consecutive commentary publications.

[3] 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 March *Issue Commentary* Picks
(Excess return is relative to the KBE bank ETF return of -3.3%)

	Return	Excess Return	Current Price	Percent Difference Between Current Share Price and Estimated Intrinsic Value
Positive Picks				
RF	0.7%	4.0%	7.38	-27.67%
MI	1.7%	5.0%	7.84	-21.01%
ZION	10.3%	13.6%	23.15	-25.60%
EWBC	-7.8%	-4.5%	16.26	14.77%
Average	**1.2%**			
Negative Picks				
USB	-9.1%	5.8%	23.29	45.18%
PNC	5.9%	-9.2%	61.16	32.07%
BBT	-2.6%	-0.7%	29.77	22.18%
MTB	-2.2%	-1.1%	77.53	31.15%
Average	**-2.0%**			
Spread Between Positive and Negative	**3.2%**			

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 and then compare it to the current share price. The model uses share-price data from 05/28/10. This provides an estimate of undervaluation or overvaluation for each of the 136 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 detailed coverage by Gradient (Wells Fargo, WFC, with an F grade, initiated 02/8/10 and reiterated 04/20/10, and Citigroup, C, with a B grade, initiated 01/21/10 and reiterated 04/21/10), 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%.[4]

We summarize the model findings in Tables 2 and 3 for the following banks: USB, MTB, CYN, WABC, COF, RF, MI, and FCNC.A. Tables 2 and 3 provide the following information for these banks, the four largest U.S. banks (BAC, JPM, WFC, and C), and the median bank in our sample:

- Current stock price and the model's estimate of intrinsic stock value;

[4] 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.

- 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 leveling off 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 continuing 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 going forward in 2010, with a corresponding boost to their reported profitability.

In the following section, we provide a detailed analysis of each of the eight banks selected for coverage in this *Issue Commentary*. One of the key questions we address (and which motivated our selection of these firms) is whether peculiarities of the individual banks (such as acquisitions or VIE consolidations) might cause the general quantitative valuation model to be biased and misleading in their cases. This is the advantage of applying a qualitative review on top of a quantitative screen (even when, as discussed before, that quantitative screen is on average correct at predicting stock returns).

Results for the Largest U.S. Banks

MODEL CONTINUES TO IDENTIFY WFC AS MISVALUED, BA AND JPM MORE FAIRLY VALUED, AND C AS FAIRLY VALUED

Before proceeding to the eight banks highlighted in this *Commentary*, we briefly discuss our model results for the four largest domestic banks.

- According to our model, BAC seems slightly overvalued. Over the past quarter, the percentage of loans 30-89 days past due relative to total loans increased by 24 bps to 2.43%, loans 90+ days past-due to total loans increased 94 bps to 3.62%, while nonaccrual loans to total loans (NAL) decreased 53 bps to 3.77%. The increases in 90 days past-due and 30-89 day past-due loans are troubling. In particular, the continued rapid growth in 90 day past-due loans 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 04/20/10, we published a *Note* reaffirming our coverage of Citigroup (C) with an Earnings Quality Grade of B. The latest model output suggests the undervaluation may have been impounded in the stock price recently. Currently, our model estimates undervaluation of $652 million (0.57%) after

C appreciated by 22.2% since we first assigned our B grade on 02/08/10. C has seen its reserve somewhat decline over the past year, but the reserve remains close to that of the median bank with 25.0% estimated deficiency (relative to our "ideal" reserve of six quarters of estimated charge-offs). Nonaccruing loans as a percentage of total loans saw significant improvement, falling 141 bps QOQ to 3.98%, while loans 30-89 days past due as a percentage of total loans saw slight improvement, falling 15 bps QOQ to 2.37%. At the current point in time, these trends reinforce our thesis that C should still be able to significantly cut its provision expense in 2010.

- We covered JPM in our 06/25/09 *Issue Commentary* with a positive view. JPM still looks good, as total nonaccruing loan growth has slowed to 3.70% QOQ, while nonaccruals adjusted for the portion guaranteed by the government saw a decrease of 3.01%. Additionally, 30-89 days past-due loans are down 5.61% QOQ, which is a good sign going forward. The relative measures of these ratios to total loans also saw improvements. As predicted JPM began to cut its provision costs in 2010 and saw a reserve release[5] of $919 million. 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.

- On 04/21/10, we published a *Note* reaffirming our Earnings Quality Grade of F on WFC. The latest run from the model is consistent with the opinion conveyed in that report, with an estimated overvaluation of $60 billion (38.9%). While as recently as four quarters ago, WFC's allowance was adequate according to our model, it has now degenerated to an estimated deficiency of 27.6% at 03/31/10. Trends going forward are not encouraging, as WFC decreased commercial NCOs while commercial nonaccrual loans increased. Additionally, loans 90 days past due and still accruing continue to increase and remain at the highest level of any bank reviewed by our model. Finally, we still have significant concerns regarding the true economic impact of the PCI portfolio (which, according to our assessment, may not be fully reflected in as-presented earnings). Considering all of these factors, we continue to expect shares to underperform the sector as a whole going forward.

(See table, **Model Evaluation of 13 Banks Covered in This Report**, *next page*)

[5] For all banks measured as provision less net charge-offs rather than change in total reserve, as change in total reserves take other noncredit-related changes into account, and in Q1 many banks brought over reserves in the consolidation of VIE as per FASB 166/167.

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

Ticker (Gradient view)	Stock Price on 05/28/10	Estimated Intrinsic Value	Estimated Mispricing ($ million)	Estimated Mispricing (%)
BAC (moderately -)	15.74	14.44	13,051	8.26%
JPM (moderately +)	39.58	45.80	-24,764	-13.59%
WFC (F)	28.69	17.54	58,069	38.85%
C (grade B)	3.96	3.98	-653	-0.57%
USB (-)	23.96	13.13	20,752	45.18%
MTB (-)	79.24	54.55	2,934	31.15%
CFR (-)	54.88	43.18	708	21.32%
WABC (-)	55.67	25.58	882	54.04%
COF (+)	41.30	51.96	-4,869	-20.52%
RF (+)	7.63	10.55	-3,480	-27.67%
MI (+)	8.15	10.32	-1,143	-21.01%
FCNCA (+)	200.00	310.95	-972	-35.68%

Table 3: Model Evaluation of 13 Banks Covered in This Report[7]

Ticker (Gradient view)	Allowance Deficiency[6]	QOQ bps Growth: Nonaccruing Loans to Total Loans	QOQ bps Growth: 90 Days Past Due to Total Loans	QOQ bps Growth: 30-89 Days Past Due to Total Loans	QOQ bps Growth: Net Charge-Offs to Total Loans
BAC (moderately -)	35.41%	-53	94	24	18
JPM (moderately +)	29.79%	-32	-15	-37	13
WFC (F)	27.62%	37	8	-13	-1
C (grade B)	25.04%	-141	22	-15	-4
USB (-)	33.95%	22	7	-29	4
MTB (-)	29.45%	4	-1	-6	-8
CFR (-)	23.84%	1	13	-1	-7
WABC (-)	47.44%	-11	0	-4	-4
COF (+)	41.19%	-20	29	-64	25
RF (+)	28.01%	31	5	-8	3
MI (+)	25.49%	-4	0	3	-30
FCNCA (+)	61.94%	276	21	92	-2
Median (136 banks)	22.38%	8	0	-1	-3

[6] 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.

[7] Calculations are based on Call Report figures as reported by SNL Financial. These figures may differ from figures provided by the banks in non-regulatory disclosures.

Issue Commentary

06.02.10

U.S. Bancorp
800 Nicollet Mall
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www.usbank.com

INDUSTRY	*Regional – Midwest Banks*
MARKET CAP	*44.64 billion*
PRICE	*$23.29 (06/01/10)*
P-E RATIO	*21.77*
PRICE/BOOK	*1.82*
SHORT INTEREST	*1.4%*
SHORT RATIO	*1.5*
VIEW	NEG

POTENTIALLY INADEQUATE ALLOWANCE FOR LOAN LOSSES WITH DETERIORATING LOAN PORTFOLIO

Our model identifies USB as potentially overvalued by 45.2%. We have continually viewed USB as overvalued for nearly nine months, and in the past quarter the stock has begun to decline. In our view, time has run out for USB, and the correction has only begun as the signs are, in fact, even worse now than before. In this regard, there are two key problems we continue to see at USB. First, the allowance for loan losses (ALL) may be inadequate for the quality of the loan portfolio. Second, the magnitude of unrealized losses compares unfavorably with peers.

In our March 2010 *Issue Commentary*, we noted the increasing gap between loan-loss provisioning and the growth in charge-offs and nonaccrual loans during H2 2009. This trend appears to have continued through Q1 2010, as the relative levels of nonaccruing loans (NAL), 90+ days past-due and accruing loans (90+ PD), and net charge-offs (NCO) all increased faster for USB than for the peer group. On a QOQ basis, in Q1 2010 USB (the peer group median) saw the ratio of NAL to total loans increase 22 (8) basis points, the ratio of 90+ PD to total loans increase by 7 (0) basis points, and NCO to total loans increase by 4 (-3) basis points. However, in fairness to USB, the ratio of loans 30-89 days past due decreased 29 bps as opposed to the peer-group-median decrease of one basis point. This absolute decrease is an improvement, but it is important to note that as of Q1 2010 1.81% of USB's total loans were 30-89 days past due, while this ratio was only 1.14% at the median bank. The higher level of nonperforming loans relative to the peer median is true for both the 90+ PD and NAL categories as well. Though the bank continues to exhibit faster rates of growth in each of the past-due loan categories, again its provisioning failed to keep pace with nonperforming loan growth during Q1. As a result, our model estimates an allowance deficiency of 34.0% relative to the peer-group-median deficiency of 22.4%, which factors into our estimate of net asset value.

The sustainability of USB's earnings also presents concerns. The high allowance deficiency is likely to require relatively high provisions (compared to peers) over the next year that will hurt the bank's earnings prospects. Furthermore, USB still continues to report significant gains from mortgage servicing rights, which are a Level 3 asset with significant subjectivity in terms of valuation and may prove unsustainable. According to the latest 10Q, the effect of "assumption changes on the fair value of MSRs and fair value changes of derivatives used to offset MSR value changes was a net gain of $42 million" for quarter ended 03/31/10.

Though the company has recorded sizeable unrealized gains in recent earnings, the bulk of unrealized losses remain stored on the balance sheet. In prior analysis of USB we have expressed concerns about the size and source of unrealized losses recognized in accumulated other comprehensive income, as these unrealized losses bypassed the income statement. While the situation at USB has improved compared to prior periods because of improvement in the equity and

debt markets, potential problems still persist. In Q1 2010, $41 million in other-than-temporary losses bypassed the income statement and a net unrealized loss of $339 million was housed in other comprehensive income. Moreover, the nature and concentration of unrealized gains and losses exacerbates the situation. Unrealized gains are concentrated in the agency securities portfolio ($626 million). Unrealized losses remain highly concentrated in nonagency nonprime securities ($375 million), municipals ($125 million), and corporate debt ($222 million). In the aggregate, as of 03/31/10 USB had $255 million in unrealized losses in the AFS portfolio ($84 million additional in the HTM portfolio), versus a loss of $635 million (net gain of $1 million) at 12/31/09. However, the concentration of these losses indicates that they will need to be recognized in income relatively soon, barring a major improvement in the quality of the securities.[8]

To summarize, we continue to view the ALL as a major problem at USB and expect to see provisioning at higher levels than peers regardless of market condition. We also expect to see unrealized losses begin to flow through income before year end. Yet USB currently trades at an unadjusted price to tangible book value (PTBV) of 3.06 versus a peer group median of 1.47. We continue to believe that this valuation premium is unjustified and that shares are due for a correction.

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INDUSTRY	*Regional – Northeast Banks*
MARKET CAP	*9.22 billion*
PRICE	*$77.53 (06/01/10)*
P-E RATIO	*21.87*
PRICE/BOOK	*1.31*
SHORT INTEREST	*12.4%*
SHORT RATIO	*11.8*
VIEW	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 essentially in line with the peer group (down 2.2%, relative to the index down 3.3%). We fail to see much justification for this performance, however, as the concerns we previously had are still relevant. Currently our model estimates that MTB is overvalued by 31.2%.

The problem we see at MTB is that, despite the fact that the firm has loan-quality metrics in line or slightly worse the median of the peer group, it continues to carry a much lower relative ALL balance. We estimate that MTB has developed an allowance deficiency of approximately 29.5%.

Our view is that the low ALL balance is due to inadequate provisioning (relative to peers). In this regard, MTB has provisioned below the peer-group-median rate (using the provision to NCO measure) in seven of the last eight quarters. Additionally, on average its provision to NCO rate was 32.4% below the peer group median in those seven quarters. Thus, we ultimately expect a significant increase in MTB's quarterly provision, which will drag down earnings in the process.

Our March 2010 *Issue Commentary* also expressed concern about a buildup of unrealized losses on MTB's balance sheet. Consistent with expectations, in Q1

[8] 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 into Q1 2010.

2010, MTB recognized $26.8 million of $29.5 million of other-than-temporary impairments in earnings. However, the bank still carries a significant net loss position[9] in both the held-to-maturity and available-for-sale securities portfolios. In the available-for-sale security portfolio, MTB holds a net unrealized loss of $163.8 million, with unrealized gains concentrated in government-guaranteed securities ($143.9 million) and unrealized losses highly concentrated in privately issued residential securities ($294.3 million). Additionally, the HTM has a net unrealized loss position of $136.1 million, with $137.4 million concentrated in private MBS. The $299.9 million total net unrealized loss could present an earnings drag or shock going forward.

MTB performed just slightly better than the index since our last *Issue Commentary*, thus we continue to believe that a correction will bring its valuation back in line with peers. As a result, we continue to believe that shares are likely to underperform relative to the banking group as a whole.

Cullen/Frost Bankers Inc.
100 W. Houston St.
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(210) 220-5578
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INDUSTRY	*Regional – Southwest Banks*
MARKET CAP	*3.24 billion*
PRICE	*$53.56 (06/01/10)*
P-E RATIO	*17.66*
PRICE/BOOK	*1.70*
SHORT INTEREST	*5.5%*
SHORT RATIO	*7.9*
VIEW	**NEG**

HIGHER-RISK LOANS WILL LEAD TO ELEVATED PROVISIONING

CFR returns to our list after previously appearing in the *Issue Commentary* of last June. It should be noted that CFR underperformed the sector by 17.4% last time we featured it. We dropped it because of a relative share-price decline rather than improved fundamentals. With the stock seeing a strong run-up this year through early May, valuation once again appears rich. Our model estimates that CFR is overvalued by 21.3%.

As was the case in prior coverage, our primary concern is CFR's exposure to higher-risk real estate categories. Commercial and industrial loans (including commercial RE) make up 66.9% of the total loan portfolio at CFR. Construction and land development make up an additional 12.0% of the loan portfolio. Together these loan categories comprise 78.9% of total loans, versus 80.7% in Q4 2009 and 85.8% in Q1 2009. Of particular interest is the increase in the nonperforming loans for these "problem" loan categories. While the total amount of NALs in the above categories decreased 5.6% QOQ in Q1 2010, considering the trends in past-due (but still accruing) loans, we believe the slight decline in NALs is unlikely to be sustainable. Specifically, 90+ PD loans in these higher-risk categories increased by 62% QOQ. Additionally, the 30-89 day PD category increased by 27.0% QOQ during Q1 2010, after seeing a decline of 24.6% in Q4 2009. Thus, going forward we predict the increases in 30-89 PD and 90+ PD will likely lead to higher NALs and higher charge-offs in 2010.

In fairness to CFR, the model estimates a reserve-allowance deficiency of 23.8%, which not too far above the median bank deficiency of 22.4%. However, we believe the bank's exposure to higher-risk loans may require higher levels of provisioning going forward. Moreover, with CFR trading at a PTBV of 2.31

[9] Net infers to gross gains less gross losses, not net of taxes.

compared to a peer group median of 1.47, we believe the bank is trading at an unwarranted premium. Thus, we expect CFR to trend toward our estimated intrinsic value of $43.18 from its current price of $53.56.

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INDUSTRY	*Regional – Pacific Banks*
MARKET CAP	*1.60 billion*
PRICE	*$54.67 (06/01/10)*
P-E RATIO	*17.37*
PRICE/BOOK	*3.13*
SHORT INTEREST	*12.8%*
SHORT RATIO	*20.5*
VIEW	NEG

HIGH NPL AND NPA PERSIST AT WABC

WABC was highlighted in an April *Snapshot*, which detailed a number of risks we saw at the bank. As noted in that publication, WABC was a unique bank in that it entered the crisis with extremely high reserves. But with quarterly provisioning below NCOs in every quarter since 06/30/05, WABC has seen a persistent (albeit, gradual) depletion of its ALL account. This continued reserve release has transformed what was once a highly conservative reserve into what we now consider a highly inadequate reserve at a model-estimated 47.4% deficiency compared to a peer-group median of 22.4%. Consequently, our model rates WABC as the most overpriced bank in our sample, with an estimated relative premium of 54.0%.

For at least eight quarters before Q2 2008, WABC had a ratio of 30-89 past-due loans to total loans lower than the peer-group median. In the past four quarters, however, WABC has seen significant increases in nonperforming loans. Over the past five quarters, the 30-89 PD to total loan ratio has been above the peer-group median by an average of 81 bps, and as of Q1 2010 the ratio was 72 bps above the peer-group median. The NAL story is similar. Before Q2 2009, the amount of loans in NAL status relative to total loans was less than the peer-group median for at least 10 quarters. However in Q2 2009, a sharp rise in NAL at WABC sent the ratio to 3.35%, versus a peer-group median of 2.02%. That deficit remained as the ratio stood at 3.33%, or 72bps above the peer group median, as of 03/31/10. WABC has an insignificant amount of loans classified as 90+ PD.

While WABC has seen the relative difference in the NAL to total loan ratio decrease from a high of 133bps in Q2 2009 to 72 BPs in Q1 2010, what we find troubling is that the bank has continued to under-provision relative to the peer group for at least 16 quarters. Using the provision-to-NCO ratio over the past two years, WABC has seen provision-to-NCO rates as low as 13.8% , as high as 86.5%, and on average 59.0% (the peer-group median ranged from 115% to 167% over the same period with an average of 146%). In light of the recent persisting trends of loan-quality metrics, and our perception of the potential ALL deficiency, we believe that a higher level of provisioning will likely be required going forward.

Currently, WABC is trading at a PTBV of 4.39 versus the peer-group median of 1.47. This implies that the market sees WABC as one of the safer banks. Whereas that might have been true a year and a half ago, our latest review of the bank suggests that it is now more risky than the median bank. If, as we expect, the market begins to discount the deterioration in balance-sheet quality, WABC may suffer a significant price decline.

Issue Commentary

06.02.10

Capital One Financial Corp.
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McLean, VA, 22102
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www.capital one.com

INDUSTRY	*Credit Services*
MARKET CAP	*18.48 billion*
PRICE	*$40.48 (06/01/10)*
P-E RATIO	*16.06*
PRICE/BOOK	*0.77*
SHORT INTEREST	*5.4%*
SHORT RATIO	*2.7*
VIEW	POS

ARE INVESTORS OVERLY PESSIMISTIC REGARDING COF?

COF offers a variety of traditional banking services but is unique in that 40% of total loans are attributable to credit cards. 2010 has been a volatile time for credit card lenders beyond the economy's health, as the CARD act has imposed new regulations on the credit card industry and FAS 116/117 now requires that all bank holding companies consolidate certain off-balance sheet variable interest entities onto their books. In regards to the CARD act, COF clearly disclosed that it expects U.S. card margins to contract from a current high of 17% to approximately 15%, with the act one of the driving factors. Assessing the impact of FAS 116/117 is a bit more difficult. Using Q1 2010 Call Report data, 40% of COF total loans are credit card loans, versus just 16% in Q4 2009 (i.e., prior to the consolidation of VIEs). We believe that such a significant shift in model inputs may be biasing the predicted ALL deficiency (41.2%) upward. Consequently, we view our estimated undervaluation of 20.5% as overly pessimistic.

The model's unusually high level of predicted charge-offs is largely a result of the fact that banks rarely carry nonaccrual credit cards on the books. Instead, these loans are typically written off at set intervals, without ever being placed on nonaccrual status. This is a problem for the model because its forecast for charge-offs depends on the relationship between historical nonaccruals and charge-offs (and for two quarters ahead, past-due and accruing amounts). For credit cards, the lack of nonaccrual amounts means the model is largely driven by prior charge-offs with an estimated growth rate based on historical norms. The large VIE consolidation in Q1 2010 has exacerbated the estimated historical growth rate, especially at COF (given its outsized credit card loan portfolio). This is a potential deficiency for all banks (and this sort of thing is inevitable in any quantitative model that by necessity has one-size-fits-all aspects) but is especially troublesome for COF this quarter.

Looking at underlying trends provides support for our view that the FAS 116/117 required consolidation has likely caused the model to overstate the ALL deficiency. Before the consolidation (in Q4 2009) COF saw QOQ improvements in total 30-89 PD loans, 90+ PD loans, and NCOs. Additionally, Q4 2009 represented the fourth consecutive quarter of declines in the credit card 90+ PD loan categories and the second quarter of declines in credit card NCOs. Following the mandatory consolidation of credit card VIEs, however, the model is now predicting credit card NCOs in Q2 2010 will be 23.8% higher than Q1 2010 levels (while Q3 2010 levels will be just 2.3% lower than Q2 levels). The estimated ideal reserve is calculated using the sum of these predications, and thus implicitly projects the 23.8% growth rate forward. After reviewing the past trends in COFs credit card portfolio, and using available 10Q data, we do not expect to see an increase in charge-offs anywhere near the model prediction.

In light of the above, we believe the overestimation of credit card charge-offs, and thus the overestimation of ideal reserves, are materially affecting the model's estimate of intrinsic value at COF. Thus, we believe COF shares are actually trading at a discount greater than the 20.5% implied by the model.

Issue Commentary

06.02.10

Regions Financial Corp.
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INDUSTRY	*Regional – Southeast Banks*
MARKET CAP	*8.80 billion*
PRICE	*$7.38 (06/01/10)*
P-E RATIO	*NA*
PRICE/BOOK	*0.65*
SHORT INTEREST	*6.8%*
SHORT RATIO	*2.4*
VIEW	POS

DESPITE 4% RELATIVE OUTPERFORMANCE AFTER OUR LAST *ISSUE COMMENTARY*, RF STILL APPEARS TO BE ATTRACTIVELY PRICED

RF again makes the grade as we continue to view it as an undervalued bank. Despite its relative outperformance since our last publication, we estimate RF is still undervalued, now by 27.7%.

As discussed previously, RF 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, as mentioned in prior *Issue Commentaries*, the bank saw signs of a turnaround in 2009, and these signs continue today.

Nonaccruing loans have been a continuing problem for RF, but we expect this growth to subside throughout 2010. NALs as a percentage of total loans have increased for five quarters because of both a shrinking loan-portfolio balance and rising levels of NAL. However, the QOQ rate of change in NAL slowed to 5.81% in Q4 2009 and to 4.12% in Q1 2010 from a high of 46.9% as recently as Q2 2009. While the slowing rate of change in the NAL category is promising, the change in the 30-89 past-due loan category is even more promising. For at least the past five quarters, 30-89 day past-due loans have decreased on an absolute basis, and the ratio of 30-89 PD loans to total loans has declined 38 bps YOY (declined 8 bps QOQ) to 1.53%. Over the same period, the peer-group-median bank has seen that ratio decline just 5 bps YOY (1 bps QOQ) to 1.14%. While RF still has a higher ratio of 30-89 PD to total loans than the median peer-group bank, we view the continued improvement of this loan category as a positive sign. Loans categorized as 90+ PD increased to 0.84% of total loans in Q1 2010 from 0.79% in Q4 2009.

NCOs have also increased since Q1 2010 (79.4% YOY). This, combined with a significant increase in provisioning during 2009, created a reserve that we currently estimate to be 28.0% deficient. Though still above the median peer bank level, this represents a drastic improvement from our estimated 42.5% deficiency at the end of Q4 2008.

As predicted, Q1 2010 also saw a 34.7% QOQ decline in the provision expense. With the current level of reserves, we believe RF should be able to continue to avoid outsized provisions going forward. We also expect to see provision-to-NCOs ratios more in line with the 1.1x seen in Q1 2010 than the 1.7x reported in Q4 2009.

In regards to the available-for-sale securities portfolio, RF continues to house a substantial unrealized gain position in AOCI. In fact, the balance of unrealized gains increased from $431 million in Q4 2009 to $483 million in Q1 2010. Importantly there are no concentrated loss positions, and the portfolio has immaterial holdings of nonagency MBS and other high-risk debt securities. As predicted, the security portfolio began reporting realized gains in Q1 2010, with

$59 million flowing through income in Q1. We believe this will likely continue throughout 2010.

As acknowledged in our prior publications, RF is certainly one of the higher-risk names 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 maintain the decrease in the provision expense seen during Q1, we would expect it to report a profit sometime in 2010. We also expect the stock to rebound from its current level of $7.38.

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Milwaukee, WI 53202
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Industry	*Regional – Midwest Banks*
Market Cap	*4.13 billion*
Price	*$7.84 (06/01/10)*
P-E Ratio	*NA*
Price/Book	*0.63*
Short Interest	*2.3%*
Short Ratio	*0.8*
VIEW	POS

Improvements Still Not Fully Impounded in Price

We covered MI in our last *Issue Commentary* and continue to believe this *previously* troubled bank is priced at an attractive discount to intrinsic value. Though the bank has outperformed the index by 2.57%, our model estimates that MI is currently undervalued by 21.0% relative to peers.

To begin, our model's estimation of reserve adequacy has improved drastically from a 42.4% deficiency at Q4 2009 to an estimated 25.5% deficiency at Q1 2010. Additionally, MI has a relatively insignificant amount of 90+ PD loans and has seen improvements in both NALs and 30-89 PD loans. On an absolute basis, both categories have been decreasing for the past four quarters, and also have shown improvement relative to total loans.

Nonaccrual loans in Q1 2010 were 4.58% of total loans, a level which is 197 basis points above the median bank. However, the Q1 2010 level represents a 4 bps decrease QOQ (54 bps decrease YOY) and more importantly a continuation of the trend of decreasing levels since 2Q 2009. Meanwhile the median peer bank has seen this ratio trend upward to 2.61% in Q1 2010, representing an 8 bps QOQ increase (69 bps increase YOY). The 30-89 past due to total loan ratio of 1.26% in Q1 1010 was only 12 bps above the peer-group median, and although a slight increase of 2 bps QOQ, can be traced to a larger decrease in the denominator than in the numerator. Overall it seems that loan-quality trends have leveled or continue to improve at MI while this is not as true at the median bank. MI has historically had an insignificant amount of 90+ PD loans to total loans and this continued in Q1 201 with 0.02% of total loans in the 90+ PD category.

The lower level of NCO in Q1 allowed MI to decrease provisioning, while maintaining a provision to NCO ratio similar to 2009. If trends in loan quality persist, we predict a reduction in provisioning costs that may return the company to profitability (excluding the possible realization of currently unrealized losses on asset-backed securities, discussed below).

We still have some concerns about the bank's unrealized loss position in available-for-sale, asset-backed securities. Although MI holds a net unrealized gain on the available-for-sale portfolio of $19.2 million, it has a highly concentrated net unrealized loss of $55.7 million in asset-backed securities that

has been in an unrealized loss position for over 12 months. MI will likely have to recognize this loss eventually, but currently the firm is not realizing gains in nonproportional amounts to the losses housed in AOCI.

To summarize, while some risks remain, we view MI as one of the more attractively priced banks in the U.S. and expect it to continue to outperform the sector as a whole.

First Citizens Bancshares Inc.
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Raleigh, NC 27608
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INDUSTRY	*Regional – Mid-Atlantic Banks*
MARKET CAP	*2.09 billion*
PRICE	*$200.60 (06/01/10)*
P-E RATIO	*9.72*
PRICE/BOOK	*1.25*
SHORT INTEREST	*0.4%*
SHORT RATIO	*0.7*
VIEW	POS

A CONSERVATIVE BANK RETURNS TO UNDERVALUED STATUS

FCNC.A tops the list of our most undervalued banks at an estimated 35.7% discount. At first glance FCNC.A seems to have rapidly increasing nonperforming loan levels, but most of the increases are from two acquisitions totaling $2.26 billion in assets (12.2% of Q4 total assets) and $1.56 billion in loans (12.1% of Q4 total loans). The acquisitions led to a $138 million gain recorded in Q1 2010 due to negative goodwill and were accounted for using PCI accounting.[10] Briefly this accounting involves estimating total contractually required cash flows and then setting two reserves against this value: one for nonperformance and one for the time value of money. The accretable difference (time value of money) is recorded as interest revenue regardless of underlying performance of the loan portfolio. The judgments involved and reclassification allowed can cause the as-presented performance from PCI portfolios to differ significantly from actual economic performance for a period of several quarters.

The mechanics of PCI disclosure in the Call Reports make it difficult to assess reserve adequacy. FCNC.A classified a large portion of its PCI loans as nonaccrual in the Call Report disclosure (this is actually quite rare, as these are normally classified as 90 days+ and accruing), but provided no allowance for them (as the nonaccretable reserve serves the same purpose). Our model treats all nonaccrual loans as equal in projecting future charge-offs, so essentially it punishes FCNC.A for its unusual classification of PCI loans in Q1 2010. In this context, before Q1 2010, FCNC.A scored much better than average on reserve sufficiency. This is clearly an artifact of the accounting and not a real deficiency. Therefore, given that the model still regards FCNC.A as undervalued even with this artificial penalty, we believe the stock may be undervalued to a greater extent than implied by our estimated discount of 35.7%.

Furthermore, despite drastically increasing the amount of loans on the balance sheet guaranteed by the government, FCNC.A still conservatively classifies 89.7% of loans that are beyond 90 days past due as NAL. This has kept FCNC.A at a 90+ PD to total loan ratio of 0.43% (very low for a recent acquirer) and bodes well for the sustainability of future earnings. Going forward, the large $138 million acquisition gain will be nonrecurring, but the remaining income items should be sustainable. Also, the $1.56 million in unrealized losses on AFS securities is dwarfed by $37.6 million in unrealized gains. These factors combined with the PTBV of 1.35 (relative to peer-group median PTBV of 1.47) cause us to

[10] For more on PCI accounting see WFC *Alert* published 02/08/10.

believe FCNC.A is a very attractive long idea at the current price. In a possible economic downturn, FCNC.A poses very little risk and can hedge some of our more speculative positive calls.

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