



Issue Commentary

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23 SEPTEMBER 2010

Quarterly Review of Earnings Quality and Valuation in the Banking Sector

In five 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 overvalued or undervalued relative to peers. Our recommendations have provided positive excess returns on average over the period up to the following quarter's *Issue Commentary*.

In this quarterly update, we provide eight new recommendations—four positive and four negative—based on the model's evaluation of Q2 2010 Call Report data. 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 6
High levels of nonperforming loans, relatively low provisioning, and an inadequate reserve continue to trouble USB.	-
TCF Financial Corp. (TCB)	Page 8
Deteriorating loan-quality metrics combined with meager provisioning may threaten earnings.	-
Trustmark Corp. (TRMK)	Page 9
Bank trades at a significant premium given significant provision cuts and what we view as an inadequate reserve relative to loan quality.	-
West America Bancorp (WABC)	Page 10
Continued reserve releases have made this bank less conservative than prior periods, but this does not appear to be represented in the price.	-
Marshall & Ilsley (MI)	Page 11
The bank continues to see loan-quality metrics trend favorably, and we see drastic improvement in estimated reserve deficiency.	+
Popular Inc. (BPOP)	Page 12
Despite high levels of nonperforming loans, the bank appears to be bargain-priced due to a recent PCI acquisition and sell-off.	+
Susquehanna Bancshares Inc. (SUSQ)	Page 13
Loan-quality metric improvement, drastically improved reserve, and conservative provisioning may bode well for earnings going forward.	+
Cathay General Bancorp (CATY)	Page 14
The bank's historically conservative reserve, loan-quality improvement, and conservative provisioning may not be reflected in price.	+

EARNINGS QUALITY VIEW

Scale +/-



09.23.10

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*¹ 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 banks over the last year and the composition of their 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 135 largest commercial bank holding companies in the United States (by market value) with continuous regulatory data since 2007.² The resulting intrinsic value estimates from the model are then compared to actual stock prices to assess potential 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 06/02/10 *Issue Commentary*. Details of the model's specification can be found in our earlier publications (see Footnote 1, below).

REVISITING GRADIENT'S JUNE 2010 *ISSUE COMMENTARY*

We highlighted eight banks in our last report (published on 06/02/10), four that we felt were likely to be relatively overvalued and four that we believed were relatively undervalued. While the model itself continued to perform well³, our specific selections (from the model's output) have underperformed the benchmark SPDR KBW Bank ETF since 06/02/10. Specifically, the index was down 4.6% through 09/22/10. In contrast, our negative picks posted an average return of +2.8%, driven largely by the 15.6% return on M&T Bank (MTB).⁴ Even excluding MTB, the other three negative picks' average return of -1.5% was better than that of the index. Additionally, the -8.4% average return of our four positive picks was below that of the index.

On the other hand, our long-term record of stock picks in this series of bank *Issue Commentaries* remains strong. Over 37 total picks, the average excess return is 4.1%

¹ Published on 06/25/09, 09/29/09, 03/15/10, and 06/02/10.

² 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.

³ The performance of our picks appears to be due to the small subsample of firms selected for coverage. In this regard, the average return of all banks over \$500 million in market value identified by the model as undervalued by the model was -3.0%, while the average return for banks identified as overvalued was -6.3%.

⁴ This appears to be a result of discussions of a takeover by Banco Santander.





09.23.10

Issue Commentary



over the period until the following *Issue Commentary* is published (generally approximately three months).⁵

It should also be noted that, in our prior report, we provided views (positive or negative) on all of the big four U.S. banks. These views proved more predictive, as the two positives (C and JPM) posted an average return of 2.3%, while the two negatives (BAC and WFC) returned -10.7%. If we factor them into the performance of the last *Commentary*, the long-short spread was just -3.1%, all of which can be attributed to MTB.

Table I. Stock Returns for June *Issue Commentary* Picks
(Excess return is relative to the KBE bank ETF return of -4.6%)

	Return	Excess return	Current price	Percent Difference Between Current Share Price and Estimated Intrinsic Value
Positive Picks:				
COF	-6.3%	-1.67%	\$37.89	-13.22%
RF	-6.1%	-1.50%	\$6.91	-5.12%
MI	-12.6%	-8.01%	\$6.84	-17.24%
FCNC.A	-8.5%	-3.88%	\$183.00	-33.56%
Average	-8.4%			
Negative Picks				
USB	-3.1%	-1.51%	\$22.52	38.64%
MTB	15.6%	-20.25%	\$88.94	44.47%
CFR	0.3%	-4.88%	\$53.24	29.22%
WABC	-1.6%	-3.03%	\$53.45	55.72%
Average	2.8%			
Spread between positive and negative	-11.2%			

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, then compare it to the current share price. The model uses share-price data from 09/22/10. This provides an estimate of undervaluation or overvaluation for each of the 135 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. Our primary screening metric was absolute difference between market value and estimated intrinsic value (to focus on larger banks), with a requirement that the

⁵ Excess return is based on the index or ETF benchmark employed in each *Issue Commentary*. The initial *Commentary* focused exclusively on regional banks, so we used the S&P regional bank index as benchmark. Since we now consider all stocks (and have included C, BAC, and JPM in the past), since the second *Commentary*, we have used the SPDR KBW ETF as the benchmark. Since the number of positive and negative picks is generally the same (at least since the first *Commentary*), the choice of benchmark for excess return is relatively unimportant.





09.23.10

Issue Commentary



estimated mispricing be at least 15%.⁶

We summarize the model findings in Tables 2 and 3 for the eight banks we are rating in this report (USB, TCB, TRMK, WABC, BPOP, MI, SUSQ, and CATY). 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;
- 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 continuing stabilization of loan-quality statistics overall. Past-due and nonaccruing loan balances are declining for the median bank after large increases in recent years. At a macro-level, the main question is whether economic conditions will permit continued improvements in the next several quarters. If so, the median allowance deficiency of 13.9% will be a non-concern, and banks will be able to continue the cuts in provision expense that many banks experienced in the last two quarters (median provision cut of 12.5% last quarter).

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) might cause the general quantitative valuation model to be biased and misleading in their cases. This is one potential 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, and that the selection of a smaller subsample for analyst review is subject to small-sample effects).

Results for the Largest U.S. Banks

MODEL CONTINUES TO IDENTIFY WFC AS OVERVALUED, WHILE VIEWING JPM AS MORE FAIRLY VALUED, AND C AND BAC AS UNDERVALUED

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

- Previously we (and the model) regarded JPM favorably, which motivated us to initiate coverage of the bank with a B grade on 06/23/10. Since then the stock has performed well, rising 4.3% even as the KBE fell 4.6%. As of now, the model perceives JPM neutrally because of the strong relative outperformance of the stock. Still, loan metrics continue to look good for

⁶ Mispricing is defined as $(\text{stock price} - \text{intrinsic value per share}) / \max(\text{stock price}, \text{intrinsic value per share})$. 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.





09.23.10

Issue Commentary



JPM. And while the sharp provision cut is a potential concern, the main question for JPM is one of valuation. While we recently maintained our B grade, we continue to monitor valuation as a potential threat to our thesis.

- WFC appears less overvalued than last quarter, due in part to a -8.4% return since our last *Issue Commentary* was published. An improvement in allowance adequacy (from 27.6% in Q1 to 17.7% in Q2) has also helped matters. One potential trouble spot for WFC is a continued rise in nonaccrual loans (10 bps QOQ as a percentage of total loans), although the rate of growth is declining. Though some concerns have been mitigated, from an overall perspective we remain concerned about WFC's valuation (and have maintained our D rating).
- The model's view on BAC has changed since last quarter, with the bank recently emerging as one of the model's undervaluation picks. The switch is due in large part to severe underperformance by the stock (down 13.0% since our last *Commentary*) and improved loan-quality metrics. Even still, given the very large estimated allowance deficiency (estimated at 30%), we are disinclined to take a positive view of BAC at this time.
- We initiated coverage of C with a grade of B in January of this year. While the stock has performed well since initiation (excess return of 14.6% relative to the index), we believe the market still is overly pessimistic about the bank's prospects. In this regard, loan metrics continue to improve at a fast rate, and we believe the bank still has substantial room to cut provision expenses going forward (more so than most other banks). Accordingly, we still view the bank as significantly undervalued.

Table 2. Model Evaluation of 12 Banks Covered in This Report

Ticker (Gradient view)	Stock Price on 09/22/10	Estimated Intrinsic Value	Estimated Mispricing (\$ million)	Estimated Mispricing (%)
JPM (grade B)	39.94	40.11	-692	-0.44%
WFC (grade D)	25.81	22.42	17,741	13.13%
BAC (neutral)	13.42	15.57	-21,543	-13.79%
C (grade B)	3.88	5.00	-32,488	-22.42%
USB (-)	22.52	13.82	16,685	38.64%
TCB (-)	15.45	12.27	453	20.61%
TRMK (-)	20.45	17.26	204	15.60%
WABC (-)	53.45	23.67	868	55.72%
MI (+)	6.84	8.26	-752	-17.24%
BPOP (+)	2.79	4.81	-2,070	-42.05%
SUSQ (+)	8.43	10.44	-260	-19.22%
CATY (+)	11.92	14.71	-219	-18.94%





09.23.10

Issue Commentary



Table 3. Model Evaluation of 12 Banks Covered in This Report⁸

Ticker (Gradient view)	Allowance Deficiency ⁷	QOQ bps Growth: Non-Accruing 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	QOQ Change: Provisions
JPM (grade B)	18.44%	-14	-19	-14	-29	-51.7%
WFC (grade D)	17.74%	10	-46	-14	-10	-24.3%
BAC (neutral)	30.16%	-4	-4	-21	-11	-13.4%
C (grade B)	20.90%	-25	-1	-6	-2	-22.0%
USB (-)	25.51%	-23	7	-6	-2	-13.1%
TCB (-)	24.41%	18	2	-4	2	-2.9%
TRMK (-)	24.75%	-6	-1	29	-9	-31.1%
WABC (-)	36.98%	-55	0	20	0	0.0%
MI (+)	20.66%	-22	0	-14	7	-4.0%
BPOP (+)	31.64%	-87	253	77	-21	-15.8%
SUSQ (+)	19.49%	-6	-7	-66	-2	-4.4%
CATY (+)	-4.76%	6	-7	-52	-59	-46.5%
Median (135 banks)	13.89%	-4	0	-11	-1	-12.5%

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POTENTIALLY INADEQUATE ALLOWANCE FOR LOAN LOSSES WITH DETERIORATING LOAN PORTFOLIO

Our model continues to identify USB as potentially overvalued—as it has for nearly a year. Our current estimate of overvaluation is 38.6%. There are two key problems we continue to see at USB. First, the allowance for loan losses (ALL) may be inadequate in light of the relatively lower quality of the loan portfolio. Second, the magnitude of unrealized losses stored on the balance sheet compares unfavorably with peers.

In our June 2010 *Issue Commentary*, we noted the increasing gap between loan-loss provisioning and the growth in charge-offs and nonaccrual loans since H2 2009. 90 day past due and accruing loans continue to be problematic at USB, growing 3.96% QOQ to \$4.69 billion. As of Q2 2010, 90-day past due and accruing loans represented 2.44% of total loans, a level that is significantly higher than the peer-group median of 0.13%. The 30-89 day portfolio at USB saw improvement, but remains elevated compared to peers. At USB (the peer-group median bank) the ratio of 30-89 day past due loans to total loans was to 1.76% (0.97%), down 6 (11) basis points QOQ. The nonaccrual loan portfolio showed improvement on a QOQ basis, and here the bank compares more favorably relative to peers. In Q2

INDUSTRY	Regional — Midwest Banks
MARKET CAP.	43.17 billion
PRICE	\$22.52 (09/22/10)
P-E RATIO	16.17
SHORT INTEREST	1.4%
VIEW	NEG

⁷ 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.

⁸ 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.





09.23.10

Issue Commentary



2010, USB (the peer-group median) saw the ratio of nonaccrual to total loans decline by 23 basis points (4 basis points) to 2.39% (2.55%).

In addition to concerns about its past due loan portfolio, the net charge-off to total loan ratio remains elevated, at 0.58%, compared to the peer median of 0.28%. Notwithstanding the higher rate of charge-offs, our estimated reserve deficiency remains elevated for USB. As a result of higher levels of problematic loans, our model estimates an allowance deficiency of 25.5% relative to the peer-group median of 13.9%.

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 may hurt the bank's earnings prospects. Furthermore, USB continues to report significant gains from mortgage servicing rights, which are a Level 3 asset with significant subjectivity in terms of valuation. We believe these gains 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 \$55 million" for the quarter ended 06/30/10.

Though the company has recorded sizeable unrealized gains in prior earnings periods, the bulk of unrealized losses remain stored on the balance sheet. In prior analyses, we have expressed concerns about the size and source of unrealized losses recognized in accumulated other comprehensive income, as these unrealized losses have, thus far, bypassed the income statement. While the situation at USB has improved compared to prior periods because of a general upward trend in the equity and debt markets, potential problems still persist. In Q2 2010, \$9 million in other-than-temporary losses bypassed the income statement. Though USB carries a net unrealized gain of \$155 million, its unrealized losses remain highly concentrated in nonagency, nonprime securities (\$323 million), municipals (\$115 million), and corporate debt (\$227 million). Thus, there are minimal gains in this category that might ultimately be used to offset the losses experienced to date.

To summarize, we continue to view the ALL as a 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 trades at an unadjusted price to tangible book value (PTBV) of 2.75, versus a peer group median of 1.30. Thus, we continue to believe that this valuation premium is unjustified and that shares are due for a correction.





09.23.10

Issue Commentary



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PROVISION CUT EVEN AS THE ALL IS SUBSTANTIALLY BELOW PEERS

Our model identifies TCB as potentially overvalued by 20.6%, in part as a result of an allowance that we estimate to be 24.4% short of its ideal level. In reviewing the company, we also see other reasons for concern, including increases in both 90-day past due and accruing loans and nonaccrual loans.

INDUSTRY	Money Center Banks
MARKET CAP.	2.20 billion
PRICE	\$15.45 (09/22/10)
P-E RATIO	17.66
SHORT INTEREST	14.0%
VIEW	NEG

During Q2 2010 loans 90 days past due and accruing at TCB increased by 4.48% QOQ. This led to an increase in the ratio of loans 90-days past due and accruing to total loans of two basis points to 0.48%. While the magnitude of the change seems small, both the absolute size of this portfolio and the change in the portfolio remain significantly larger than the peer-group median, which was 0.13% in both Q1 and Q2 2010. TCB also saw nonaccrual loans increase on both a relative and absolute basis. In Q2 2010 nonaccrual loans increased 8.11% on a linked-quarter basis to \$330 million. This increase, combined with a decrease in total loans, caused the nonaccrual loan to total loan ratio to increase by 18 basis points to 2.26%. In fairness, this level is still below the median of the peer group of 2.55%. However, the peer-group median bank saw this ratio decrease four basis points on a linked-quarter basis.

TCB also saw net-charge offs and provisions diverge from peers in Q2 2010. Specifically, between Q1 and Q2 2010 TCB saw net-charge offs increase 7.34% to \$47.8 million while the peer-group median bank saw a QOQ decline of 6.55%. Relative to total loans, net charge-offs at TCB increased two basis points QOQ to 0.33%, while the peer-group median saw a one basis point decline to 0.28%. Despite the increase in net charge-offs, TCB cut its provision for loan losses by 2.93%, leading to a QOQ decline in the provision to net-charge off ratio of 1,084 basis points to 103%. During the same period, the peer-group median bank saw the provision-to-NCO ratio decline by 828 basis points to 111%.

Our concerns are elevated when these trends are viewed in light of the allowance for loan losses (ALL). As mentioned above, TCB cut provisions to just 103% of net charge-offs in Q2 2010, leading to only a slight reserve build during the quarter. This also caused the ratio of ALL to nonaccruing loans (ALL to non-accrual and 90 days past due and accruing) to fall from 82.0% (67.2%) in Q1 2010 to just 76.2% (62.8%) in Q2 2010. This compares unfavorably to a peer-group median level of 85.8% (73.2%) in Q2 2010. Our model estimates that TCB has an allowance deficiency of 24.4%, compared to the peer-group median of 13.9%.

To summarize, we view the bank's rising troubled-asset levels, increasing net charge-offs, lower provisioning, and relatively lower reserve as significant risks to earnings for TCB going forward. Yet TCB trades at a price to tangible book value of 1.66, compared to the peer-group median of 1.30. We view this as an unjustified premium and believe shares are due for a correction.





Issue Commentary

09.23.10



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INDUSTRY	Regional – Southeast Banks
MARKET CAP.	1.31 billion
PRICE	\$20.45 (09/22/10)
P-E RATIO	14.58
SHORT INTEREST	7.9%
VIEW	NEG

CURRENT ALLOWANCE DOES NOT JUSTIFY PROVISION REDUCTION

TRMK also makes our list of overvalued banks, as our model identifies TRMK as potentially overvalued by 15.6% because of increasing 30-89 past due loans, high levels of 90-day loans, and what we view as an inadequate reserve. Furthermore we have concerns about the sustainability of interest income, as TRMK accrues interest on 90% of nonperforming guaranteed loans.

Between Q1 and Q2 2010, TRMK saw an increase in 30-89 day past-due loans of 23.9% to \$89.8 million. This caused a 29 basis point increase in the ratio of 30 to 89 days past due loans to total loans (1.43% at 6/30/10), which compares unfavorably with the peer-group median bank decline of 11 basis points to 0.97%. On the other hand, 90 days past due and accruing loans at TMRK and the peer-group median bank were essentially unchanged quarter over quarter at 0.89% and 0.13%, respectively. While this decline was in line with the peer group, TMRK's ratio of 90 days past due and accruing loans to total loans is still 76 basis points higher than the peer group. Between Q1 and Q2 2010 nonaccrual loans to total loans at TRMK fell by six basis points to 2.55%, which was in line with the peer group.

TRMK cut its provision by 31.1% to \$10.4 million between Q1 and Q2 2010, while the median peer bank saw provisions decline by 12.5%. TRMK also saw net charge-offs fall 33.5% (to \$11.4 million) on a linked-quarter basis, compared to a decline of 6.55% at the median peer bank. Although the provision reduction coincides with a decrease in net-charge offs, we question the sustainability of the recent decline in charge-offs given that loan-performance metrics have not improved. Additionally, we note that the amount and timing of charge-offs is more discretionary in nature than that of other metrics used to assess the quality of a bank's loan portfolio.

Our model estimates TRMK's allowance deficiency at 24.8%, compared to a peer-group median of 13.9%. At the end of Q2 2010, the allowance was 63.0% of the outstanding adjusted nonaccrual loan balance, a level that was 2,282 basis points below the peer-group median of 85.8%. When including both nonaccrual and 90 day past due and accruing loans, the disparity increases, as TRMK reports an allowance-to-combined-nonperforming-loan ratio of 46.7%, compared to the peer median of 73.2%. Going forward, this causes us to question the sustainability of the recent decline in provisioning.

Another area of concern is the amount of guaranteed loans that are 90 days past due and still accruing interest. We estimate that 89.6% of TRMK's guaranteed loans that are over 90 days past due are still accruing interest.⁹ While we understand the argument that these loans should not be charged off, we still question the practice of accruing interest on these loans. Currently we estimate

⁹ The estimate is calculated as the sum of guaranteed loans that are classified as 90+ day past due and nonaccrual. We take the total amount of loans in the category less the portion guaranteed by the U.S. government less the portion guaranteed by GNMA. This provides the guarantee-adjusted figure, which is taken from the total loan figure in order to determine the amount of loans guaranteed.





09.23.10

Issue Commentary



TRMK classifies \$52.0 million of guaranteed loans as 90 days past due and accruing, or 0.83% of total loans. We estimate that these loans accrued \$700,000 of interest in Q2 2010, which represents 1.81% of reported earnings before taxes.

Currently TRMK is trading at a PTBV of 1.57, in comparison to a peer-group median of 1.30. Given the issues discussed above, we believe that the bank's premium valuation is unwarranted. Thus, we expect TRMK to trend toward our estimated intrinsic value of \$17.26 from its current price of \$20.45.

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HIGH NPL AND NPA PERSIST AT WABC

We featured WABC as a potentially overvalued bank in both our last *Issue Commentary* and in a 04/06/10 *Snapshot*. The stock has outperformed the KBE index by 3.03% since the publication of our June *Issue Commentary*. Nevertheless, we continue to believe that shares are overvalued. Indeed, our model estimates that WABC remains the most overpriced bank in our sample, with an estimated relative premium of 55.7%.

INDUSTRY	Regional - Pacific Banks
MARKET CAP.	1.56 billion
PRICE	\$53.45 (09/22/10)
P-E RATIO	16.73
SHORT INTEREST	13.1%
VIEW	NEG

As mentioned in prior coverage, WABC is somewhat unique in that it entered the financial crisis with extremely high reserves. But with quarterly provisioning below net charge-offs (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. Our model estimates a 37.0% deficiency compared to a peer-group median estimated deficiency of 13.9%.

According to Call Report data, 30-89 day past due loans increased 8.24% QOQ to \$59.6 million. Relative to total loans, this represents a 20 basis point increase to 2.06% compared to the peer-group median bank, which saw an 11 basis point decrease to 0.97%. On the other hand, nonaccrual loans showed improvement, falling 18.4% to \$80.3 million.

Net charge-offs (provisions) remained relatively flat, declining 3.60% (0%) to \$3.40 million (\$2.80 million). This led to the 20th consecutive quarter in which WABC has had a reserve release. During this time (since Q2 2005), the allowance has fallen by more than a third. Ultimately we believe this trend must reverse, putting pressure on earnings.

Currently, WABC is trading at a PTBV of 4.17, versus the peer-group median of 1.30. This implies the market sees WABC as one of the safest 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 in line with that of the median bank. Thus, we believe the market must ultimately begin to price in the deterioration in balance-sheet quality, which may lead to a significant price decline.





Issue Commentary

09.23.10



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INDUSTRY	Regional – Midwest Banks
MARKET CAP.	3.61 billion
PRICE	\$6.84 (09/22/10)
P-E RATIO	NA
SHORT INTEREST	3.1%
VIEW	POS

IMPROVEMENTS STILL NOT FULLY IMPOUNDED IN PRICE

We have covered MI in three prior *Issue Commentaries* and continue to believe this *previously* troubled bank is priced at an attractive discount to intrinsic value. In our first period of coverage, the bank outperformed the index by 44.9%. However, in our most recent coverage, the bank underperformed the index by 8.01%. We find this recent underperformance puzzling, and our model estimates that MI is currently undervalued by 17.2% relative to peers.

To begin, our model estimation of reserve adequacy has improved drastically from a 42.4% deficiency at Q4 2009, to an estimated 25.5% deficiency at Q1 2010, to an estimated 20.7% deficiency at Q2 2010. Additionally, MI has seen improvements in both nonaccrual loans and 30-89 day past due loans. On an absolute basis, both categories have been decreasing for at least the past four quarters and have shown improvement relative to total loans over the same period. For reference, MI has an insignificant amount of 90 day past due and accruing loans.

In Q2 2010 nonaccrual loans represented 4.36% of total loans, a level which was 181 basis points above the median bank. However, the Q2 2010 level represents a 22 bps decrease QOQ (65 bps decrease YOY) and, more importantly, a continuation of the trend of decreasing levels since Q2 2009. Meanwhile the median peer bank saw this ratio level off at 2.36% in Q2 2010, representing a one bps QOQ decrease (41 bps increase YOY). The 30-89 past due-to-total-loan ratio of 1.12% in Q2 2010 represented a 14 basis point QOQ decrease (76 bps decline YOY) for MI. Again this represents a significant YOY improvement for MI, while the median peer bank was essentially unchanged in this metric.

Overall it seems that loan-quality trends have leveled or continue to improve at MI, and the nonaccrual loan portfolio continues to improve at faster rate than the median bank in the peer group. Even still, net charge-offs increased 3.51% to \$438 million. If trends in loan-quality metrics persist, however, we expect a decrease in future charge-offs and a reduction in provisioning costs.

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 \$106 million, it has a highly concentrated net unrealized loss of \$54.7 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.

To summarize, while some risks remain, we view MI as one of the more attractively priced banks in the United States and expect it to outperform the sector as a whole. On a price-to-TBV basis, MI is one of the most undervalued banks in the country, with a multiple of just 0.64. If loan metrics continue to improve, we should see a rebound from the current share price of \$6.84 toward our intrinsic-value estimate of \$8.26.





09.23.10

Issue Commentary



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INDUSTRY	Foreign Regional Banks
MARKET CAP.	2.85 billion
PRICE	\$2.79 (09/22/10)
P-E RATIO	35.77
SHORT INTEREST	2.5%
VIEW	POS

A UNIQUE OPPORTUNITY IN A MISUNDERSTOOD BANK

BPOP tops the list of our most undervalued banks this quarter at an estimated 42.1% discount. At first glance BPOP appears to have high levels of nonperforming loans, but several mitigating factors indicate that loan quality is not as bad as it appears on the surface.

As of Q2 2010 BPOP's reported 30-89 day past due loans to total loans of 5.53%, 90 days past due and accruing loans of 3.62%, and nonaccrual to total loans of 9.11%. At first glance this suggests that nearly 18.3% of BPOP's total loan portfolio is in some stage of delinquency. However, a significant portion of the 30-89 day past due and 90 day past due portfolio can be explained by a recent FDIC transaction. On 04/30/10, BPOP acquired the banking operations of Westernbank Puerto Rico from the FDIC, including approximately \$8.6 billion in loans. Using purchase-credit-impaired accounting, BPOP estimated these loans had \$11.0 billion in contractually required principal and interest payments. On that \$11.0 billion portfolio BPOP set a \$5.79 billion nonaccretable reserve, which was equivalent to 52.7% of the contractually required payment. Another \$1.30 billion accretable yield was taken to account for the time value of money. This led to the \$11.0 billion loan portfolio ultimately being accounted for at a fair value of \$3.90 billion.

The sizes of the nonaccretable and accretable yields recorded in connection with this acquisition suggest this acquisition will be extremely beneficial for BPOP going forward. Using data from the most recent 10Q, we estimate that \$690 million of the \$713 million increase in 90 day past due and accruing loans between Q1 and Q2 2010 were related to the acquisition. Similarly we estimate that \$97.4 million of the \$114 million increase in nonaccrual loans was related to the acquisition. While no specific data is provided by BPOP in the most recent 10Q, we believe the majority of the \$370 million increase in this portfolio is also related to the acquisition. This suggests that the organic increases in the 90 day past due (nonaccrual loan portfolio) between Q1 and Q2 was only 9.23% (0.72%), as opposed to the 283% (4.93%) implied by the raw data.

Although the majority of the increases in nonperforming loan metrics can be explained through a very advantageous acquisition, the fact remains that organic nonperforming loan metrics remain elevated relative to peers. Our model takes this fact into account in estimating that the reserve is 31.6% deficient, despite only having an allowance-to-nonaccrual-coverage ratio of 52.6%, compared to a peer-group median of 85.8%. The model deficiency calculation is estimated using the specific nonperforming-loans portfolio at BPOP, which is extremely unique. Specifically, BPOP's total loan portfolio comprises only 7.42% of construction and land-development loans. However, construction and land-development loans account for 18.3% of the total 30-89 day past due portfolio, 21.5% of the total 90 day past due and accruing portfolio, and 36.8% of the nonaccrual loan portfolio. The unique situation arises from the rate at which construction and land-development loans are charged. Specifically, over the past four quarters the ratio of construction charge-offs to





09.23.10

Issue Commentary



construction nonaccrual loans has been only 9.01%, compared to revolving 1-4 family loans at 117%, and closed-end junior liens at 29.8%. The slower charge-off rate in construction and land-development loans partially explains the estimated allowance deficiency relative to the level of nonperforming loans.

Another factor that may explain seemingly large deficiency is the bank's loss-sharing arrangement with the FDIC. Though the acquisition of Westernbank brought a large balance of poorly performing loans on balance sheet, under the terms of the acquisition 80% of loan losses (from the first dollar) are absorbed by the FDIC.¹⁰ This guarantee significantly limits BPOP's risk.¹¹

To be clear, we are not arguing that BPOP will see drastic improvements in loan quality, nor do we believe it is the most adequately provisioned bank. However, we do believe the current share price is well below its intrinsic value. Currently BPOP trades at a PTBV of 1.03, compared to the peer-group median of 1.30. Bolstered by the favorable terms of the acquisition, we believe BPOP should be able to move toward our intrinsic value estimate of \$4.81 from a current share price of \$2.79.

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SUSQ APPEARS TO BE ATTRACTIVELY PRICED

We covered SUSQ last year and saw a 30.6% excess return, after which the stock seemed fairly priced according to the model. However, the stock again appears to be a bargain as conditions at the bank have continued to improve faster than implied by the share price. In this regard, SUSQ has seen drastic loan improvement across all loan categories, has conservatively provisioned, and has seen a substantial decline in allowance deficiency from Q1 2010.

INDUSTRY	Regional – Northeast Banks
MARKET CAP.	1.09 billion
PRICE	\$8.43 (09/22/10)
P-E RATIO	104.07
SHORT INTEREST	14.2%
VIEW	POS

Loans that were 30-89 days past due showed improvement in Q2 2010, falling 66 basis points from 1.27% of total loans in Q1 to 0.61% in Q2. The current level of 30-89 past due to total loans also compares favorably with the peer-median bank, at 0.97%. Furthering our optimism are trends in both the 90 days past due and nonaccrual portfolios. Ninety days past due and accruing loans fell seven basis points QOQ to 0.13% of total loans, which is in line with the median peer bank. Additionally, nonaccrual loans fell six basis points from Q1, and the overall level of 2.43% is below the peer median of 2.55%.

NCOs also showed improvement, declining 6.55% from Q1 2010. This, combined with higher provisioning over the past two years has created a reserve that we currently estimate to be 19.5% deficient. Though still above the median-peer-bank level of 13.9%, this represents a drastic improvement from our estimated 30.5% deficiency at the end of Q1 2010.

Despite the decline in net charge-offs during Q2 2010, provisions were only

¹⁰ A true-up payment back to the FDIC is required if losses do not reach expected levels.

¹¹ The FDIC guarantee is carried on BPOP's books as a \$3.3 billion asset, which must be written down as losses are reimbursed over time. Thus, there is unlikely to be any material accounting impact from this arrangement.





09.23.10

Issue Commentary



slightly decreased, leading to an increase in the provision-to-net charge-off ratio from 117% in Q1 to 119% in Q2. In this regard, the 119% provision-to-net charge-off ratio in Q2 2010 is 828 basis points higher than the peer-group median during the same period. And with the current level of reserves, we believe SUSQ should be able to continue to avoid outsized provisions going forward, especially if loan-quality trends continue to improve.

In regards to the available-for-sale securities portfolio, SUSQ continues to house a net unrealized gain position of \$12.9 million on a portfolio of \$2.13 billion. While the portfolio houses a net unrealized gain, as with other banks its unrealized losses are concentrated in nonagency RMBS (\$19.5 million net unrealized loss) and other structured finance products (\$14.0 million unrealized loss). These losses will likely need to be recognized at some point in the future.

SUSQ trades at a price-to-tangible book value of 1.17, compared to the peer-group median of 1.30. In light of the bank's improving loan-quality metrics and increases in its allowance for loan losses, we view the bank as undervalued at a current price of \$8.43, versus our model's estimate of intrinsic value at \$10.44.

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A CONSERVATIVE BANK RETURNS TO UNDERVALUED STATUS

Based on the latest Call Report data, our model ranks CATY as another undervalued bank at an estimated 18.9% discount. A significant part of the estimated discount relates to a reserve that our model estimates as being 4.76% *above* the ideal level, compared to a peer-group median of 13.9% deficient. Other promising signs include a low stock price relative to tangible book value and substantial loan-quality metric improvements in recent periods.

INDUSTRY	Commercial Banks
MARKET CAP.	936.0 million
PRICE	\$11.92 (09/22/10)
P-E RATIO	NA
SHORT INTEREST	11.3%
VIEW	POS

On a QOQ basis CATY saw drastic improvement in 30 to 89 day past due loans. Specifically, the balance of adjusted 30-89 past due loans declined 38.6% to \$56.5 million. Relative to total loans, this represented a 52 basis point decline at CATY to 0.82%, compared to an 11 basis point decline at the peer-group median bank to 0.97%. While the improvement in the 30-89 day category was clear, the nonaccrual loan balance remains significantly higher than peers at 4.67% relative to total loans compared to only 2.55% at the peer-group median bank. Even still, this represents a significant improvement from the 5.29% seen in Q2 2009. Combined with the improvement in the 30-89 past due category, we believe CATY could see a continued decline in provision expense going forward. (For reference, CATY has an insignificant amount of loans that are 90 days past due and still accruing at only 0.01% of total loans.)

Another promising sign at CATY was the 64.2% QOQ decline in net charge-offs, from \$63.1 million in Q1 2010 to \$22.6 million in Q2 2010. Coinciding with the decline in charge-offs, the bank's provision also declined, falling 46.5% on a QOQ basis to \$45.1 million. Despite the decline in provisions, CATY still maintained a provision-to-net charge-off ratio of 200% compared, to the peer-group median of 111%. CATY has consistently provisioned higher than the peer-group median,





09.23.10

Issue Commentary



averaging a provision-to-net charge-off ratio of 159% over the last two years, compared to the peer-group median of 140%. This has allowed the bank to become one of just a handful in the sector to report an ALL balance above our estimated “ideal” level. Given this solid allowance position, we see the sharp provision decline in Q2 2010 as sustainable.

On the basis of PTBV, CATY trades at a multiple of 1.11, compared to the peer-group median of 1.30. Given the improvement in 30-89 day past due loans and net charge-offs, and extremely conservative allowance, we view CATY as a very attractive value at the current share price of \$11.92.

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