Community Banking Monitor
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A Second Cut at First-Quarter Results

In our previous newsletter, we took a quick look at the main themes from the first-quarter earnings releases from the larger banks, those which reported in early April. We now have more extensive data on the results for the broader bank industry, including many smaller (and often not publicly-held) community banks, as well as the very recent Quarterly Review from the FDIC, so we thought it might be appropriate to take a deeper cut at first-quarter results in order to get a fuller picture of the industry's underlying fundamental trends.

Brief Overview
We noted with interest the following paragraph headings in the FDIC Quarterly Report:

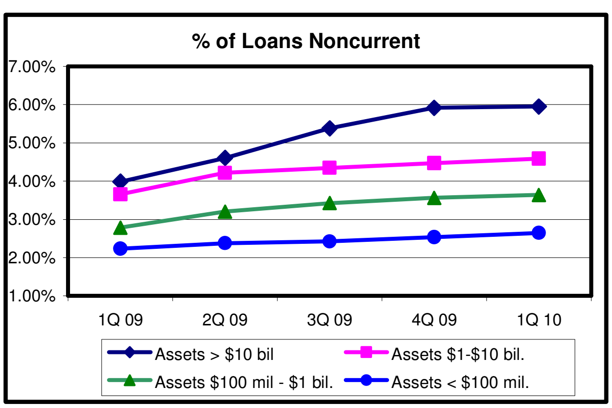
- Reduced Loan-Loss Provisions Help Drive Earnings Improvement
- C&I Charge-Offs Decline for First Time in Four Years
- Increase in Noncurrent Loans Is Smallest in Three Years
- Internal Capital Generation Turns Positive for First Time in Two Years

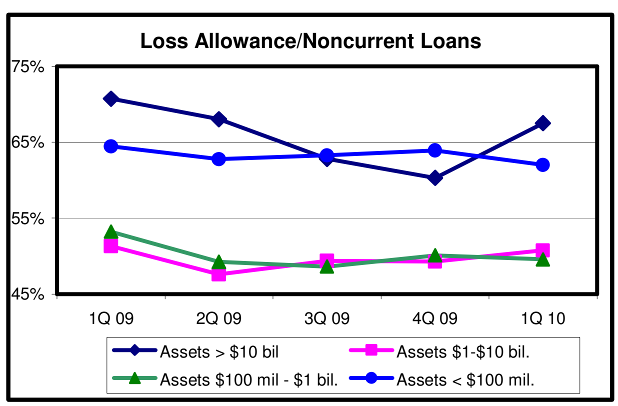
But

- "Problem List" Continues to Grow. The total number is now 775 banks, or almost 10% of the industry. 73 banks have failed already this year, versus 140 in all of 2009, and the FDIC continues to expect elevated failure rates at least through this year.

These headlines pretty much sum up the quarter, and the overall message remains consistent with our conclusions in last month's newsletter.

Looking Deeper
Since our primary interest is in community banks, especially those located in the upper Midwest, we decided to broaden our review to focus more on smaller banks rather than the larger ones that dominate the headlines. Our emphasis continues to be on asset quality metrics, which remains by far the most important performance metric. As shown in the following charts, there were interesting relationships between the results and asset size:





Source: FDIC

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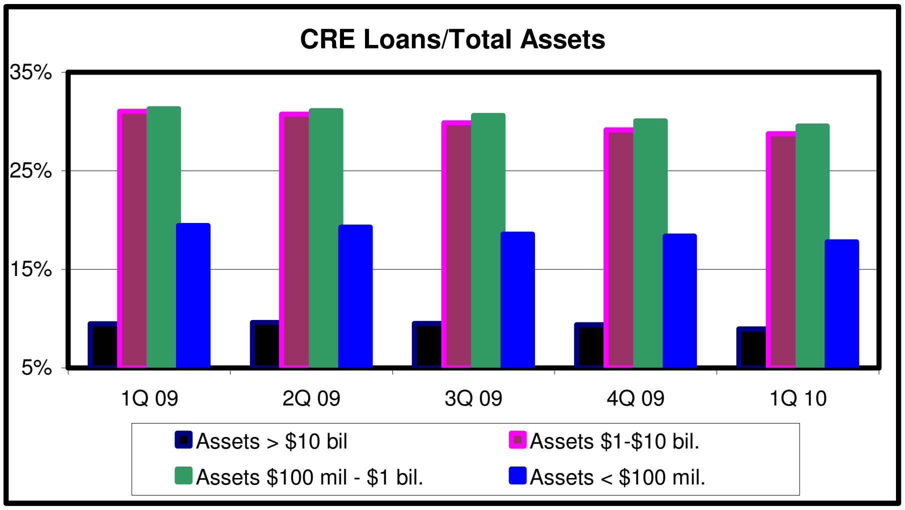
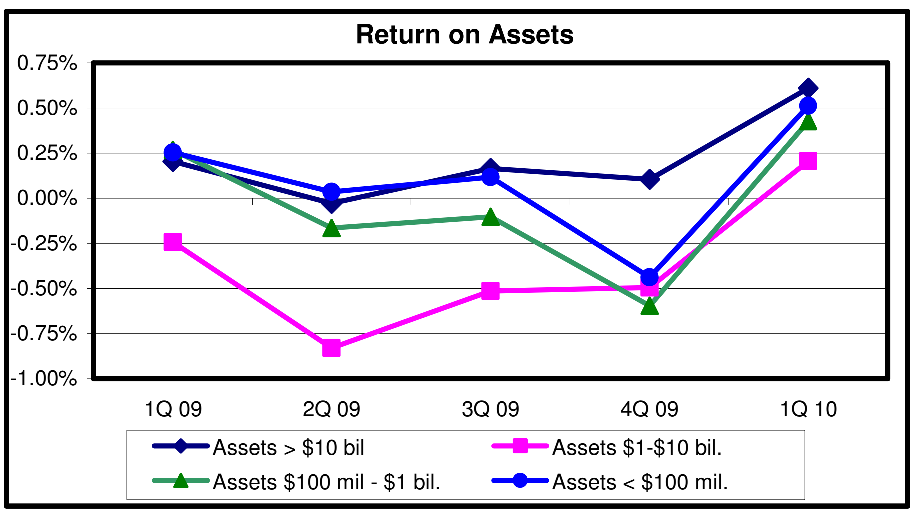
As a broad generalization, the smallest banks have tended to provide the best numbers, with the largest banks coming in second (higher NPL ratios but also higher reserve coverage of NPLs) and the mid-sized banks lagging well behind. The following chart may be a partial explanation:



Source: FDIC

Since commercial real estate loans are almost certainly the major risk factor hanging over the heads of the bank industry, these disparate weighting could explain at least part of the better profitability performance by the biggest and the smallest banks:



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Finally, we broke down the results into a state-by-state and even some metro vs. rural comparisons:

	Return on Average Assets		Net Interest Income Growth	Nonperforming Loans/ Loans		Nonperforming Assets/ Assets		Loss Reserve/ Nonperforming Loans	
	Q1 2010	Q4 2009	Q1/Q4	Q1 2010	Q4 2009	Q1 2010	Q4 2009	Q1 2010	Q4 2009
Iowa	0.95	0.76	3.8	1.33	1.29	1.96	1.71	0.92	1.02
Illinois	0.49	0.22	3.5	2.93	2.82	2.92	2.84	0.52	0.52
Chicago	*0.23*	*-0.13*	*3.4*	*4.89*	*4.51*	*4.85*	*4.95*	*0.40*	*0.43*
Kansas	0.61	0.66	3.8	2.97	2.76	2.54	2.83	0.68	0.63
Kansas City	*0.35*	*-0.29*	*3.4*	*5.64*	*5.76*	*7.85*	*7.19*	*0.40*	*0.42*
Minnesota	0.51	0.17	4.1	3.53	2.61	4.88	4.72	0.55	0.59
Twin Cities	*0.16*	*-0.06*	*3.9*	*4.06*	*3.47*	*5.81*	*5.78*	*0.54*	*0.54*
Nebraska	1.27	0.86	4.3	1.11	1.80	1.14	1.70	0.94	1.29
North Dakota	0.74	0.75	4.2	1.75	1.73	1.59	1.80	0.90	0.81
South Dakota	1.23	1.01	4.4	1.64	1.52	1.43	1.96	1.19	1.00
Wisconsin	0.65	0.24	3.7	2.88	2.97	3.31	3.24	0.58	0.56
Milwaukee	*0.46*	*0.18*	*3.6*	*3.83*	*3.58*	*3.68*	*3.45*	*0.58*	*0.52*

Source: FDIC

This is a pretty busy table, but it does show some interesting things:

- The less populous, more rural states outperformed the larger ones, and the industry as a whole. A lower concentration of real estate loans, and a greater sensitivity to agriculture, probably explain much of this.
- Within the more populous states, the metro markets underperformed the rest of the states, probably for the same reasons.
- The group's net interest income growth was actually pretty good, given the typical sequential fall-off in the first quarter and the fact that the larger banks (as measured by the Keefe Bank Index) showed virtually no growth at all.

So, What's the Message?

On balance, first-quarter results were pretty decent, with reasonably positive implications for the outlook for the next several quarters. But even though problem credit levels seem to be peaking, there are still a lot of bad loans that need to be worked off bank balance sheets. To make things worse, loan and revenue growth is at best minimal, giving the banks less earnings to cover the costs of dealing with the problem assets. So while most banks survived the crisis, and the patient is not dying, it seems clear to us that truly healthy conditions will come only after a long and gradual recovery period.

The implications for any given bank will vary greatly, however, depending on the strength of its balance sheet. Those with more than adequate capital, clearly adequate loss reserves, and a thoughtful and focused management team will be in place to take market share, either through organic growth (taking customers away from the weaker banks) or via acquisitions, and to come out of this down cycle substantially stronger; those with barely adequate capital ratios and an overhang of slow-to-cure credit problems will be forced to remain with their wagons circled until they can restore adequate ratios; those too weakened by actual and likely losses will probably end up disappearing, with little or no return for their owners.

Clearly, the strategic benefits of having "excess" capital are extraordinarily high as the industry restructures, offering once-in-a-generation advantages for those banks having the requisite strengths. Bank boards and bank managements should be taking hard looks into the next 3-5 years, and perhaps be willing to take steps that might seem a bit painful over the short terms but potentially very rewarding over the longer term.

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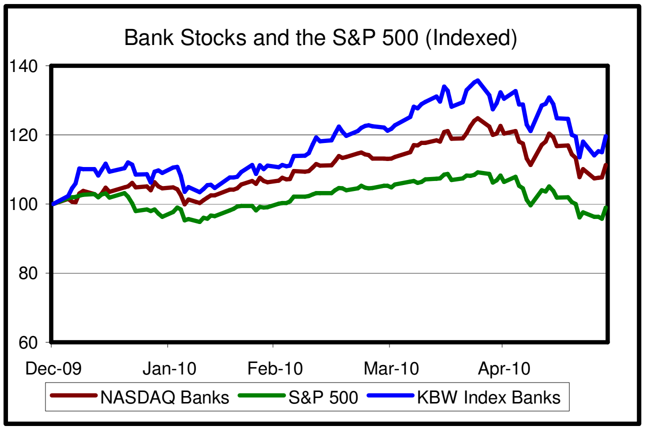
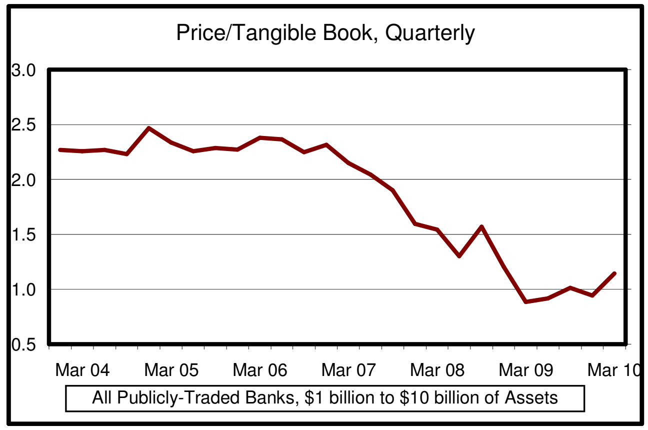
Bank Stock Trends

As the chart below left shows, the recovery in bank stocks that began in early 2009 continued through the first three months of the current year, with the probable causes being the improving economy and the realization that first-quarter bank earnings were likely to be better than recent quarters, and better than previous expectations.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

Beginning in April, that uptrend ran out of steam for both bank stocks and the broad market, as the developing Greek economic crisis reminded investors how much world economies are chained together, and how severe weakness in one (or a few) links can threaten the whole chain. Just as with the subprime lending issue, a problem that initially seemed only distantly related to the operations of our banks (particularly our community banks) came to be recognized as an issue that could impair activity in our economy (notably the export-related segments) and also lead to a less effectively-operating world-wide financial system. How will it all work out? No one knows for sure, but it's not likely to be pretty.

The good news, at least to some extent, is that smaller-bank valuations seem to have bounced up a bit from the floor of less than 1x tangible book value. As the second chart shows, however, valuations are still historically very low. One can argue fairly persuasively that banks are undervalued on a long-term basis, but we don't see the triggers that would force a more normalized level over the near term. In other words, banks that are waiting to be acquired at 2.0x or more of tangible book might have quite a long wait.

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