

Running in Place

We have all witnessed this health club scene: a row or two of people, some healthy and some not, huffing and puffing as they push themselves on treadmills. Although they are probably improving their health (albeit slowly), it surely doesn't look as though they are really enjoying themselves. And while we need to respect their considerable effort, we can also somewhat simplistically point out that they are in fact going nowhere.

Such a scene is not a bad metaphor for the banking industry in general, and the community bank industry in particular; while it is certainly true that bankers have put in a lot of effort in trying to bring their banks' credit problems under control and start the banks out on a new recovery/growth trend, and it is also true that the industry's underlying health is better than it was in the middle of 2009, it does not appear that there has been any significant forward momentum since the beginning of the year. As the following table shows, third-quarter financial performance for a group of Midwestern community banks we track was essentially flat with that of the second quarter, which was in turn roughly flat with the first quarter.

2010 Third Quarter Midwestern Banks By Asset Size	Return On	Net		Nonperf.	Loss	Loss	Net			
	Average	Interest	Efficiency	Loans/ Gross	Reserve/ Gross	Reserve/ Nonperf.	Charge- Offs/ Loans	Nonperf. Assets/ Assets	Texas Ratio	Tang. Equity/ Assets
\$4-\$10 bil. Median (8 banks)	0.34	3.40	61	5.09	3.14	0.61	2.35	4.69	45	7.3
\$2-\$4 bil. Median (16 banks)	0.58	3.63	58	2.45	2.04	0.88	1.41	2.37	22	8.7
\$1-\$2 bil. Median (61 banks)	0.71	3.68	63	2.97	1.89	0.62	0.54	2.85	24	8.8
\$500 mil - \$1 bil. Median (145 banks)	0.61	3.71	64	2.24	1.75	0.69	0.58	2.89	23	9.3
\$200 - \$500 mil. Median (435 banks)	0.84	3.87	62	1.90	1.68	0.82	0.34	2.29	18	9.5
\$100 - \$200 mil. Median (574 banks)	0.90	3.95	64	1.64	1.48	0.90	0.24	1.83	14	9.7
2010 Second Quarter Midwestern Banks By Asset Size	Return On	Net		Nonperf.	Loss	Loss	Net			
	Average	Interest	Efficiency	Loans/ Gross	Reserve/ Gross	Reserve/ Nonperf.	Charge- Offs/ Loans	Nonperf. Assets/ Assets	Texas Ratio	Tang. Equity/ Assets
\$4-\$10 bil. Median (8 banks)	0.37	3.30	64	4.51	2.76	0.65	1.04	4.16	40	7.7
\$2-\$4 bil. Median (16 banks)	0.55	3.55	60	2.81	2.23	0.88	0.87	3.21	24	8.6
\$1-\$2 bil. Median (61 banks)	0.64	3.78	64	3.04	1.88	0.58	0.34	3.01	25	8.9
\$500 mil - \$1 bil. Median (145 banks)	0.61	3.69	65	2.49	1.72	0.69	0.35	2.83	25	9.2
\$200 - \$500 mil. Median (435 banks)	0.82	3.84	62	1.97	1.62	0.78	0.21	2.33	18	9.3
\$100 - \$200 mil. Median (574 banks)	0.89	3.93	65	1.65	1.48	0.86	0.10	1.74	14	9.6

Source: Highline Financial data, Oak Ridge Financial calculations

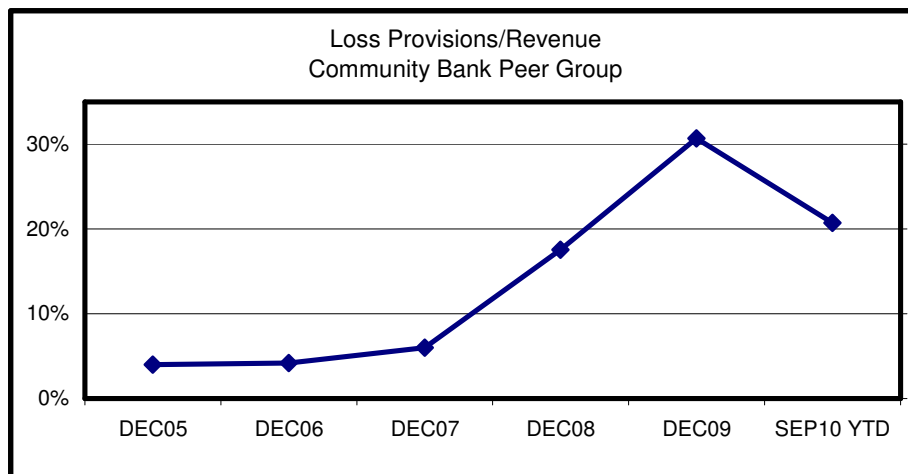
Although there was modest progress in some performance metrics within the above asset size groups, the total picture was one of a struggle to show any meaningful improvement. This seems to have been particularly true for the upper end of the peer group (assets between \$4 billion and \$10 billion), which actually showed backsliding in critical areas such as credit quality, Texas ratios, and the tangible equity/asset ratios. Furthermore, as the next chart shows, the banks in the large metropolitan areas continued to significantly underperform their less urban counterparts, and in fact often showed lower performance metrics than in the second quarter.

Midwest Community Bank Third-Quarter 2010 Results											
	Return on Average Assets		Net Interest	Net Interest Margin		Net Charge-offs/ Avg. Loans		Nonperforming Loans/ Loans		Loss Reserve/ Nonperforming Loans	
	Q3 2010	Q2 2010	Income Growth Q3/Q2	Q3 2010	Q2 2010	Q3 2010	Q2 2010	Q3 2010	Q2 2010	Q3 2010	Q2 2010
Iowa	1.23	1.11	0.8	4.03	3.95	0.44	0.48	1.21	1.60	1.34	1.02
Illinois	0.58	0.53	1.0	3.60	3.63	0.64	0.60	3.41	3.24	0.54	0.52
Chicago	0.32	0.25	-0.2	3.54	3.54	1.24	1.16	5.47	5.12	0.38	0.42
Kansas	0.74	0.63	0.8	3.71	3.71	0.72	0.84	1.87	2.96	0.83	0.63
Kansas City	0.43	0.42	-1.3	3.26	3.57	0.89	0.84	7.20	7.31	0.36	0.43
Minnesota	0.52	0.47	-0.9	4.12	4.06	0.88	0.88	3.23	3.27	0.63	0.59
Twin Cities	0.17	0.30	-1.4	4.12	3.94	1.20	1.16	4.44	4.37	0.51	0.55
Nebraska	1.16	1.15	1.6	4.17	4.11	0.28	0.32	1.21	1.20	1.18	1.29
North Dakota	1.24	0.91	4.0	4.27	4.21	0.44	0.44	1.33	1.58	1.23	0.81
South Dakota	1.29	1.26	3.0	4.49	4.36	0.54	0.56	1.79	1.70	1.30	1.00
Wisconsin	0.73	0.68	0.8	3.81	3.75	0.66	0.80	3.08	3.11	0.62	0.56
Milwaukee	0.40	0.47	-0.9	3.62	3.67	0.74	1.06	4.76	4.29	0.46	0.50

Source: Highline Financial Data, Oak Ridge calculations
Numbers are all percentages, annualized where appropriate

Scant Relief on Credit Quality

Bank earnings typically responds vigorously as our economy turns up after a recession -- the combination of large built-up loss reserves and the improving health of borrowers (declining nonperforming loans and charge-offs) usually leads to a sharp drop in loan loss provisions, which has a very positive and leveraged impact on banks' bottom lines. The following chart shows how much of recent revenues have been "chewed up" by escalating loan loss provisions, and how much of a potential earnings boost exists for the community bank peer group with assets between \$200 million and \$2 billion that we track. With 20% or 30% of revenues going to cover loss provisions, it is not surprising that earnings have been minimal to negative, nor is it hard to see the existence of a great deal of upside earnings leverage, a doubling or tripling of profitability.

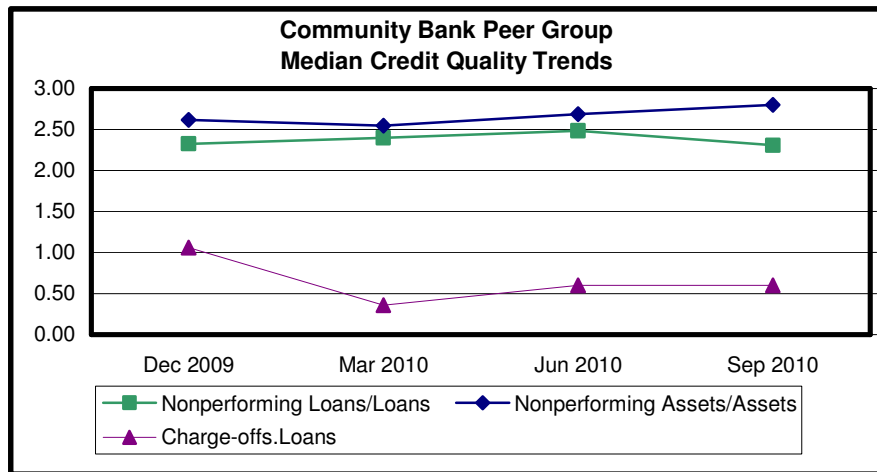


Source: Highline Financial data, Oak Ridge calculations

Unfortunately, while the chart does indicate some improvement this year (more than five quarters past the official end of the recession), the earnings burden from elevated provisions is still historically (and painfully) high – we have a long way to go before we can hope for acceptable profitability.

Part of the reason for this has undoubtedly been the atypical lack of vigor in the economic recovery -- high unemployment, high debt levels, and fragile business and consumer confidence have restrained the post-recession rebound.

Whatever the reasons, it is clear that credit quality is not showing much improvement within this smaller community bank peer group. While the chart below shows that there has been some drop in the median NPL ratio, the absolute level of that ratio is still uncomfortably high. Pretty much the same holds for charge-offs, which showed a nice dip in the first quarter but have moved back up in the last two quarters. Furthermore, it would appear likely that some portion of the NPL improvement was due to the migration from nonperforming loan status to real estate owned; as the chart also shows, the total nonperforming asset ratio is still climbing.

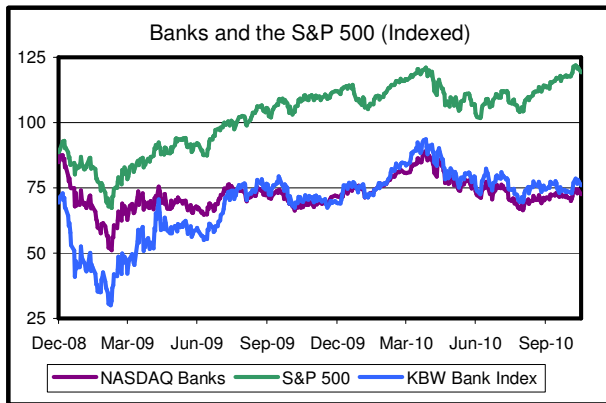


Source: Highline Financial data, Oak Ridge calculations

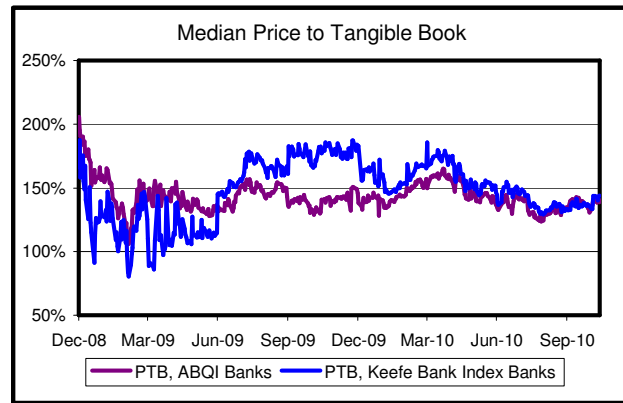
Although we might tend to feel a little better due to the declining trend line of nonperforming loans, the ratio needs to get well under 1% (it was 40-50 basis points five years ago) before we could think of saying that the community bank industry was healthy once again.

Bank Stock Performance Update

This lackluster recovery in credit quality has been reflected in a similarly lackluster recent performance by bank stocks. As shown in the charts below, bank stocks have at best gone nowhere in the past few months, pretty much completely missing the last three months' broad market rebound represented by the S&P 500 trend line. Furthermore, bank stock valuations seem stuck at 135%-140% of tangible book value, below the levels of a year ago and not even in the same ball park as the 200%+ valuations seen during the middle of the previous decade.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

What this suggests to us is that investors recognize that bank balance sheets still need some considerable work. Given this, along with the uncertain but generally unfavorable regulatory environment, it is not surprising that bank stocks seem locked in place. What it will take to change this is some combination of clear and substantial progress against credit quality issues and the resulting higher and more consistent earnings, and probably a notable pickup in bank merger and acquisition activity. While we expect all three to show up within the next 12-18 months, none seem to be imminent.

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