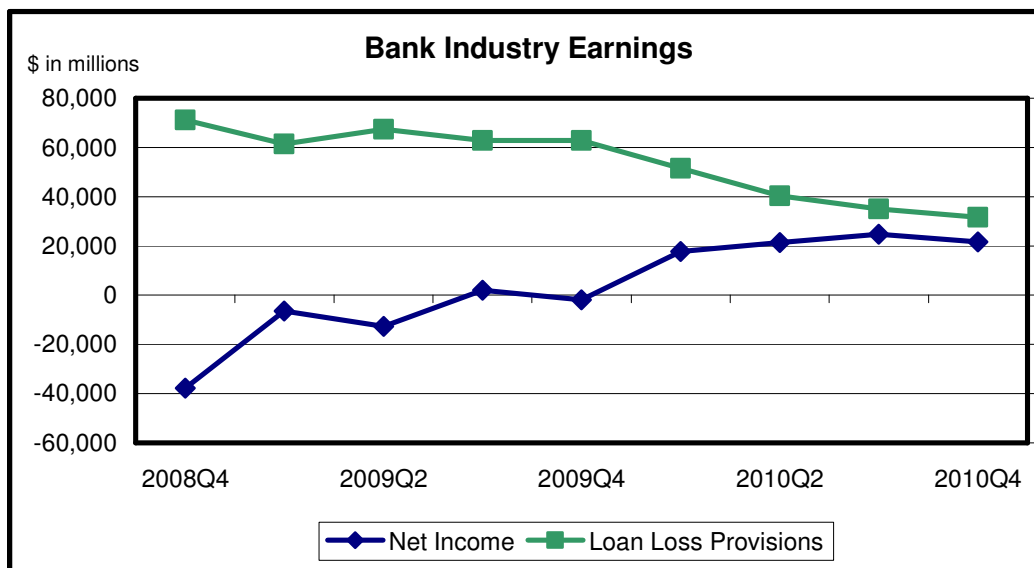


## A Strong Finish, Sort Of

For a year that certainly was a challenge for the banking industry, 2010 did show some encouraging trends, scoring substantial year-over-year gains in a host of performance measures. The fourth quarter of 2010 was no exception; as the FDIC's recently-released Quarterly Banking Profile noted, the industry reported its sixth consecutive quarter of year-over-year earnings increases. Specifically, industry profits were \$21.7 billion in the fourth quarter, a very positive comparison with the \$1.8 billion loss of the previous year's final quarter. The headlines from the FDIC report were indeed pretty positive.

So we are pretty clearly out of the woods as regards to the recent bad times for bank earnings, and except for the unlikely occurrence of a double dip in the economy, we should see further improvements in the industry's health in 2011 and beyond. Nevertheless, the positive picture is a bit muted. For one thing, there was minimal upward momentum after mid-year, as indicated in the following chart; if this relative flatness continues, the year-over-year earnings gains will soon become much more modest. In addition, there is a high likelihood of a double dip in residential real estate values for 2011, which could impact a wide variety of community banks.



Source: FDIC

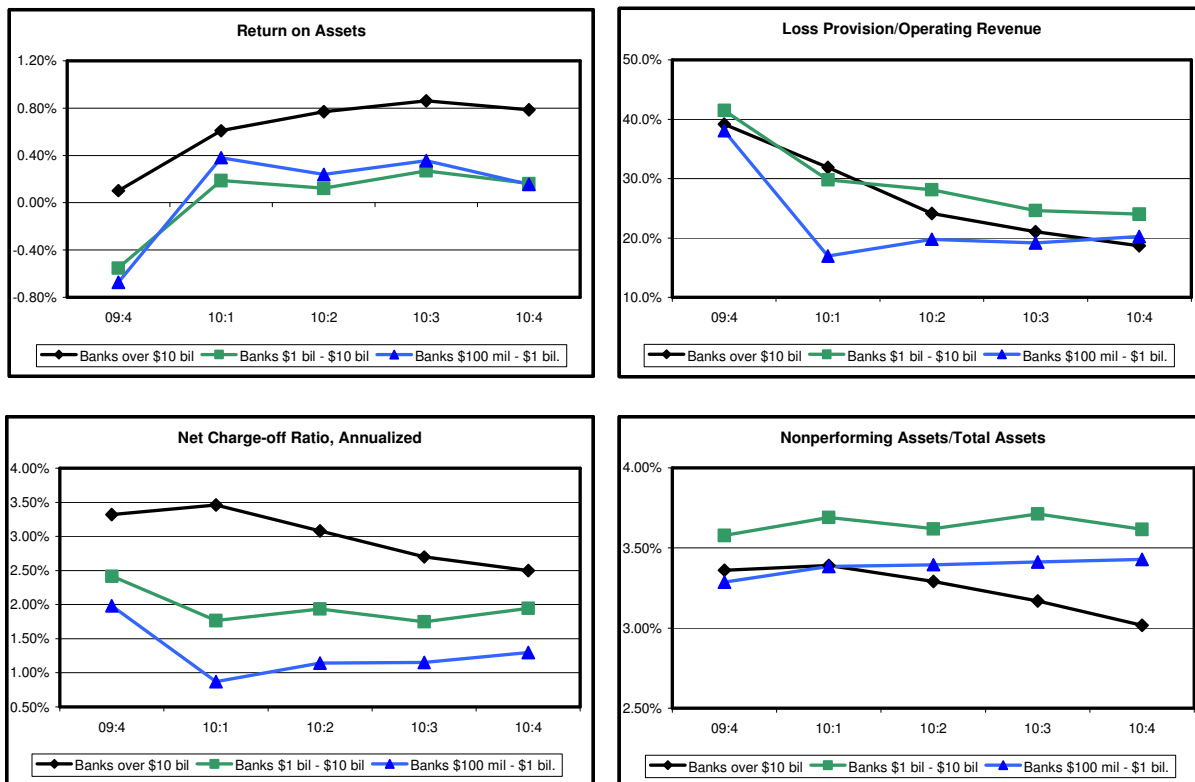
Secondly, and as we have discussed in the past, the earnings gains are not being driven by growth in loans or net interest income, but by lower credit costs. While lower credit costs are certainly a welcome development, we would argue that this trend is probably not sustainable for too many more quarters; we note that the reduced loan loss provisions are not being accompanied by equivalent reductions in nonperforming loans and assets, and this should put some sort of limit on how much lower loan loss provisions can be taken. And a relatively flat trend in loan loss provisions would mean that earnings gains would be largely dependent upon revenue growth, which will be very hard to achieve unless we see renewed vigor in the recent

sluggish trends in loan growth.

And finally, the FDIC noted that the number of problem banks continued to climb in the quarter, from 860 to 884. Note that this represents 11.5% of the population of U.S. banks, up from 11.2% at the end of September. So in sum, while the fourth quarter results were certainly not bad news, the underlying momentum wasn't as encouraging as might have first appeared.

**A TALE OF TWO SEGMENTS**

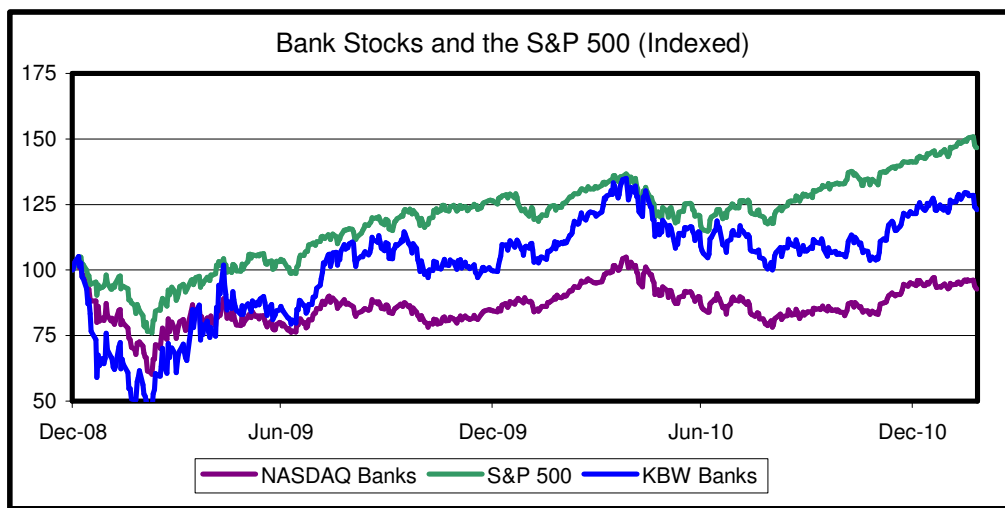
Unfortunately for us at Oak Ridge and our focus client base of smaller community banks, the industry's improved results were not evenly shared within industry segments. Even though we continue to argue that community banking is in many ways a better business model than that of the super-large, money center-type banks, this has not been evident in the recent results of the industry. Note the following set of charts:



Source: FDIC

As is apparent from these charts, the large banks have shown greater (and continuing) improvement in their nonperforming asset ratios, allowing them to show ongoing reductions in charge-offs and the loan loss provision burden, while the smaller bank segments have essentially shown no gains in charge-off or NPA ratios since the middle of last year. This, plus the fact that the big banks generate significantly more noninterest income on a relative basis and have substantially lower efficiency ratios, goes a long way toward explaining their superior profitability as measured by return on assets. Unfortunately for the smaller banks, their substantially higher weightings of commercial real estate loans suggests that further reductions in credit costs are likely to come fairly slowly, and their laggard profitability may persist for a while. In other words, the bank industry as a whole may have a hard time generating vigorous earnings growth, and smaller banks may be even more challenged.

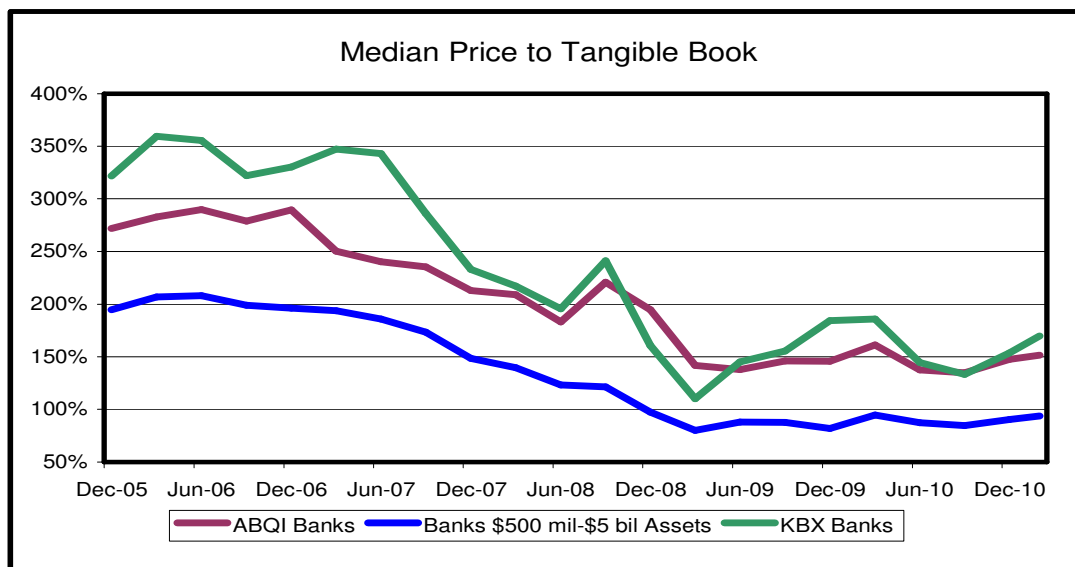
Such expectations may explain why bank stocks, and especially smaller bank stocks, have lagged behind the broad market for the past several months, as shown in the following chart:



Source: Highline Financial data, Oak Ridge calculations

### MUSINGS ON BANK VALUATIONS

Given the previous discussion about the relative prospects for big banks and smaller banks, it is not too surprising that the equity valuations of the big banks are higher than those of the smaller banks, as shown in the following chart:



Source: Highline Financial data, Oak Ridge calculations

In fact, there is a quite linear relationship between asset size and the valuation (as measured by price/book) that the market is placing on bank stocks. For example, the above chart shows that banks with assets between \$500 million and \$5 billion are trading at about 95% of tangible book value; what is not in the chart is that publicly-held banks between \$250 million and \$500 million of assets are trading at about 73% of tangible book value per share, banks with assets under \$250 million are trading at about 65% of tangible book value per share:

## By Asset Size:

Publicly Held U.S. Banks by Asset Size	Price.	Return on
	Tangible BV	Assets
\$5 bil. - \$10 bil.	1.59	0.60
\$500 mil - \$5 bil	0.94	0.47
\$250 mil-\$500 mil	0.73	0.46
Under \$250 mil.	0.65	0.30

Source: Highline Financial data, Oakridge calculations

We suspect that the market's preference for bigger rather than smaller banks reflects more than relative profitability. In our experience, a significant percentage of investors see the primary investment appeal of banks as being their acquisition potential, and it seems as though there might not be a lot of acquirer interest in the small end of the banking spectrum at the present time. The large banks tend to view small acquisitions as being too much work for limited benefit, and (unlike previous decades) there is a relative paucity of mid-sized banks (say, \$5-\$20 billion in assets) that are positioned with the capital and experience necessary to play the role of consolidators.

But as the old cliché says, there is probably an opportunity hidden within every problem, and extreme movements of investor psychology usually create attractive investment opportunities. In this case, the fact that the smaller banks are, as a class, clearly unloved and ignored should suggest that many of them are significantly undervalued on a longer-term basis. With the median smaller bank trading at a discount to tangible book value, and that book value having typically been scrubbed down by a series of asset write-downs driven by tough regulatory exams and more pessimistic (realistic) attitudes on the part of bank managements, it is hard not to conclude that the category of small banks (for example, the group between \$500 million and \$5 billion of assets referenced above) contains a significant number of very undervalued franchises. Of course, it would take time, effort and thought to pick out those with good managements, attractive franchises, and healthy business models (focused strategies, solid deposit bases, high-quality and balanced loan portfolios), and a full pay-off would probably not occur until the economy moves onto firmer ground and a new group of mid-sized consolidators emerges, but we suspect that it is most likely a pretty good time for investors to sift through this smaller-bank group in search of exceptionally attractive long-term investments.

*Oak Ridge Financial is an independent, full-service financial services firm providing Private Client and Investment Banking Services to individual, institutional and corporate customers. Oak Ridge's Financial Institutions Group specializes in providing investment banking and fixed income sales and trading services to financial institutions. Our team consists of professionals with over 70 years experience with in-depth knowledge of the capital markets and financial services industry. Web: [www.oakridgefinancial.com](http://www.oakridgefinancial.com) Member: FINRA/SIPC*