GETTING DOG HONEST

by Steve Brown

The three things we love about dogs are that they always love you; they are honest as the day is long and they have a firmly held belief that licking is the appropriate action for all problems. If dogs ran a bank today, they would lick their financial

statements. In that vein, we need to have an honest conversation with you regarding capital. We feel that if we don't raise these issues, some board member or investor will. The question is - when is the right time to return capital?

Aside from the honest answer that you want to keep your job, the question merits thinking about. Given robust earnings from other industries that we are seeing (albeit largely as a result of significant staffing cuts), returns on equity are running 5% for the general market and 7% for many industries. Community banking, on the other hand, will likely be below an annualized 1% for 1Q. Regulatory risk, deleveraging, greater capital requirements, higher CRE reserve requirements, greater legal fees, the pay back of TARP capital and a host of other negative pressure points just makes a bank shareholder want to bark. In fact, many bank equity analysts believe solid community bank equity performance is 2Ys off. Given the market, CEOs will be hard pressed to make an argument why the bank shouldn't return capital so that it may go to its highest and best use.

That said, like a furry friend, we are not about to leave your side. While we do believe that many banks should consider returning capital, our best argument as to why shareholders should keep capital in a community bank is that the longer term horizon for community banking looks fantastic. In the go-go days of 2004 to 2006, banks made 16% returns without really trying. Most community banks had no risk-adjusted loan pricing or profitability models; little regard for deposit pricing (as most CDs were structured at a loss), no way to target profitable customers and no real appreciation for risk. Now, most bankers have received a Phd-level education on all the before mentioned topics and have seen first hand how they can do things better.

If we are in fact at the bottom of the credit and interest rate cycle, then banks are poised for a nice, steady long-run expansion. While this may take a year or two, investors with a 5Y or longer view could easily see 17% annual appreciation over that period of time (similar to what larger and regional banks are experiencing now in the equity markets). More importantly, we are of the mind that banks can still produce a 20%+ ROE by employing about 20% less leverage by utilizing some of the basic lessons learned over the past couple of years. With greater diversification and lower leverage, earnings volatility will be less, resulting in higher multiples.

Already in Apr, the equity markets are markedly better. Banks with Texas ratios between 75% and 125% are even starting to get capital and the price to tangible book is on the rise. Currently, there is huge investor interest in putting capital in banks that can complete FDIC assisted transactions. This, we believe, is the tail wagging the dog and will soon pass. Basing your business model on arbitraging the FDIC is not a sustainable practice for the long- run. The FDIC is getting wise and will continue to bring the economics down. Aggregating a bunch of banks is interesting, but without the FDIC, it doesn't result in any higher equity returns. In the next year, equity investors will go back to rewarding solid bank operators.

The next couple of years will undoubtedly be rough, but community banking is poised for a comeback and shareholders don't want to miss out. Like a loyal dog, capital owners should stick to bank's side lest they miss future years of solid appreciation - if they lick your face in the process, so be it.

BANK NEWS

FOMC Members

Today, the President is expected to nominate SF FRB President Janet Yellen as Vice Chair and economist Peter Diamond and state bank regulator Sarah Bloom Raskin for seats as board members.

More Branches

In an effort to garner more market share, JPMorgan Chase said they will add 90 new branches in CA this year, taking the total network to more than 800 branches and almost 3,000 ATMs across the state.

Regulatory Reform

By unanimous consent, the Senate agreed to undertake debate on the biggest restructuring of financial-market oversight since the 1930's. As if community bankers weren't in enough pain already, the shenanigans of those outside the system that created much of the credit crisis, has pushed 67% of Americans in a brand new poll to support tighter rules for banks and other financial institutions.

Scary Prediction

Famed economist Nouriel Roubini (aka "Dr. Doom") predicts the 2nd half of 2010 will produce an economic slump in the US, as the effects of the stimulus, tax credits and Census hiring is gone. He sees GDP dropping to 2% or less once that happens.

More Mobile

A study by Sybase finds 32% of customers would switch banks for free mobile banking, with 39% interested in the service.