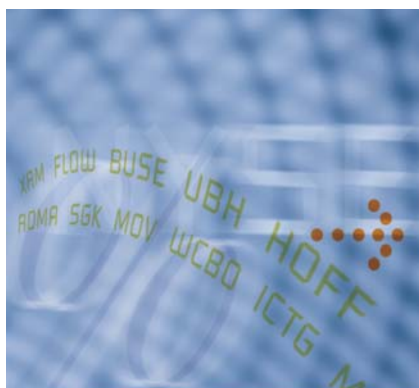

EarningsQuality EQA ANALYTICS™

Issue Commentary

ANALYST: MICHAEL WILLIAMS (PHDs IN ACCOUNTING AND ECONOMICS)

29 SEPTEMBER 2009

Revisiting Earnings Quality and Valuation in the Banking Sector

In this *Issue Commentary* we identify eight banks that may be over (-) or under (+) valued relative to peers. This research follows in the path of a larger body of work dating back to 2007, during which we have shown a consistent track record for identifying mispricing in the banking sector. Our earliest work focused on the analysis of high-risk banks, most of which have since suffered severe price declines. The success of this early work led us to develop an earnings-quality model specific to the banking sector. The model debuted in an October 2008 *Issue Commentary* highlighting five banks that the model identified as potentially undervalued. The featured banks earned average excess returns of 22% in the subsequent three months. Likewise, a June 2009 *Issue Commentary* identified eight banks identified as potentially mispriced by the model. Since publication, returns for the positively (negatively) rated banks have exceeded (lagged) the KBW Banking Index by 10.5% (7.9%), giving a long-short spread of 18.4%.

US Bancorp (USB)	*Page 8*
The loan-loss allowance is not keeping pace with declining performance of the portfolio; substantial losses on securities have not been recognized.	−
PNC Financial Services Group (PNC)	*Page 9*
We have serious qualms about acquisition accounting that appears to have provided more than 100% of reported earnings this year.	−
M&T Bank Corp. (MTB)	*Page 10*
A strong recent rally in the stock seems unjustified given what appears to be inadequate recognition of loan and securities portfolio losses	−
First Horizon National Corp. (FHN)	*Page 11*
With an extremely high rate of non-accrual loans, we question why the firm has such a modest allowance and relatively low provision expense.	−
Fifth Third Bancorp (FITB)	*Page 12*
We applaud the bank's willingness to confront its loan-quality problems through massive charge-offs and provisions.	+
Regions Financial Corp. (RF)	*Page 13*
While we don't think the bank has been sufficiently conservative in its accounting, we see the current stock price as too cheap to pass up.	+
Prosperity Bancshares (PRSP)	*Page 14*
This bank is exceptionally solid with a sterling balance sheet. We have seen very few banks that are this conservative.	+
Susquehanna Bancshares (SUSQ)	*Page 15*
Our review of the company suggests that the hard-hit stock price is well out of line with both net asset value and sustainable earnings.	+
EARNINGS QUALITY VIEW	*Scale +/-*

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Introduction and Model Overview

INTRODUCTION

In this *Issue Commentary* we identify eight banks that may be over (-) or under (+) valued relative to peers. Banks selected for coverage were among those that our bank-sector-specific, earnings-quality model identified as most likely to outperform or underperform their sector peers. Subsequent to the initial, model-driven identification process, we reviewed each bank's financial statements to ensure the efficacy of underlying data and model conclusions. The resulting coverage includes a balance of four banks that we believe are likely to underperform peers (USB, PNC, MTB, and FHN) and four banks we believe are likely to outperform the sector (FITB, RF, PRSP, and SUSQ).

The research coverage presented herein follows in the path of a larger body of work dating back to 2007 and early 2008, during which we have shown a consistent track record for using accounting-based metrics to identify mispriced equity securities in the banking sector. Our earliest work focused on the analysis of high-risk banks. Most of these banks—including Citibank, Countrywide Financial, Downey Financial, National City Corp., Pacific Capital Bancorp, Synovus Financial, United Community Banks, Wachovia, and Washington Mutual, to name only a few—have suffered severe price declines since our initial coverage in late 2007/early 2008.

The success of this early work led us to develop the aforementioned, banking-sector-specific model, which debuted in an October 2008 *Issue Commentary* highlighting five potentially undervalued banks. The featured banks earned average excess returns of 22% in the subsequent three months. Likewise, a June 2009 *Issue Commentary* identified eight banks identified as potentially mispriced by the model. Since publication, returns for the positively (negatively) rated banks have exceeded (lagged) the KBW Banking Index by 10.5% (7.9%), giving a long-short spread of 18.4%. We analyze this performance in more detail in the next full section of the report.

MODEL OVERVIEW

For this report we are using a slightly revised version of the model detailed in our earlier *Issue Commentary* of 06/25/09. Please refer to that report for a full specification of the model. Herein we will provide a brief summary of the model and recent refinements.

Our objective is to identify banks that we believe are over or undervalued relative to peers in the sector, given their specific economic situations. To that end, we model the two key drivers of value: net asset value of the business and sustainable earnings. Accordingly, our modeling approach involves constructing measures of both adjusted book value and sustainable earnings. As to book value, we estimate the adjustment that would be required in order to establish what we estimate to be reasonably conservative allowance for loan losses. With respect to sustainable earnings, we adjust for temporary increases in the provision (that should abate

once the current crisis has passed) and other material nonrecurring items.

Our estimates of adjusted book value and sustainable earnings 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 bank over the last year and the composition of their securities portfolios. Data used in the model were taken from regulatory filings (call reports).

The model is estimated using a multistep regression analysis to derive an estimated intrinsic value relative to other banks in the sample, which consists of the 141 largest bank holding companies in the U.S. (by market value) with continuous regulatory data since 2007.[1]

These relative value estimates are then compared to actual stock prices to assess relative over or undervaluation of the sample banks. We subsequently use this comparison as a starting point in selecting a subset for a qualitative (i.e., analyst) review. The final review led to the selection of eight banks, which we review in more detail at the end of the report.

CHANGES TO THE MODEL

Fundamentally, the model is the same as last quarter. We have added an additional quarter of data and re-conducted all of the statistical estimation using the additional data. The only substantive change in design is the second-stage regression, where only two explanatory variables are needed this time (other variables considered have little explanatory power this time): the YOY change in adjusted book value and the fraction of assets invested in "high-quality" securities (which we define as all securities other than mortgage- and asset-backed securities).

The new version of the model explained 86% of the variation in current stock prices across the banks in our sample. The model's predictions are relative, in that our performance expectations for each bank are made with respect to the average for the industry as a whole.

Before discussing the banks selected for coverage this quarter, next we review the performance of the picks highlighted in our June 2009 report.

Revisiting the June 2009 Issue Commentary

PERFORMANCE ATTRIBUTION FOR SELECTED BANKS

The June 2009 banking sector report highlighted eight banks: four that we believed were potentially overvalued and four potentially undervalued. These banks were selected based on the output of our model, supplemented by analyst

[1] This excludes recent bank holding company conversions, such as Goldman Sachs. The original sample had 150 banks, but some of them were dropped because of data limitations. One bank was dropped as a result of having negative adjusted book value, which made valuation by our approach impossible.

review of the underlying financial statements.

In the intervening three months, bank stocks have performed exceptionally well, with the SPDR KBW Bank ETF up 33.3% since 06/25/09. Both our positive and negative picks are up with the sector. But the positively rated banks are up 43.8% (+10.5% vs. the ETF) while the negatively rated banks are up just 25.4% (-7.9% vs. the ETF).Thus the long-short spread is 18.4% over an approximate three month period. Additionally, three of the four positively (negatively) rated banks outperformed (underperformed) the benchmark ETF. (See Table 1 for details.)

Looking at specific banks featured in the June report, the highest-risk names—MI, which was positively rated, and C, which was negatively rated—did the best. Given the strong uptick in the market, that is unsurprising. However, of the two, MI was much stronger (78.2% versus 50.3% for C) and, in fact, outperformed every other $400 million+ bank during the period.

The respective laggards of the two groups were VLY (negatively rated) and FCNC.A (positively rated), which underperformed the benchmark ETF by 18.3% and 10.1%, respectively. Of note, however, we had indicated in our report that FCNC.A was attractive only due to its lack of downside risk, and that it had limited upside potential. Despite its relative "underperformance," at a current price of $157.01 FCNC.A is now above the target price established in our June report.

Looking at all 150 stocks scored by the model with market value at 06/24/09 of $300 million+ (89 of them), we conducted a regression of subsequent returns on our overvaluation scores. The result indicates that every 1% of estimated undervaluation resulted in an additional 0.15% of return over the last three months, on average. This relationship is statistically significant with 99% confidence (t-stat of 2.52). The model's overvaluation percentage and subsequent returns have a correlation of -26%, implying that more overvalued stocks had consistently lower returns.

Looking forward, we have updated overvaluation estimates for all eight banks. These updated valuations are also summarized in Table 1. In short, the latest model valuations reflect the following developments:

Positively rated banks

- According to the model, neither JPM nor MI is regarded as undervalued any longer. Arguably JPM is now overvalued, but as we suggested in the June report, the model is likely to be biased for JPM based on the accounting for assets acquired from Washington Mutual. So we now see the company as neutral, along with MI. For both of these banks, we see the Q2 2009 financials as less conservative than desirable as, for example, JPM cut its loan-loss provision 8% sequentially while MI's allowance did not increase sufficiently to account for the deterioration in loan quality during the quarter.

- The model is also essentially neutral on BAC at this time as its degree of potential undervaluation has diminished because of a less conservative accounting for loan losses during Q2 (i.e., the provision declined slightly, but without any evidence of improving loan quality).

- We still like FCNC.A as a stock with minimal downside risk, but we are currently neutral on the name because of the lack of upside potential.

Negatively rated banks

- Here the big change is C, which is now only moderately overvalued according to the model. C had much more conservative accounting in Q2 than the other money-center banks (the bank had significant catch-up provisions). It also shored up its balance sheet to a significant extent thanks to a $6.7 billion after-tax gain on the sale of Smith Barney (which is not counted in sustainable earnings but does boost capital). Thus, in light of these developments, we are now essentially neutral on C, but with a number of continuing reservations that still preclude a favorable rating.

- The other three negatively rated banks from last quarter (CBSH, CFR, and VLY) are less negative than before, primarily as a result of their mediocre stock-price performance over the last three months. While we don't think well of their prospects, we feel that other banks are more likely to underperform going forward. Thus, we are only moderately negative on these names going forward.

Table 1: Stock Returns for June *Issue Commentary* Picks
(Excess return is relative to the KBE bank ETF return of 33.3%)

	Return	Excess Return	Current Price	Current Overvaluation Estimate
Positive picks:				
BAC	39.5%	6.2%	17.22	-13.3%
JPM	34.1%	0.8%	44.81	26.9%
FCNC.A	23.2%	-10.1%	157.01	-15.9%
MI	78.2%	44.9%	8.47	19.1%
Average	43.8%	10.5%		
Negative picks:				
C	50.3%	17.0%	4.57	25.3%
CBSH	20.3%	-13.0%	37.12	27.6%
CFR	15.9%	-17.4%	51.74	30.9%
VLY	15.0%	-18.3%	12.38	25.5%
Average	**25.4%**	**-7.9%**		
Long-short spread	**23.5%**			

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Current Model Predictions

SUMMARY OF OUR LATEST MODEL RESULTS

Consistent with our approach in the last two *Issue Commentaries*, we used the model to identify a set of potentially mispriced banks based on the latest financial filings. An analyst then reviewed each bank to narrow the list down to a final selection of eight names. Based on our review, we have identified four banks at each end of the spectrum that appear to have stock prices too high or low to be justified by their financial condition.

Below we provide a high-level summary of our findings. In the final section of the document, we provide a more detailed analysis of each of the eight featured banks.

POTENTIALLY OVERVALUED

- US Bancorp (USB) is currently valued at $22.23 per share but our model suggests it is worth just $14.14. We estimate that the allowance for loan losses falls short by approximately $3.2 billion. On a percentage basis, the allowance deficiency is second among large-cap banks. We are also worried about sizable unrealized losses in USB's securities portfolio ($2.2 billion), as well as the extent to which the bank has avoided income-statement recognition of those losses.

- PNC Financial Services (PNC) currently trades at a price of $46.55 per share, while our model values it at just $35.41. Of concern, the bank acquired National City in a merger at the end of 2008, which we believe has provided significant, nonrecurring boosts to income. Specifically, we note unsustainable accretion income ($1 billion) and post-acquisition adjustments to avoid loss recognition on $2.6 billion of loans that turned out worse than expected. Together, these two items, in our estimate, provided more than 100% of reported profits in H1 2009.

- M&T Bank (MTB) is currently valued at $63.23 per share, compared to our model's estimate of $39.82. Though the stock has performed well over the past six months, we see a bank that has reduced its provision despite a rapid decline in loan quality (charge-offs up 38% QOQ in Q2 2009). This has caused the allowance to come up 59% short of what we estimate it should be. Furthermore, the bank has a massive amount of unrecognized securities losses, some <u>not</u> even reflected on the balance sheet, which may ultimately drag down its earnings.

- First Horizon National (FHN) is currently valued at $13.56, but our model suggests it is worth just $8.38. FHN has piled up substantial losses on the income statement since Q3 2007, and we see no reason for that to change anytime soon. In our view, the firm's provisioning has failed to keep pace with the poor quality of its loan portfolio (5.6% of loans not accruing) while cuts in the Q2 loan-loss provision appear to have set the firm up for more

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large losses ahead.

POTENTIALLY UNDERVALUED

- Fifth Third Bancorp (FITB) is currently valued at $9.83 per share, but our model estimates that it is worth $17.56. While the loan portfolio has had performance problems, the bank took massive charge-offs in Q4 2008 to clean up the balance sheet and simultaneously took a big provision ($2.4 billion in one quarter) to bulk up the previously inadequate allowance. The charge-off situation also has been much better this year, and the allowance now appears reasonable.

- Regions Financial (RF) is currently valued at $6.58 per share vs. our model's prediction of $9.98. The bank also has seen some significant losses recently and carries a very low-quality loan portfolio. Even so, there are signs of stability in past-due measures. While the allowance appears much too low, in our opinion, we think that the current share price reflects a market overreaction.

- Prosperity Bancshares (PRSP) is currently valued at $35.32, while our model indicates a fair value of $47.21. Prosperity is the epitome of the conservative bank, both in its loan activities (minimal amount of non-performing loans) and its accounting. The bank has a much higher allowance than seems necessary (12.1 quarters of charge-offs), and it carries a significant amount of unrealized gains in its held-to-maturity securities portfolio, which are not reflected on the balance sheet. We like this bank as a low-risk investment that should hold up well even if the market goes down again.

- Susquehanna Bancshares (SUSQ) is currently valued at $6.08, but our model suggests it is worth $11.86. The key appeal of SUSQ is its abnormally low stock price. While there are certainly some problems with the loan portfolio, they don't seem that severe given that SUSQ has been proactive in recognizing the losses, with high provisions (2x charge-offs) and an above-average allowance (6.4 quarters of charge-offs). The stock is also priced at a deep discount to both our estimated sustainable earnings stream (7.5x) and adjusted book value (0.6x).

In the pages that follow we provide more detailed discussions of each of the eight banks highlighted in this report.

Issue Commentary

09.29.09

US Bancorp
800 Nicollet Mall
Minneapolis, MN 55402
(651) 466-3000
www.usbank.com

INDUSTRY	*Regional—Midwest Banks*
MARKET CAP	*42.50 billion*
PRICE	*$22.23 (09/28/09)*
P/E RATIO	*27.11*
SHORT INTEREST	*2.9%*
VIEW	NEG

Scale +/-

DECLINING EARNINGS QUALITY WITH DETERIORATING PORTFOLIO QUALITY

Our model identifies USB as potentially overvalued by 57%—up from an estimate of 39% last quarter. In Q2, we saw a continuation of an unfortunate trend at USB in which the bank seems to have become progressively less conservative in its accounting. The loan-loss provision increased just 5.8% QOQ compared to 18.4% QOQ growth in non-accruing loans and 17.9% growth in net charge-offs. The anemic Q2 provision means that USB's allowance deficit, by our estimate, has risen to $3.2 billion, or 72.2% of the allowance for loan losses. The allowance deficiency has also risen rapidly for several quarters and is one of the highest in the country. Among banks with a market capitalization of $10 billion or higher, USB ranked second in allowance deficiency, behind only SunTrust—which was featured in an Earnings Quality *Alert* dated 09/01/09.

USB's allowance is a mere 4.7x Q2 net charge-offs, well below the sector median of 6.1x. We believe that is a dangerously low level that is likely to lead to large catch-up provisions going forward. Furthermore, given that charge-offs and non-accrual loans are still growing rapidly at the bank, the ramp-up in provisions is likely to be much more severe at USB than at most other banks. Given that its portfolio is relatively heavily weighted in commercial and consumer loans and leases (as opposed to real estate lending, which may be bottoming out), we don't think that the bottom in loan performance has been reached yet.

INCOME STATEMENT FAILS TO REFLECT THE MATERIAL AMOUNT OF UNREALIZED LOSSES ON LOW-QUALITY SECURITIES; CHANGES IN ACCOUNTING STANDARDS HAVE ALLOWED FOR A LAPSE IN CONSERVATISM

USB's available-for-sale (AFS) securities portfolio includes an unrealized loss of $2.2 billion. The main sources of loss are non-agency residential MBS ($844 million), municipal debt ($476 million), and corporate debt ($417 million). While the losses have declined this year from $3.3 billion at the end of 2008, we are concerned about the bank's choice to record $595 million of the losses as impairments (meaning the decline in value is expected to be permanent) but not include those impairments in net income. This is allowed under current GAAP, but we regard this behavior as the antithesis of conservative accounting. Those losses, if they had been recognized as per pre-2009 accounting rules, would have reduced pretax income by 48% in H1 2009.

To make matters worse, the true magnitude of losses on MBS could be even greater. USB classifies all non-agency MBS ($3.5 billion) as Level 3 for fair-value purposes, meaning that values are divorced from market prices. Most of those securities were transferred to Level 3 just this year ($2.4 billion).

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Issue Commentary

09.29.09

PNC Financial Services Group
One PNC Plaza
249 Fifth Avenue
Pittsburg, PA 15222
(412) 762-2000
www.pnc.com

INDUSTRY	*Money Center Banks*
MARKET CAP	*21.32 billion*
PRICE	*$46.55 (09/28/09)*
P/E RATIO	*37.03*
SHORT INTEREST	*3.1%*
VIEW	**NEG**

Scale +/-

2009 HAS SEEN A DECLINE IN ASSET QUALITY THAT DOES NOT APPEAR TO BE REFLECTED IN LOSS PROVISIONS

Our model suggests PNC may be overvalued by 31%. This is a big change from last quarter, when the model rated PNC as slightly undervalued. Of note, PNC's loan-loss accounting appeared reasonable last year, as the $3.9 billion year-end allowance was relatively close to our expectation.[2] Unfortunately, while the loan portfolio remains similar to a year ago (i.e., it continues to decline fairly rapidly), the allowance has not kept pace. Remarkably, while the sequential growth in charge offs was 108% in Q1 (much of the Q1 growth is due to the National City merger) and 84% in Q2, the loan-loss provision actually fell 10% in Q1 and increased just 22% in Q2. Given that the acquisition substantially increased the scale of the bank and the size of its loan portfolio in Q1, we find it shocking that the provision was actually reduced. Furthermore, in our view, PNC has now fallen well behind in its loan-loss allowance.

NATIONAL CITY MERGER ACCOUNTING RAISES QUESTIONS

On 12/31/08 PNC acquired National City in a stock-for-stock deal valued at $6.1 billion. As expected, PNC imposed significant fair-value marks to the National City loan portfolio, including a write-down of $7.2 billion (or 7%) of net loans acquired. A portion of the fair-value markdowns on loans will be accreted to earnings over time through an amortization process (originally $6.1 billion), while the remainder (applicable to impaired loans) will be used to absorb subsequent losses that are not accretable.

What concerns us is PNC's apparent use of post-acquisition adjustments to re-write history and effectively boost earnings in H1 2009. In short, during the first half of 2009, PNC decided that an additional $2.6 billion of loans acquired last year from National City loans must have been impaired at the time of acquisition. As a result, it has *cut* the allowance for those loans by $114 million, added $300 million to its accretable yield (to flow through net income), and cut the purchase allowance for net loans by $1.6 billion.

Normally, if a bank discovers its loans are not performing, it needs to take a hit to earnings to build up its allowance. By claiming the impairments had existed (but not been recognized) in 2008, PNC was able to record a surprisingly low provision this year. Meanwhile the bank has recognized $1.0 billion in earnings in H1 2009 from the accretion of yield on the fair-value marks. The accretion income on loans that turn out well is supposed to compensate for additional losses incurred on those that turn out worse than expected (since at the time of acquisition it is not known which specific loans will default). By not taking losses on the bad loans (by simply

[2] Given the year-end acquisition of National City, our model's technique for estimating the ideal allowance at that point in time is flawed. However, the allowance deficiency in Q3 2008 was just 13%, a relatively low level, and Q4 saw a large QOQ jump in provision.

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changing the purchase allocation ex post) while reaping the accretion benefit, PNC has been able to record a profit on the National City loan portfolio despite the portfolio's poor performance. For comparison, total pretax income reported by PNC in H1 2009 was $905 million, so it appears that more than 100% of the bank's earnings are due to accreted yield from National City. Likewise, if we reverse out the purchase allocation adjustments, it appears that PNC has really lost money so far this year.

M&T Bank Corp.
One M&T Place
Buffalo, NY 14203
(716) 842-5445
www.mandtbank.com

INDUSTRY	*Regional—Northeast Banks*
MARKET CAP	*7.46 billion*
PRICE	*$63.23 (09/28/09)*
P/E RATIO	*24.47*
SHORT INTEREST	*13.3%*
VIEW	NEG

Scale +/-

STOCK RUNUP DOES NOT APPEAR JUSTIFIABLE IN LIGHT OF RECENT PERFORMANCE

We estimate that MTB, with a current market value of $7.5 billion, is overvalued by 59%. Part of the reason that MTB has become one of the most overvalued banks, according to our model, is a 43% run-up in stock price since 06/22/09. Another contributor is the apparent decline in conservatism, as MTB cut its Q2 2009 provision by 7.0% while charge-offs grew by 37.7%. As a result, MTB is one of the few banks whose allowance remained essentially flat during the period (up just 1.1% compared to the median growth of 6.8%). By our estimate, the allowance now falls 58.9% short of the preferred level.

SECURITIES PORTFOLIO HAS SIGNIFICANT LOSSES NOT YET INCLUDED IN INCOME

Like USB—only worse on a relative basis—MTB has a substantial amount of unrealized losses on AFS securities, principally private MBSs ($708 million). The company has recognized $139 million in other-than-temporary losses in H1 2009, but only $57 million of that has been included in the income statement. The rest of the losses will be recognized later. If the former rules of GAAP were followed (with all OTTI losses in income), Q2 pretax earnings would have been reduced by 81%.

While the losses on AFS are troubling enough, the held-to-maturity (HTM) portfolio is even more disturbing. At quarter end, MTB reported the highest amount of unrealized losses on HTM assets among all banks in our sample.[3] At $198 million, nearly all of the bank's HTM losses are attributable to its private MBS portfolio ($195 million or 51% of as-presented book value). But because HTM losses are not reflected on the balance sheet, book value is at risk of overstatement due to these potential impairments.

We are further concerned as to how such a large percentage of the HTM portfolio could be impaired, yet the loss is still considered to be temporary. We also wonder why the portion of private MBSs classified as HTM have declined in value so much more than seemingly similar securities contained in the AFS portfolio (with an aggregate loss of just 20%). Even more remarkable is the fact

[3] In our sample, no other regional bank comes close in HTM losses to MTB.

that the HTM securities have continued to fall in value this year, when most MBSs have recovered to some extent.

Putting it all together, we question why MTB has classified all the really bad MBSs in the HTM portfolio, where the losses are ignored completely (even on the balance sheet), while the better-performing MBSs have been included in AFS. Does this imply that the firm intends to hold on to its bad assets and sell its relatively less bad assets? Or was it just fortunate to have the really bad loans in its HTM portfolio by pure chance? Then again, given that all of these private MBSs are Level 3 valued, and have been since last year, we can't be sure how the bank is determining the gains and losses on the two portfolios.

At the end of the day, we question whether MTB has really had any economic income this year, and whether its book value may be significantly overstated due to the omission of fair-value marks on its HTM portfolio of MBSs (which, again, is 51% of as-presented book value).

First Horizon National Corp.
165 Madison Avenue
Memphis. TN 38103
(901) 523-4444
www.fhnc.com

INDUSTRY	*Regional—Southeast Banks*
MARKET CAP	*2.96 billion*
PRICE	*$13.56 (09/28/09)*
P/E RATIO	*NA*
SHORT INTEREST	*11.6%*
VIEW	NEG

Scale +/-

MAJOR HOME LENDER STILL DOESN'T APPEAR TO HAVE CAUGHT UP ON ITS ACCOUNTING FOR IMPAIRMENTS

According to our model, FHN is overvalued by approximately 62%—which is one of the largest potential mispricings identified by our model. FHN's problems stem from the fact that it is heavily into residential mortgages and home equity loans, which has led to severe deterioration in loan performance (5.6% of all loans and leases were non-accruing as of the last balance sheet date). Unfortunately, by our estimate the bank's allowance falls 55.3% short of our target level and has been consistently behind since 2007. We also question how the firm was able to justify cutting its Q2 loss provision by 13%. While its loan portfolio has started to stabilize, charge-offs were up 15% during the period. We are also concerned by the fact that loss provisions recorded for the quarter were just 1.09x charge-offs, leaving the firm with a mere 4.02 quarters of chare-offs—much less than the seven or eight quarters worth that we have consistently advocated.

EIGHT CONSECUTIVE QUARTERLY LOSSES WITH NO END IN SIGHT

FHN has posted a pretax loss for eight straight quarters[4], and the situation appears unlikely to change any time soon. In this regard, the as-presented, Q2 2009 pretax loss of $181 million appears far too optimistic given our qualms about the potential inadequacy of the bank's loan-loss provision. And because of the low level of the allowance relative to charge-offs and non-performing loans, we expect that catch-up provisions will be necessary going forward. Certainly, we are not nearly as optimistic as the seemingly exuberant group of sell-side analysts that, on average, appear to expect the bank's losses to decline rapidly in H2 (consensus H2 EPS estimate of -$0.53 versus actual EPS of -$0.57 in Q2

[4] This is according to call report data. The firm appears to have revised its Q1 2008 pretax income to a small profit in the Q1 2009 10Q, but the basic pattern remains.

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alone) and a return to profitability in Q2 2010.

CAN THE BANK SURVIVE WITHOUT SIGNIFICANT ADDITIONAL DILUTION?

Longer-term EPS forecasts are only relevant if the bank can survive and do so without significant dilution. Our estimate of adjusted book value of $7.02 per share is just 5.3% of assets, while the median for the full sample of banks was 6.6%. But the real problem is the steady erosion of capital that is likely to continue based on the ongoing deterioration in the firm's loan portfolio. The bank has avoided dilution of common stock so far, in part by getting $867 million in TARP money (which is unlikely to be paid back anytime soon). Thus, while we expect that FHN can raise more capital if needed, the seemingly low intrinsic value of the business (and likely dilution) should limit its upside potential, while its downside risk remains substantial.

Fifth Third Bancorp
Fifth Third Center
38 Fountain Square Plaza
Cincinnati, OH 45263
(513) 534-5300
www.53.com

INDUSTRY	*Regional—Midwest Banks*
MARKET CAP	*7.82 billion*
PRICE	*$9.83 (09/28/09)*
P/E RATIO	*NA*
SHORT INTEREST	*2.9%*
VIEW	POS

Scale +/-

TROUBLED BANK APPEARS TO BE TURNING A CORNER

FITB was hit by the financial crisis about as hard as any bank in 2008. Rapidly decaying loan quality, a disintegrating balance sheet, and sizable losses on the income statement set the bank on the brink of failure. Indeed, the stock price closed at just $1.03 per share on 02/20/09. Despite its rocky past, we see signs of improved stability. Even though the price has climbed to $9.83, our model sees it as underpriced by 44% with an estimated intrinsic value of $17.56.

To FITB's credit, it has reacted aggressively to recognize its loan-quality problems. In Q4 2008, the bank took massive charge-offs ($1.7 billion gross versus $481 million the prior quarter).[5] At the same time, it incurred $2.4 billion in provision expense, a huge amount for a single quarter (2.8% of total loans and leases). It has turned out to have been a very conservative approach, as gross charge-offs in H1 2009 of $1.2 billion were substantially less than those reported in Q4 2008 alone. Meanwhile recoveries, though modest, have increased nicely, further indicating that the write-downs at the end of 2008 were highly conservative.

In light of the decline in charge-offs this year, along with boosts to the allowance for loan losses, the allowance deficiency has contracted substantially. We estimate an 81% deficiency existed at the middle point of 2008, which was indeed a very high level. But by mid-2009, FITB had cut the estimated deficiency to just 27%. That is below the median bank's 35% deficiency relative to our recommended levels.

OTHER THAN THE LOAN PORTFOLIO, THE BALANCE SHEET IS SOUND

The securities portfolio does not appear to be a source of trouble at this time, as the bank doesn't own non-agency MBS or other low-quality investments. In

[5] The big charge-offs were not only in real estate loans ($1.2 billion), but also in commercial loans ($373 million).

addition, total unrealized losses of $101 million are dwarfed by $342 million in unrealized gains.

Soundness of the bank was also enhanced by two steps taken in Q2 2009. The bank sold 51% of its Processing Solutions business, booking a gain of $1.8 billion. The gain is not that important (it isn't sustainable), but the deleveraging effect is valuable, and it does boost regulatory capital. FITB also sold $1 billion in new common stock and converted some of its preferred stock to common. While these transactions were dilutive, they boosted Tier 1 capital to a solid $13.7 billion (12.9% capital ratio) and Tier 1 common equity to a more stable 6.9% ratio (compared to just 4.4% at the end of 2008). It seems quite plausible that FITB could pay off its $3.4 billion in TARP preferred stock in the near future with the steps it has taken.

Regions Financial Corp.
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INDUSTRY	*Regional—Midwest Banks*
MARKET CAP	*7.82 billion*
PRICE	*$6.58 (09/28/09)*
P/E RATIO	*NA*
SHORT INTEREST	*5.2%*
VIEW	POS

Scale +/-

A BANK WITH MANY PROBLEMS, BUT A POTENTIAL BARGAIN

RF, like FITB, has struggled mightily with sizeable asset-quality problems arising during the financial crisis. Relative to FITB, however, RF hasn't participated quite as strongly in the stock-market recovery this year. After falling from $38.87 on 10/13/06 to just $2.50 on 02/04/09, the stock has bounced back to just $6.58. Our model estimates the value of RF at $9.98, suggesting the shares are trading at a 34% discount.

LOAN QUALITY IS BAD, BUT THE FIRM SEEMS TO BE TURNING A CORNER

Non-accruing loans totaled $3.0 billion (3.1% of total loans) at quarter end, compared to $1.5 billion at the end of 2008. With an allowance of just $2.3 billion, RF's reserves are clearly inadequate relative to our recommendations ($3.8 billion is the model's estimate). The good news is that—perhaps because of the firm's greater willingness to classify loans as non-accruing—past-due but accruing loans fell in Q2 2009 (by 21% QOQ for 90 days+ and 12% for 30–90 days).

EVEN ADJUSTING FOR LOW ALLOWANCE AND DILUTION, STOCK IS CHEAP

Our model adjusts for the allowance shortfall discussed above. Given the favorable trends in past-due loans (which are not factored in our allowance estimate), however, our model may be penalizing RF too harshly. Yet even with this large adjustment, RF's adjusted book value is $8.09 per share (after accounting for massive dilution from Q2 equity issues). That is well above the current stock price, giving it a very low market-to-adjusted book of 0.81 versus the median bank's 1.51.

The natural question is whether there are other problems with the balance sheet besides the weak loan portfolio and its seemingly inadequate allowance. We don't see anything too concerning. The AFS securities portfolio is relatively modest in size (14% of total assets) and the HTM portfolio is essentially non-

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existent. The AFS portfolio does consist mostly of MBS, and there are $191 million of other-than-temporary impairments not charged to income, which we believe may be a bit aggressive. But compared to USB, the amount is much smaller (relative to total assets), and unlike USB, RF has at least recognized most of its fair-value losses as impairments.

Just like MI last quarter, we see RF as a bank with problems (but not insurmountable ones) and accounting concerns (but not all that bad in light of the choices made by some in the sector) whose stock price is so beaten down that the upside seems much stronger than the downside.

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INDUSTRY	*Regional—Southwest Banks*
MARKET CAP	*1.63 billion*
PRICE	*$35.32 (09/28/09)*
P/E RATIO	*18.11*
SHORT INTEREST	*17.4%*
VIEW	POS

Scale +/-

CONSERVATIVE BANK AND QUALITY BALANCE SHEET

Unlike the first two positives (FITB and RF), which are high risk/reward banks that should do well in an improving financial environment, PRSP is a bank we favor because of its ability to weather potentially severe economic difficulties, should they arise again. The model estimates the stock is undervalued by 25%, with an intrinsic value of $47.21 per share.

The bank is very heavy into real-estate lending but clearly has maintained high standards, as non-performing loans are relatively rare. In fact, both non-accrual and 90+ day past-due loans are down this year (a mere $8.1 million combined as of Q2 2009 out of $3.5 billion in total loans), although the bank also carries $11.1 million in real estate acquired during the downturn. Even adding in the real estate, non-performing assets are a mere 0.57% of total loans and other real estate.

Given the dominance of real-estate lending for the firm and the relative stabilization of the residential real-estate market, we expect the worst may be over for PRSP (and the worst was not bad at all). Despite the modest level of loan-quality problems at PRSP, the bank has done an excellent job of maintaining a strong allowance. The current allowance of $42.6 million is 12.1x Q2 net charge-offs, almost double the median ratio of 6.1. Our model also suggests the allowance far exceeds the necessary level, a very rare accomplishment. Even though the allowance is already high, the bank has continued to make substantial provisions. In Q2, the provision was 2.0x charge-offs, compared to a ratio of 1.5 for the median bank. PRSP is conservative not only in loan issuance but also in accounting. Though the continued accrual of large provisions could, at some point, lead to concerns regarding a possible "cookie jar" reserve, in this environment that is the least of our concerns.

SECURITIES PORTFOLIO ALSO LOOKS HEALTHY; ACTUALLY CONTAINS $106 MILLION IN "HIDDEN GAINS"

Another common concern of ours is that banks may be hiding losses in their securities portfolios, especially the HTM portfolio, where losses don't even go on the balance sheet. However, PRSP actually has the opposite situation. Total

unrealized losses are just $5.7 million. But unrealized gains are $106 million. Moreover, 80% of those gains are hidden in the HTM portfolio, so PRSP isn't getting any credit for them on the face of the financial statements.

LOW RISK BUT LESS UPSIDE; UNLESS INVESTORS HAVE MISSED THE HIDDEN GAINS

PRSP isn't exciting, and the stock hasn't been slaughtered in the last year (it's near an all-time high). But much like FCNC last quarter (see June *Issue Commentary*), we see it as a very safe, high-quality business that balances the more speculative choices discussed earlier. Despite provisioning more than we feel is necessary and an inability to recognize gains on its HTM securities portfolio, PRSP has continued to record strong profits throughout the financial crisis. Trailing 12-month EPS is $1.95, and we expect that this amount will keep growing over the next year as the excess provisions taken recently wind down. To this point, we estimate the bank's sustainable EPS to be $2.72 (implying a PE of 13.0).

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INDUSTRY	*Regional—Northeast Banks*
MARKET CAP	*524.86 million*
PRICE	*$6.08 (09/28/09)*
P/E RATIO	*36.19*
SHORT INTEREST	*11.4%*
VIEW	POS

Scale +/-

AN OVERLOOKED BANK THAT IS REASONABLY STRONG

SUSQ is the smallest bank highlighted in this *Commentary* with a market value of $525 million. However, with an intrinsic value estimated at $1.02 billion, we see SUSQ as one of the best bargains in the space with a price that our model estimates to be 49% below intrinsic value.

SUSQ is not without its problems. The bank's real-estate-loan-heavy portfolio has been deteriorating at a rapid pace. Non-accrual loans are up 89% since the start of the year and equal 2.0% of total loans. The good news is the relatively low level of past-due loans. Loans 90+ days past due are just 0.2% of total loans, suggesting the bank has been conservative in deciding when to classify a loan as non-accruing. Loans 30+ days past due are 0.9% of total loans, but down 35% from the start of the year.

With an allowance of $157 million, SUSQ has 6.4 quarters of charge-offs covered. Though slightly below our recommended level, the ratio is still above the sector median. The bank has continued to provision strongly, with the Q2 provision equal to 2.0x charge-offs (the bank sector median is 1.5x). Given the bank's low and declining past-due rates, we feel it has provided a sufficient allowance and should be able to scale back its provision expense in the future.

STOCK HAS BEEN PENALIZED TOO MUCH

SUSQ reported a $0.14 per share loss in Q2 2009, but considering the excess provision taken along with other considerations, we believe that the bank's sustainable earnings are actually quite good. Our model estimates sustainable annual EPS at $0.84, giving it a PE of 7.2 at its current share price of $6.08. At that price we feel the bank may be one of the best bargains in the sector right

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now.

SUSQ shares fell hard in the last year. From $22.97 on 9/18/08, the stock plummeted along with the sector to $6.86 on 03/09/09. What is unusual is that SUSQ has not participated significantly in the rally since then. Though the bank cut its dividend substantially this year, the decision seems prudent in our view as it will allow it to bolster the capital base. After jumping over $10 briefly, the stock fell in April, May, June, and July to a low of $3.96 on 7/21/09. It still hasn't recovered from its losses earlier this year.

In our view, the declining quality of the loan portfolio isn't as bad as it looks, and the bank has provisioned more than adequately for it. The balance sheet is on the whole solid, with an adjusted book value of $10.11 per share (6.3% of assets). The level of capital is a bit light, but we don't see a catalyst for bank failure or significant dilution, and the market to adjusted book ratio of 0.60 is outstanding. We see SUSQ as a much higher-quality version of RF and priced at a bigger discount.

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