Banks Making Money

FDIC

IN 2006: II Q, FDIC - EARNINGS SET NEW RECORD FOR FIFTH TIME IN LAST SIX QUARTERS

Strong commercial and consumer loan demand outweighed the disadvantages of rising interest rates and a flat yield curve, enabling insured commercial banks and savings institutions to continue to post record profits in the second quarter. The quarterly net income of $38.1 billion was $1.2 billion (3.2 percent) higher than the previous record set in the first quarter, and $3.7 billion (10.9 percent) higher than the second quarter of 2005, when trading revenues at large institutions were especially weak. The improvement in net income compared to year-earlier levels came from higher non-interest income ($6.7 billion or 12.1 percent higher), and from increased net interest income, which was up by $4.4 billion, or 5.4 percent. Much of the improvement in non-interest income came from a rebound in trading revenues (up $2.2 billion, or 90.1 percent), and servicing fees (up $1.4 billion, or 46.7 percent). Due to lower gains on sales of securities and other assets (down $2.0 billion, or 87.8 percent), and higher non-interest expenses (up $3.3 billion, or 4.0 percent), the year-over-year improvement in quarterly earnings was limited. Loan-loss provisions were only slightly changed from a year earlier, declining by $17 million (0.3 percent). The average return on assets (ROA) was 1.34 percent, unchanged from both the first quarter of 2006 and the second quarter of 2005. While industry earnings continue to grow, many institutions are struggling with the flat yield curve environment. Only 56.6 percent of all institutions reported higher quarterly net income than a year ago, and fewer than half of all institutions (48.7 percent) had higher ROAs than in the second quarter of 2005.

PROFITABILITY TRENDS ARE CLOSELY TIED TO TRENDS IN NET INTEREST MARGINS

The proportion of institutions reporting improved net interest margins (45.7 percent) is very close to the proportion reporting improved ROAs. Almost three out of every four institutions (71.9 percent) that reported higher quarterly net interest margins (NIM) than a year ago also reported higher ROAs. An almost identical proportion of institutions (71.2 percent) that experienced declining NIMs also had year-over-year declines in their quarterly ROAs. As short-term interest rates have risen faster than long-term rates, increases in institutions' funding costs have outpaced increases in the yields on their investments. The resulting margin squeeze has been more pronounced at larger institutions, which rely more on short-term, interest-sensitive liabilities to fund their assets. Margins have declined at smaller institutions as well. They obtain more of their funding from retail deposits, which reprice upwards more slowly when interest rates rise, and their average funding costs have remained below the industry average. However, their assets include a larger proportion of longer-maturity loans and other investments, which reprice more slowly when interest rates rise, so the average yields on their assets have risen more slowly than other institutions.'

CAPITAL INDICATORS REMAIN ROBUST

Equity capital increased by $20.6 billion, or 1.8 percent, during the second quarter. Retained earnings contributed $16.4 billion to the increase. The industry's ratio of equity capital to assets fell from 10.38 percent to 10.27 percent during the quarter. The core capital (leverage ratio) had a smaller decline, from 8.27 percent to 8.24 percent. The tier 1 risk based capital ratio slipped from 10.76 percent to 10.75 percent, while the total risk-based capital ratio improved from 13.06 percent to 13.08 percent, as the industry added more assets with low risk weights in the second quarter. All capital ratios remained near long-term highs. At the end of June, more than 99 percent of all insured institutions met or exceeded the requirements of the highest regulatory capital standards.

ASSETS CONTINUE TO GROW AT DOUBLE-DIGIT ANNUAL RATE

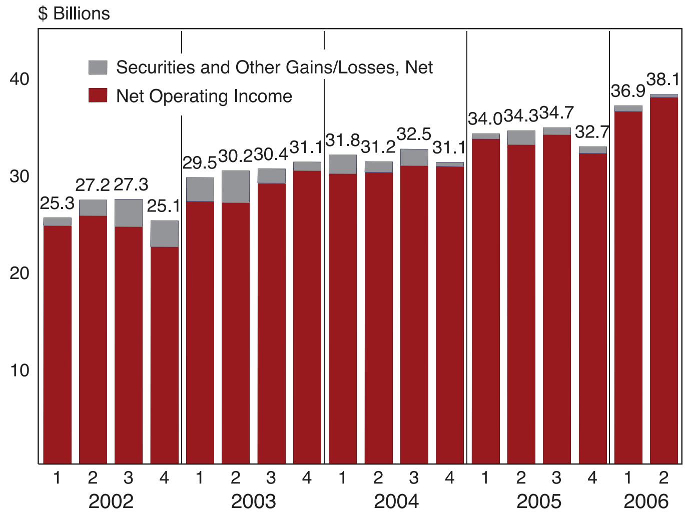
Total assets of insured institutions increased by $314 billion (2.8 percent) during the second quarter, as loan demand remained strong. During the 12 months ended June 30, industry assets increased by more than $1 trillion, the first time that an increase of this magnitude has occurred over a 12-month period. Loans and leases accounted for almost two-thirds of the increase in assets during the second quarter. Residential mortgage loans registered the largest increase, growing by $54.3 billion (2.6 percent). C&I loans rose by $31.7 billion (2.8 percent), followed by real estate construction and development loans, which increased by $30.4 billion (6.3 percent). During the last 12 months, construction and development loans have grown by $123.9 billion (31.8 percent). Other loan categories that exhibited significant growth include loans secured by commercial real estate properties, which were up by $21.3 billion (2.5 percent) during the quarter, and credit card loans, which increased by $15.7 billion (4.4 percent). In addition to the growth in residential mortgage loans, the industry also saw its mortgage-backed securities (MBS) increase by $25.5 billion (2.1 percent) during the quarter. Data on loans to small businesses and farms, which is reported each June 30, show that lending to small domestic commercial borrowers grew at a more rapid rate in the 12 months ended June 30 than in the 12 months ended June 30, 2005. However, the data also show that growth in loans to larger domestic commercial borrowers remains stronger. During the last 12 months, C&I loans with original amounts of $1 million or less increased by $12.7 billion (4.5 percent), while larger C&I loans grew by $80.5 billion (13.0 percent). Commercial real estate loans with original amounts of $1 million or less increased by $20.7 million (6.6 percent), while larger loans grew by $55.6 billion (11.9 percent). Agricultural production loans with original amounts of $500 thousand or less increased by $1.5 billion (4.9 percent), while larger agricultural loans rose by $3.0 billion (17.6 percent). Real estate loans secured by farmland with original amounts of $500 thousand or less increased by $921 million (2.8 percent), while larger farm real estate loans increased by $2.9 billion (20.3 percent).

MORE THAN TWO YEARS SINCE LAST BANK FAILURE

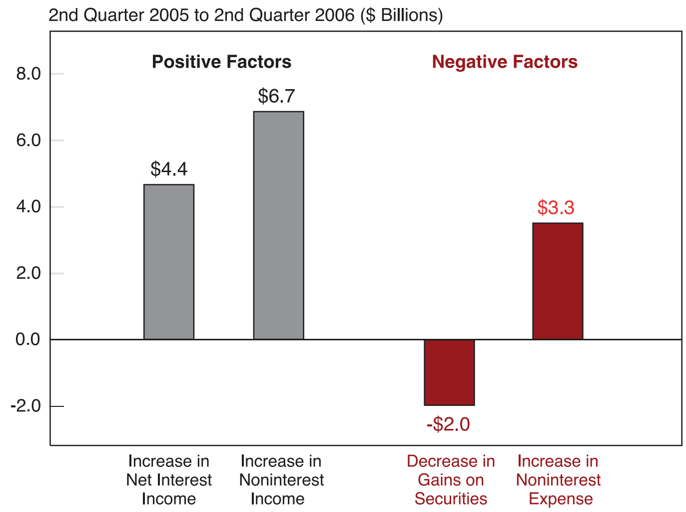
The number of FDIC-insured commercial banks and savings institutions reporting financial results declined from 8,790 to 8,778 during the second quarter. This is the second-smallest net decline in the number of insured institutions in any quarter since the industry began consolidating in 1986. During the 12 months ended June 30, the industry had a net contraction of 90 institutions, the first 12-month period in 20 years that has not had a net decline of more than 100 insured institutions. There were 55 new institutions added during the second quarter, while 67 insured institutions were absorbed by mergers. For the eighth consecutive quarter, no FDIC-insured institution failed. The length of time since the last bank failure, which now exceeds two years (the last failure occurred on June 25, 2004), is unprecedented in the 73-year history of federal deposit insurance. The number of insured institutions on the FDIC's "Problem List," increased from 48 to 50 during the quarter, and total assets of "problem" institutions increased from $5.4 billion to $5.5 billion, but these numbers remain near historic lows for the industry. Four insured savings institutions with $1.7 billion in assets converted from mutual to stock ownership in the second quarter.

Source: FDIC

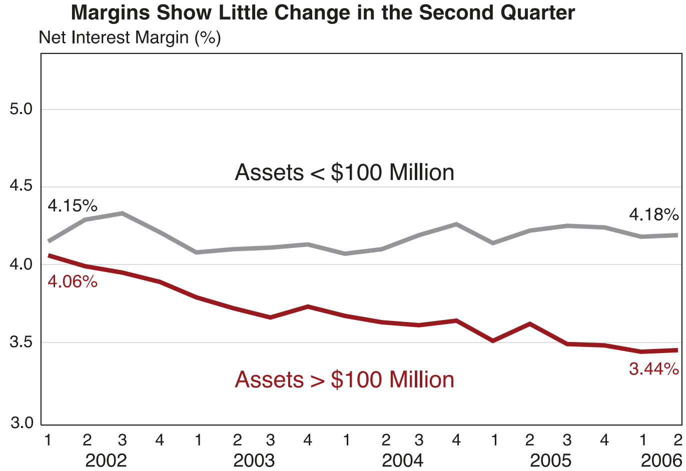
Profits Continue to Rise Steadily



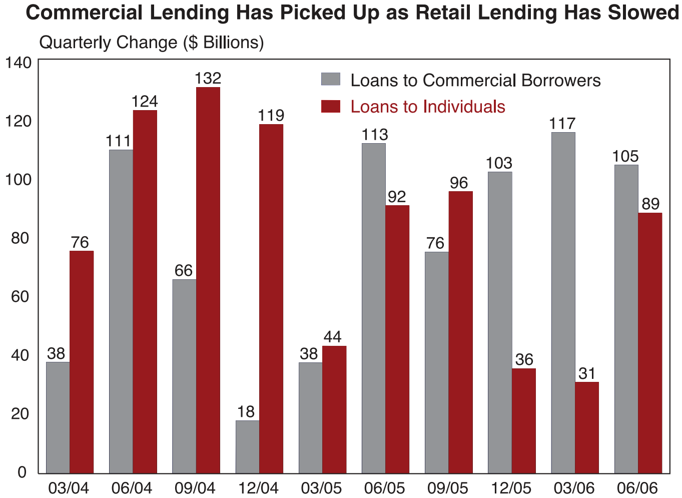
Rebound in Trading Revenue Lifts Noninterest Income



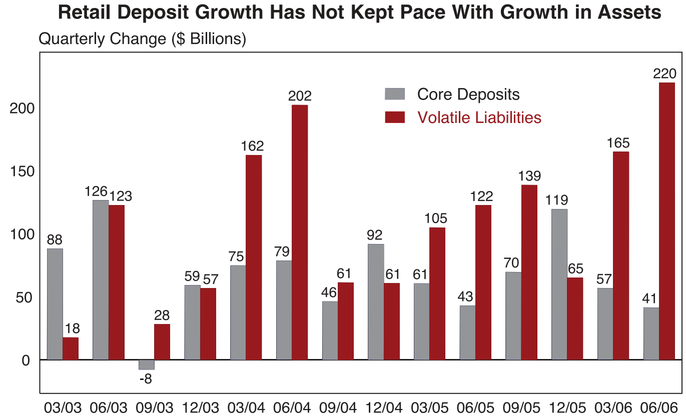
Margins Show Little Change in the Second Quarter



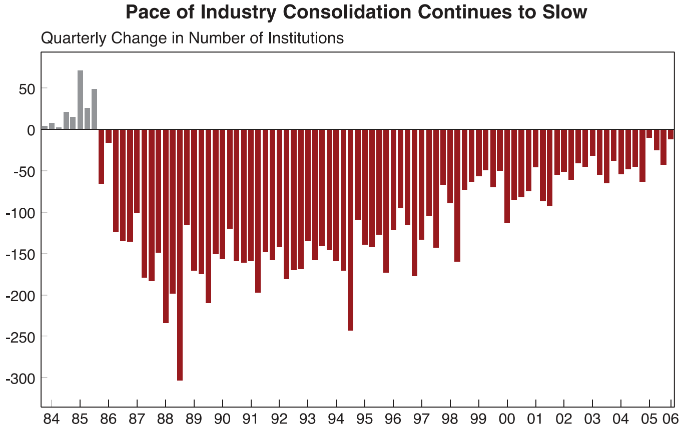
Commercial Lending Has Picked Up as Retail Lending Has Slowed



Retail Deposit Growth Has Not Kept Pace With Growth in Assets



Pace of Industry Consolidation Continues to Slow



The Artform of De Novo Bank Investing- A Discussion

De Novo banks are new organizations that have been formed and brought to existence by local community organizing groups.They have a board of directors made up of business leaders and professional from the local area. The management team is usually a group of banking professionals that typically possess a vast core of experience. From the time these banks emerge from the formation phase their shares are available to the investor public. I have done an extensive review of the performance of the shares of de novo banks over the past 5 years. I will not cite specific banks or data in this piece but will present summary conclusions in the discussions. Here is the obvious and serious caveat to readers regarding investing in de novo banks. There are risks involved including but not limited to- restricted liquidity, past performance does not necessarily portend future results, small company shares possess high potential volatility and the community bank industry is specialized and investors must be able to assess the fundamental process of a bank. Succinctly put- don't venture into the sector unless you have the assistance of a professional or have a personal degree of sophistication.

My sampling revealed that over the past five years the median annualized rate of return to investors who purchased their shares in the offering periods was in excess of 16%. That is a very impressive number. Some of the banks posted results well in excess of that level. Why? Market supply and demand factors, and additionally it is planting season. The business cycle of the banking industry is not unlike a crop cycle. The burst of merger activity that occurred over the past few years (harvest time) created space and market share opportunity for the new banks that have been forming.

The current market for established banks is in my opinion generally overvalued. It is difficult to find a reasonable value in community bank stocks at this time. Shares are priced at premium level price to book and price to earnings multiples. As investors we cannot "reach" for opportunities in the banking sector. We are value investors thus a poor entry point in a position is very difficult to overcome. This relative valuation dynamic causes some of the de novo bank shares to be values.

To further look at the valuation process it is helpful to follow the fundamental progress of a new bank. The example I will cite is a compellation of modal results in the de novo industry.The organizing group will form what is known as a pre-organization corporation and fund that company with the monies necessary to reach a point where a bank charter is issued by the appropriate regulatory bodies. The bank is now deemed to be qualified to raise capital. Common shares are sold to the public via a process sponsored by the bank "in organization". This marketing process also calls for expenditures to be made. Typically the shares are offered at $10 per share. When the offering is completed it is not unusual for the calculated book value of the bank shares to be in the $9 per share range reflecting an approximate 10% cost draw down. At this point the new bank is trading at 1.1x book value. Even though the probable fundamental outlook for the bank is to post operational losses for the near term, on the average the pricing level has not proved to be excessive. With the doors open and operational expenses accruing further losses are probable until the bank reaches a cash flow breakeven point which now averages about 7 quarters. When cash flow break even is attained it is not unusual for the new bank to have a book value in the $8 per share range or a total of 20% drawdown on shareholder value. If the share value on the open market is still around $10 the price to book value ratio is about 1.25x. In the current market environment that has proven to be sustainable for a bank that is now into the phase of recovering the capital depletion through operational "earnings". The bank is not liable to pay corporate taxes on positive cash flow (earnings) until losses have been recouped. Again modal experience shows a time frame of 30 to 36 months from opening the doors a successful community bank has re-established the book value per share. With about 3 years of successful operational history and prospects for ongoing profitable results the bank will trade at a multiple of the $10 per share. What multiple? Good question and the answer is that it varies greatly. For discussion purposes a 1.5x multiple is not an excessive median level at this time. From this point on the pricing of the bank shares are at the vagrancies of the market as it relates valuating an ongoing community bank. Examples of recent median valuations of community bank shares as it relates to price to book value ratios show California banks with a 2.3x median, Arizona 2.4x and Alaska 1.8x.

Great care must be taken in coming to absolute conclusions from the discussions in this piece. Know one knows with absolute certainty what the future holds for the market action of community bank shares because in the final analysis the market is the market and does what the heck it wants! However, what can be inferred and my basic point is that- knowledgeable value oriented investors may be well served to participate in the De Novo bank process. Historical experience over the last 5 years has indicated the endeavor is likely to yield a successful outcome. Another critical assumption in this discussion is that investors have a minimum time frame of 3 to 5 years. In bank investing, patience is truly a virtue. Here is the final and a crucial point I want to make. I have been using numbers and multiples to indicate procedure. Never forget that People make the numbers. Management and the Boards of Directors of banks are the keys to success. One must add the qualitative elements to the analysis process also to get a "feel" for the people.

Thus the title--it's an art form process.

The Times They Are A Changing--Alerting all Bank Investors

Quoting Bob Dylan is apropos as one scans the very latest business news headlines. In particular bank stock investors need to raise the level to Defcon 4. I am talking about the glimmering of some fundamental and psychological turnings in the economic mix. These items bode particularly well for the bank stock sector. The items I am going to list here are early calls on my part. By the time all the evidence of changes is in it is many times too late for investors as prices will have risen. The action to be taken now is to actively pursue finding and purchasing shares of well valued banks.

Here's what I see happening;

Interest rates seem to have topped out for the cycle. The Fed has passed twice now without raising rates. As a matter of fact it is my opinion that the next move to come in the first or second quarter will be a decrease in rates!

Gas prices are on the decline. I believe we have seen the top for quite a while. Not only do lower gas prices help the pocket books of consumers it is a great psychological boost. No longer will the consumer feel that another raise is just around the corner and he better not plan that trip, vacation or deferred purchase. In a nut shell, we feel better about our collective personal financial outlook.

With the lowering of interest rates the real estate markets will improve. Some areas of the country are still working through a bubble (and I believe will continue to do so through much of 2007) but transactional activity and loan origination are showing signs of rejuvenation. As I related before these are only minor initial indications but I think they will continue and become more apparent- watch your local business news headlines for further proof of action. A large portion of loans made by community banks somehow involve real estate. Even if they are not direct real estate loans, real estate may be the ultimate collateral for a business line of credit. As the real estate market firms I expect loan activity to increase in all sectors- a leading indicator if you will. More loans mean higher gross profit margins for banks.

I think we will begin to see an increase in merger and acquisition activity in the Community Banking sector. This will evolve as the acquirers are able to discern a clearer look into the economic future. With the aforementioned interest rate discussion in this piece acquiring banks are more likely to be able to forecast increasing earning scenarios for potential acquisitions. Additionally they will feel more positive about their own future economic success. Mergers and acquisitions are a healthy element for investors to say the least.

Here is my final, ethereal, and most intriguing opinion. I think the Federal Reserve Board is now more concerned about a possible recession than inflation. This would mean that the interest rate outlook is in fact for lower rates. It also would be an indicator that other fiscal and monetary activity could be of a stimulative nature. Such a forecast could bode well for Community Bank investors as Banks could thrive in such an economic environment.