

January 7, 2005

A Special Report From Bankstocks.com

Looking Back, Looking Ahead

Financial-services industry highlights of 2004,
and what to expect in 2005

By Thomas K. Brown
CEO and Portfolio Manager, Second Curve Capital

What were the most important events in the financial services industry in 2004--and what's likely to be in store for 2005? You've come to the right place to find out! We've had an extended discussion around here lately on those very topics. Here's what we came up with. First, the **highlights of 2004:**

1. Regulators stepped up the pressure across virtually all sub-sectors. Boy, are the 1990s ever *over*. In 2004, financial services companies dealt with a vast increase in regulatory scrutiny considerably greater than anything non-financial companies endured. The pressure seemed to come from all sides. New York Attorney General Eliot Spitzer turned the screws on the mutual fund companies, and then lowered the boom on the insurance industry. The Securities and Exchange Commission roped in hedge funds, and tightened the rules governing mutual funds. OFHEO skewered Fannie Mae and Freddie Mac. The Office of the Comptroller of the Currency read the riot act to the banking industry regarding money laundering. Then there was

Sarbanes-Oxley.

There seemed to be no end. Regulation is of course an essential part of both the free-enterprise system and the proper functioning of markets. And, yes, during the bubble years it occasionally seemed as if the regulators were mostly sleepwalking. But based on the level of squawking I heard from CEOs last year, 2004 could have been the year when the regulatory pendulum swung toward overkill. Alas, no relief is expected in 2005.

2. The growth of consumer credit rolled on. Much to the dismay of that small sector of the peanut gallery that has made a life's work of predicting a consumer crackup, the U.S. consumer did just fine in 2004. His income, net worth, and level of borrowing all rose. And--wonder of wonders!--he's servicing his debt ably, thanks to the steadily expanding economy and continued low level of interest rates.

The consumer-credit skeptics were wrong once again.

The most notable new news on the consumer-borrowing front in 2004 was the continued surge in mortgage loan originations to sub-prime borrowers. The numbers were powerful: certain sub-prime mortgage lenders have generated annual earnings per share growth of 30% or more over the past several years. (Something new for the naysayers to worry about!) Part of sub-prime lenders' rapid growth is cyclical, of course. But it's also been driven by powerful secular and demographic forces, such as immigration trends and lenders' ability to move profitably down market.

As interest rates rise in 2005, I expect one or more sub-prime originator to stub its toe--it happens to lenders every cycle--and a cloud will be cast over the earnings outlook of the entire sub-sector. When that occurs, investors will likely have an opportunity to own some extremely well-managed companies at attractive valuations.

3. Bank and thrift mergers returned with a bang. While fewer

deals were done in 2004 than in 2003 (249 versus 264, to be exact), the dollar value of 2004's deals soared (to \$131 billion from \$72 billion). That makes 2004 the second-biggest (and wackiest) year for M&A activity among banks and thrifts. If you think that bodes well for the future, think again! In 1998--the all-time champ for bank and thrift deals--504 transactions were closed, with an indicated value of \$289 billion. Sure enough, with the exception of the Wells Fargo-Norwest combination, all the big entities created in 1998 subsequently announced big-time earnings disappointments. The net result of the merger mania was destruction of shareholder value at the acquirers on a not-so-small scale.

The aftermath this time isn't apt to be much different. In 1998, the median price paid for acquisitions was a record 23.2 times trailing earnings. It was a record, that is, until 2004--when the median bank-buyout P/E hit 24.9 times earnings. At those kinds of prices, *everything* has to go right for a deal to have any chance of creating even a shred of value. Cost saves must be bigger than budgeted and be achieved ahead of schedule, integration has to be flawless, customer attrition negligible, and revenue synergies really need to happen. Care to make any bets?

Buyout multiples set a record in 2004.

4. Big banks continued to improve their retail banking operations. Thanks to their deal focus in the 1990s, most big banks had let their retail service levels deteriorate badly by decade's end. At rock-bottom, service levels at many had fallen to state-DMV-type levels. Luckily, some CEOs (such as First Union/Wachovia's Ken Thompson, Fleet's Chad Gifford, National City's Dave Daberko, and even BofA's Ken Lewis) saw the hole their retail businesses had fallen into, and set out to salvage them.

By almost all measures, their efforts worked. The retail banking performances at BofA, Fleet (before its acquisition), Nat City, and Wachovia improved tremendously over the past few years. That

improvement continued in 2004.

The companies were helped by an exceptionally benign environment, of course: deposit costs were low, consumer-savings alternatives (read: the stock market) unappealing, and home-loan demand strong. Even so, the retail turnarounds executed at one big bank after another were extraordinary.

5. Excessive bank branching continued in 2004. This is the unhappy flip side of the resurgence of retail banking. By now, too many banks are convinced that they are bulletproof to competition, and think they can aggressively expand their branch networks with little risk. They can't. It is highly likely that in certain markets, banks are opening many more branches than can possibly be justified by the level of potential demand. An expensive shakeout is coming, I believe.

*Too many new
branches chasing too
little new business.*

Some numbers, if you doubt it: We estimate that the banking industry opened around 2,000 branches in 2004, increasing the total number in the U.S. by 2.5%, twice the rate of population growth.

Worse, some of the largest, most competitive markets in the country have seen a surge in branch openings. In New York, for instance, the number of branches has jumped by 8% over the past five years. In Texas, it's up 19%. Chicago has seen 21% growth. In Atlanta, perhaps Ground Zero in the industry's de novo riot, there has been an incredible 24% increase in the total number of branches over the past five years.

I don't feel like I'm too far out on a limb when I predict that there won't be enough business to go around for all these new locations--particularly when you consider that most of the branches opened in the years just before the de novo surge began haven't been particularly successful.

More numbers: bank-branching experts Marketech Systems International looked at all the branches opened in the U.S. five years ago, and found that the median branch in the group had attracted just \$14 million in deposits. That's only about half the level needed for breakeven at a typical bank. Marketech estimates that only 50% of the de novo branches opened five years ago are even covering their operating costs!

Almost all bankers concede that over-branching is going on--but also believe that their companies won't be the losers when the shakeout comes. They won't all be right!

6. Interest rate risk mismanagement came into play in 2004. In aligning the durations of their assets and liabilities--as time-honored a task in banking as there is--virtually all banks buy and sell securities; some also use off-balance-sheet derivatives. But don't for a moment think asset-liability management is a surgical process. It's not. Rather, the task is as much an art as it is a science. There's basis risk between certain instruments, for instance, and uncertain duration in others. Occasionally, the real world intrudes in unexpected ways.

The "carry trade" can be addicting--and dangerous

What's more, bankers will sometimes go beyond mere risk management when they rejigger their balance sheets, and will try to eke out an extra dollop of earnings or two. How? By adding more short-term liabilities than they need, and investing the proceeds in long-term securities. When the yield curve is upwardly sloping (as is typical) this strategy of borrowing short and lending long is famously known as the "carry trade." It can be addicting when the yield curve is steeply sloped. And inasmuch as the profitability of the trade depends entirely on changes in the shape of the yield curve, it can be dangerous, as well.

In 2004, the spread between the fed funds rate and the yield on five-year Treasuries was cut by more than half--and a few carry-trade-crazy

banks felt the sting. In particular, institutions such as New York Community Bank and Fifth Third, which had come to rely heavily on the carry trade for a meaningful portion of earnings, had to lower their earnings guidance for the year as the yield curve flattened. This is only the beginning. Other banks will feel carry-trade-related pain in 2005.

7. Commercial loan demand failed to recover in 2004 as expected. When 2004 began, we (and most other observers) expected commercial loan demand to recover as the economy picked up steam. We were wrong! But that might be about to change, at last. The Fed's last two quarterly surveys of loan officers give us increasing confidence that commercial demand is strengthening. Indeed, there's been some improvement in outstandings in the last few months. I believe that C&I loans will be a critical component to bank earnings growth in 2005.

C&I loans could be a critical component to bank earnings growth in 2005.

Outlook For 2005

No doubt, 2004 was a fascinating year to be an observer of (and participant in) the financial services industry. Now, to our predictions for 2005:

First, some background. We've used the consensus economic forecast as the foundation for our 2005 predictions. I believe that forecast calls for:

- > **Real GDP growth:** 3% to 4%.
- > **Inflation:** 2% to 3%.
- > **Fed funds:** 3.0% to 3.5% at year-end
- > **10-year Treasury yield:** 5.0% to 5.3% at year-end.

In my view, the greatest risk to this forecast is that the actual rate of inflation and interest rates may prove higher than expected. That said, here are our top predictions for 2005:

1. Bank earnings growth will disappoint. Of all the major sub-sectors in financial services, regional banks will almost surely have the most difficulty achieving the current consensus estimates, in my view.

There are several reasons why. First, net interest margins will be under pressure because of growing competition for deposits (particularly CDs) and the negative impact of a flattening yield curve. Second, mortgage-related income will fall as interest rates rise. And third, loan loss provisions might rise (they sure can't fall any further). More generally, expenses will be difficult to contain given the industry's increased regulatory costs and the expenses it's incurring related to its misbegotten branch expansion.

Regionals' P/E multiples are well above their historical averages.

Ironically, despite the challenging outlook I see for most regional banks, their stocks are trading at P/E multiples that are well above their historical averages. Because of this, I expect regional bank stocks to underperform in 2005.

2. The mortgage market is in for more pain. Single-family mortgage originations dropped by around 20% in 2004 from the peak level reached in 2003. Originations will likely decline another 30% in 2005, I believe. Unfortunately, industry capacity hasn't dropped nearly as fast as demand has. Worse, too many players are looking to expand their capacity even as the industry goes through a cyclical contraction. The almost-certain result: more pricing pressure and earnings challenges in the mortgage banking business in 2005.

As noted, sub-prime mortgage loan originations have been skyrocketing for several years, driven by both cyclical and secular forces. The last time the business grew this fast, in the late 1990s, things didn't

end well. The culmination was an industrywide blowup in 1998 that saw a few players go out of business, and many others driven to the brink. While I don't expect a repeat of 1998 in the sector this time around, I do expect at least a few sub-prime lender players to stumble; when that happens, it will create an excellent investment opportunity with respect to the other well-run sub-prime mortgage originators, I believe.

3. Commercial loan demand will improve--but credit conditions will weaken. As I mentioned, commercial loan demand did not rise with the economy in 2004. Company managements were still wary following the 2000 recession, and sat on record piles of cash.

But that's changing. C&I loan volumes have begun to grow at last; the rate of growth should increase at least through the first half of the year, I believe. Unfortunately, we are already hearing too many chief credit officers bemoan the deterioration of credit standards, particularly with respect to middle-market lending where competition is most intense. Banks won't experience significant credit problems in 2005--but have likely begun to sow the seeds for credit problems in the future.

M&A will likely pick up across the entire spectrum of the industry in 2005.

4. Financial-services mergers and acquisitions will increase. Despite acquirers' sorry track records over the years, M&A activity will likely pick up strongly across the entire spectrum of the financial services industry in 2005.

There will be all kinds of reasons why, I believe. Sellers will be motivated by an increasing regulatory burden, for instance, and by (often yield-curve-related) earnings shortfalls. Other sellers will be moved by succession issues. For their part, buyers will be looking to add size (an all-season M&A motivation) and to buy growth. Foreign players might want to exploit the strong euro.

Where do I believe the activity will be greatest? In almost every sub-sector, including banks, credit card companies, asset managers, and mortgage companies.

5. The investment environment will be challenging. Most market forecasters seem to expect gains of 6% to 10% in the S&P 500; I believe that's optimistic. Financial stocks in particular will likely be a mixed bag. In such an environment, a good investor can still make an attractive return (say, 15%-20%) but he'll need to be more nimble than in the past couple of years.

And he'll need to select the right companies, and not just make sector or sub-sector bets. My favorites for 2005 are **Capital One (COF)**, **Investors Financial Services (IFIN)**, **Commerce Bancorp (CBH)** and **Morgan Stanley (MWD)**.

Good luck to all in 2005!

ABOUT TOM BROWN: Thomas K. Brown is the CEO of Second Curve Capital, a New York-based hedge fund that specializes in financial services companies.

Prior to starting Second Curve in 2000, Brown headed the North American Financial Services group at Tiger Management in New York, from 1998 until 2000. Before that, he was the pre-eminent bank analyst on Wall Street. In the ten years from 1989 through 1998, Brown was the top-ranked bank analyst on Wall Street nine times, according to *Institutional Investor* magazine's annual survey. (He was ranked second, once, in 1991).

From 1983 through 1998 Brown covered regional banks for three leading investment firms: Smith Barney (1983-1989), Paine Webber (1989-1991), and Donaldson Lufkin & Jenrette (1991-1998). *Institutional Investor* four times rated Brown a Top-10 Stock Picker across all industries, in 1992, 1993, 1994, and 1996.

In addition, Brown writes a regular column for *Bank Director* Magazine. He is the Chairman of *American Banker's* annual "Best Practices in Retail Financial Services" Symposium. Brown is also closely involved with a number of conferences held by BAI, the banking industry trade group and conference organizer.

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