E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & James Bruss
DATE: January 31, 2011
SUBJECT: A Return of Sanity to the Bank Stock Market?

Last month, we reflected ruefully on the bank consolidation wave that never was (or, at least, has yet to occur). The table is set, with external pressures from the market and regulators and internal pressures from management and board fatigue. But in 2011 the entire banking industry bled from its wounds, self-inflicted and otherwise. Buyers of banks simply haven't trusted the sellers; sellers simply haven't been willing to sell at the resulting discounts.

So, that's the bank M&A market: disappointing, distrustful, in need of good news. The market for publicly traded bank stocks has mirrored the M&A market. In 2011, bank stocks suffered miserably. The SNL U.S. Bank Index (all publicly traded U.S. banks, market cap-weighted) was down almost 24%. The SNL Micro Cap U.S. Bank Index (all publicly traded U.S. banks under $250MM in market cap) was down only 7%, though valuations for micro-cap banks had lagged behind the rest of the industry going into 2011. Whatever the causes—regulatory and political uncertainty, the sluggish economic recovery, the Eurozone crisis—the market for bank stocks took a beating in 2011.

We are loathe to generalize from a quarter plus a month of market performance, but there is indeed good news in the air amid the rough going. In early October, the market turned around. Since the end of 3Q11, bank stocks have performed extremely well. The SNL U.S. Bank Index is up almost 21% since then; the SNL Micro Cap U.S. Bank Index is up 9.5%. The best performers were small cap banks, up almost 29%. The Eurozone crisis seems a continuing saga with one solution after another proposed and approved, then shelved. Regulatory and political uncertainty have not subsided and while recent news on the economy has been more positive than earlier in the year, it has not suggested a full-fledged boom. So what has changed?

In short, we believe the market is becoming less skeptical about bank fundamentals—with good reason. The industry as a whole has finally become pro-active about addressing credit quality. As a result, non-performing assets (NPAs) are down more than 15% in 2011. Meanwhile, banks are actually making money. Whereas the industry returned 1.3% and 2.5% on equity in 2009 and 2010, respectively, in 2011 the industry returned 6.3% on equity. (Caveat: some banks have yet to file call reports for the fourth quarter of 2011; these numbers reflect only those that have already reported.) So, even in the middle of working through their still high level of NPAs, banks are growing profitability. Of course, a 6.3% ROE is hardly worth celebration, but it certainly belies market valuations.

Alongside shrinking skepticism about bank fundamentals, the market has begun to filter out the noise from Washington and abroad. You will never hear us cheer the Dodd-Frank Wall Street Reform and Consumer Protection Act. In fact, we've consistently criticized it as overweening and off-point. But we've also been of the belief from the beginning that a well-run bank (yes, even a small community bank) can surmount the regulatory costs associated with Dodd-Frank and the Consumer Financial Protection Bureau it established. The costs associated with regulation are familiar to bankers. Notwithstanding the complaints about deregulation causing the financial crisis, the banking industry has been one of the most tightly regulated industries for most of the last century and banks have still found a way to be profitable. It appears the market is starting to relearn this. The market also appears to finally understand the limited exposure (if any) that most banks have to the Eurozone. This is not to minimize the significance of Dodd-Frank or the European crisis, but rather to put them into perspective. A mere four months ago,

investors assumed that which is not knowable must turn out to be catastrophic. Fortunately, the market has begun to abandon that dour logic in favor of hard analysis.

Even after the current run-up in the public markets, bank stocks remain remarkably inexpensive. As of the end of January, the industry is trading at 83% of tangible book value. For an industry that has, on average, returned over 6% on equity in the past year, that is remarkable. There are still plenty of dogs out there, from among the smallest community banks to the largest money center banks. But the focus on those on those poor performers obscures the recovery that has taken place (and is still taking place) in the banking industry and can divert our attention from the value that exists in individual banks. We think that is short-sighted. Whether 2012 is a bull market year for bank stocks remains to be seen. But long-term investors will be rewarded for recognizing the value opportunity that is now ripe in banks.

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FORTRESS
PARTNERS
CAPITAL MANAGEMENT, LTD.
700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029
262-369-1095 (Jon Bruss and James Bruss)
www.fortresspartners.com

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