

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
Date: May 20, 2008
Subject: Deposits Make Banks Different

Banks are different. What other business would you hand your money to through a car window or at an ATM and drive away without giving a second thought to safety and security? Who else, for that matter, would you give your money to at all for safekeeping? That is a big deal, but a fact we take for granted as did generations before the creation of the Federal Deposit Insurance Corporation.

Banks have the public's trust. We may not like the service or the location or the fees but we trust our bank and its employees to keep our money safe until we need it. But infrequently, the public's trust is betrayed. During the S & L crisis of the 1980s, hundreds of banks and thrifts (mostly the latter) failed. We expect bank failures will increase in 2008 and 2009 from none in 2006 and three in 2007. But the problems will not be as extensive as they were 20 years ago. Today, banks are better capitalized, better managed, and better regulated than they were in the '80s.

True banks—including even Citigroup, JPMorgan Chase, Bank of America, and Wachovia, each of which has very significant non-banking businesses—are distinguished from investment banks because they are authorized to accept deposits which, in turn, are insured by the federal government. Unlike true banks, Bear Stearns and Thornburg Mortgage did not and could not take deposits. They had to rely upon wholesale funding from investment banks and commercial banks. That kind of funding is granted in large chunks and can be lost in large chunks. When one bank gets sweaty palms regarding a company or an asset class, it is contagious and the anxiety spreads. The contagion began to make its way through the financial system a year ago and culminated in the sale of Bear Stearns to JPMorgan Chase, when Bear's shareholders got \$10 per share for a stock that traded at over \$150 less than a year before. Thornburg's shareholders also got crushed by its bankers. Even though Thornburgh has been recapitalized, its shareholders saw their shares drop from \$26.38 on May 22, 2007, to \$0.68 on May 20, 2008. True banks don't have this problem because they take deposits. In contrast to wholesale funding, deposits are granular; losing one depositor will not cause a collapse in a bank's leverage structure.

Ex-banker Vernon Hill was the founder and long-time CEO of Commerce Bank of New Jersey, which was a great success story. He recently wrote an article entitled "The Fool's Gold of Wholesale Funding", which appeared on March 24, 2008 on bankstocks.com:

Item: British savings bank Northern Rock is hit by an old-fashioned bank run, and is bailed out by the U.K. government.

Item: Customers and trading counterparties suddenly refuse to do business with Bear Stearns, on fears the firm faces imminent insolvency. The prophecy fulfills itself, and within days Bear agrees to be acquired by J.P. Morgan at pennies on the dollar in a deal brokered by the Fed.

Item: Carlyle Capital, a publicly traded mortgage investor operated by Carlyle Group, of the private equity world's super-elite, is forced to liquidate in the face of a tidal wave of margin calls.

Item: Lenders cut off CIT, the venerable middle-market finance company. CIT is now scrambling to sell non-core assets to stave off insolvency.

Item: Thornburg Mortgage, a mortgage REIT whose portfolio consists of entirely of gilt-edged, super-prime paper, teeters on the edge of extinction as margin demands mount.

Item: Countrywide Financial, once the largest originator in the mortgage industry, sees one source of funding dry up after another and is forced into a fire sale at a price 80% below its 52-week high.

Are you sensing a pattern here? Scan the laundry list of financial woe above, and a few common features stand out:

First, the companies that have come acropper, almost without exception, let themselves get way, way too levered. Second, none of these firms has a deep well of core deposit funding to fall back on when times get unsettled. Finally, just about all the companies relied on short wholesale funding much too much.

In the end, all the firms fell victim to one form or another of a modern-day run on the bank. The one thing they all lacked, we now know, is a true unique business proposition that could endure when the environment became uncertain. Why bother with the hard work of building a deposit and core funding base? Why attract customers who'll form the basis of a real business, when you can make a phone call to Wall Street and borrow billions?

The answer is obvious now, even if it might not have been so obvious this time last year: Availability of wholesale funding has no stability, disappears on a moment's notice (and just when you need it most), and is way too sensitive to what the rumor mongers have to say. When Wall Street concocts its sophisticated "risk management" models, does no one take into account (and plan for) the possibility that that one day the money spigot might simply get turned off? Or do these geniuses' business models all assume the unending availability of endless wholesale funding? As we see more companies brought to earth by liquidity squeezes, when will we learn the differences between the creation a real financial business and mere financial engineering?

If it's not a deposit-taking bank, it's just financial engineering. But wait, don't deposit taking banks fail? What about ABN Bank of Bentonville, Arkansas? Wasn't that a "deposit-taking bank"? Indeed it was. But it relied almost exclusively on brokered deposits, a temporary tool used to manage a bank's funding when inexpensive local deposits are tough to come by. Many banks cap funding from wholesale sources at 10% to 20%. Some bankers won't rely on any wholesale funding but use local deposits to fund loan demand, regardless of the near-term cost. We don't know the directors or shareholders of ABN but we must conclude they weren't very sophisticated. Sophisticated shareholders and directors demand more than just earnings. They demand the bank build franchise value—core deposits—which supports shareholder value. ABN failed because it had no franchise value—i.e., no value to shareholders or another bank. A subsidiary bank of Iberia Bancorp agreed to purchase ABN's deposits for a premium of 1% plus the cost of real estate of ABN's branches.

Unlike the price Iberia will pay, a bank's franchise is worth 15% to 25% of core deposits when it focuses on franchise value. But the May 16th *Wall Street Journal* reported in "A Gamble That Went Bust," that "Mr. Dykema [Dan Dykema, the bank's founder] offered some of the highest interest rates in the country on certificates of deposit. ANB also aggressively sought deposits sold through *securities firms*. By last year, such brokered deposits had increased to *more than 80% of the bank's total*". (Italics are mine.) In a subsidiary headline, the article further highlights this issue by pointing out that "ANB's Collapse From Real-Estate Bet Is Ominous for Small, Midsize Lenders". Certainly ABN was stressed by its "real-estate bet" but the threat of losing its brokered deposits (which are analogous to wholesale financing on Wall Street) turned stress into failure.

In contrast, East West Bank (EWBC), a Los Angeles based bank that has built its franchise by serving the Chinese-American community in southern California, survived the real estate bust in southern California's Inland Empire. It needed to supplement its capital, and raised \$200 million in preferred equity (a \$150 million offering oversubscribed by \$50 million, according to the May 19th *Barron's*). According to its regulatory filings EWBC has 59% percent core deposit to total deposit ratio. The remaining 41% of its deposits are jumbo CDs (\$100,000 or more). (Jumbo CDs are viewed as non-core by regulators and most analysts. Still, most wealthy bank customers with jumbo CDs at their local banks are there because they trust their banks, not because they are rate shoppers. This leads bankers to categorize most jumbo CDs as core deposits while the regulators and analysts think of jumbos as "hot money".) The market is currently assigning a value of \$836 million to EWBC, excluding the \$200 million in convertible preferred sold after March 31, 2008. That is 75% of nominal book value. If 59% of the bank's \$7.55 billion in deposits are core deposits—which is understated—at a 20% premium, the deposit franchise alone is worth nearly \$900 million. Even though the market values EWBC under book value, the reason EBWC was able to raise \$200 million is

its solid deposit franchise. The directors and shareholders of ABN Bank learned this lesson the hard way. East West Bank survived. ABN did not.

Succeeding in bank investments has always involved searching for the right combination of management, markets, and bank fundamentals. That was again demonstrated by banks reporting earnings for the first quarter of 2008. We were disappointed that our banks didn't do better. But we take some comfort that our bank selection process is working. We saw a slowdown in growth and some erosion in performance but not the disaster the media portrays. Our banks continue to grow and experience acceptable performance in a tough environment. We may see some further erosion of credit quality in the second quarter as residential housing problems work their way through the banking system. Nevertheless, one of the more under-reported stories was Friday's announcement that housing starts had increased in April. The consensus expected a decline to 939,000 starts (annualized) but was surprised when starts were actually up by 8.2% to 1,032,000. This is still 31% down from a year ago and nearly 55% off from its January 2006 peak. But March numbers were revised upward slightly, and new home permits grew to 978,000 annualized. While that is still way off its peak, it is moving in the right direction. This bit of good news contrasts with the media's dour outlook.

We continue to see strong loan growth among our banks and we expect that to be one of the catalysts reversing the decline in bank stock prices. Another catalyst should be the stabilization of interest rates, with increased chances the Fed will raise rates before the end of the year. Our bankers are telling us net interest margins will probably normalize in the third and fourth quarters of 2008.

The decline in bank stock prices has exaggerated the perception of earnings declines and erosion of credit quality. While bank stock indices are generally down 25% to 30% over the past 12 months, according to SNL's data base, earnings are down a median of 6.2%. The earnings of our banks declined only 4.3%. Here are those growth and performance metrics we've shown and discussed in the past updated for the March 31, 2008 results:

TABLE 1

Median Change Growth Metrics	Per Share Earnings Growth	Loan Growth	Deposit Growth	Asset Growth	Book Value Growth
Q108 vs. Q107	-4.3%	13.1%	6.0%	11.9%	5.9%
Q407 vs. Q406	-15.0%	8.0%	10.9%	11.0%	4.8%
Q307 vs. Q306	-8.4%	9.8%	14.7%	15.7%	8.6%

We continue to observe strong loan growth, a liquidation of investment securities to fund loans with higher yields, and sound growth in book value. The sharp decline in market prices belies growth in book value and distorts price-to-book-value ratios. When prices to book value drop below 100%, it means the market thinks banks are headed for earnings losses. These statistics indicate otherwise. Approximately 20% of our banks recorded high single digit or low double digit earnings increases. The stock prices of these same banks reporting earnings increases have declined an average of 23.5% in the past year. We believe that we have picked great banks but the market, for now, disagrees.

TABLE 1-A

Actual Financial Performance Metrics	Return on Ave. Assets (%)	Return on Ave. Equity (%)	Net Interest Margin (%)	Non-Interest Inc./ Operating Revenue (%)	Efficiency Ratio (%)	NPA's/Loans & OREO (%)	Reserves/ NPAs (%)	Net Charge-Offs/ Recoveries (%)
Q108	0.76	7.62	3.70	13.36	65.90	0.85	136.3	0.13
Q407	0.67	7.61	4.01	13.38	57.75	0.75	174.7	0.10
Q307	0.84	10.36	4.05	12.19	60.88	0.46	311.6	0.11

We expect net interest margins to begin to stabilize in the current quarter as loan rates stop declining and significant blocks of CDs mature and roll over at lower rates. It is possible, if not likely, non-performing assets will creep up and reserves may need to be replenished at some of our banks as charge-offs increase. But strong loan demand will help drive net interest income and net interest margins should begin to return to pre-rate cut levels. Strong loan demand will also help anchor earnings by providing fee income.

We don't know when the decline in bank stock prices will reverse itself. But we do know that it will happen fast, and the first month or two will show a very sharp reversal just as in 1991-1992 when bank stocks rallied 10% in just two months. We will be there.

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