

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss  
**Date:** June 24, 2008  
**Subject:** Management, Markets and Metrics (Part 1)

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Managing a bank is a simple process requiring a simple and straight forward job description. One of my former bank presidents said anyone could run a bank as long as he or she could break up the knife fights in the back room during a data processing conversion. Well, maybe. Human resource specialists and management recruiters require a more complex, more detailed job description—perhaps far more detailed than required and not very memorable. A job description can tell you what's expected of you, but it can't give you the skills needed to fulfill those expectations.

So what is the proper job description for a bank manager? As the regent of a small college, my fellow regents and I were faced with the retirement of a long time president and the need to replace him. We didn't have a job description so I asked a friend of mine who had achieved success as a college president to tell me his job description. "Run the college," he said. He was also a bank director and told me the CEO's job was similar: "Run the bank."

So if this three word job description works, why not use it? In practice that is precisely what takes place in many banks throughout the country. But how do we know he or she is running the college or running the bank? Measurement of results. My friend, the college president, was all about the measurement of goals and objectives—"metrics," in the parlance of our times. All his goals and objectives were cast in terms that could be measured. So, at the end of the day or quarter, semester or year, the results were there to be measured. And there are plenty of ways to get there, to achieve monthly, quarterly, or annual goals. The person running the bank is being paid to do that without referring to a job description. Just run the bank.

Management has a lot to do with markets, determining how and when to enter a particular market or analyzing how long-established banks miss what is going on in their markets. In making these judgments, management and investors should think in terms of these market descriptors: underserved (or un-served), over-served, growing, and consolidating. Theoretically, a market may be un-served, underserved, or over-served. But in the age of personal computing and online demographic data it is difficult, if not impossible, to find an un-served market. Underserved markets may exist, but they are also difficult to find. On the other hand, over-served markets abound. Where I live, one wonders whether the banking industry hasn't over branched in the past five to eight years resulting in markets being over-served. Will the banking industry need to shutter some of those offices?

**Growing geographic markets** are markets growing faster than the US population or as one banker put it, "A growing market is any market growing faster than mine." One need not search too far to find banks of all sizes reaching across state lines or leap-frogging whole regions to find growth. Banks here in the Midwest, as an example, have entered markets in sunbelt states from New Mexico, Arizona, and California in the west to Florida in the east. Other banks have planted roots in Montana or Colorado. Markets like these can be readily identified. If the market is being served by a super-regional bank or a large money center or national bank, there will be an opportunity to provide the kind of highly personalized service only smaller community banks effectively deliver.

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In some cases these markets are also **consolidating markets**. St. Louis is a classic example. Bank of America gobbled up Boatmen's and Firststar took out Mercantile and then US Bank. More recently, National City Bank bought Allegiant and M & I bought Mississippi Valley Bancshares (Southwest Bank) and Trustcorp Financial. This consolidation has spawned nine start-up banks from 2000 to 2007 that have grown rapidly, some approaching \$500 million. Existing banks like Enterprise and Pulaski have also profited handsomely by strategic lift-outs of key personnel from the consolidated institutions.

So how do we measure market performance—what are our **market or growth metrics**? Regular readers of the *E-Memo* will be familiar with the metrics we use to determine whether bank growth is adequate to reach the goals we have set for investment returns.

Underlying these growth statistics is a management team that recognizes and exploits the opportunities presented in a growing and/or consolidating market. The first and last metric we focus on is **per share earnings**, the ultimate measure of a bank's management. Management achieves per share earnings growth by focusing on building a talented and experienced staff. Frequently, we hear successful managers tell us they hire the people and then build their banks around them. This may appear to give short shrift to the importance of markets in a bank's success, but it underscores the central fact of per share earnings growth: it takes people to grow earnings and the best bank managers know that.

Earnings can also grow by reducing expense. Reducing expenses without growing loans, deposits, or assets presumes that expenses had gotten out of hand—something a good manager would not allow to happen. More likely than not, earnings will be supported by loan, deposit, and asset growth, and will, in turn, drive growth in per share book value. **Loan growth** is easy. Quality loan growth—loans to profitable, strong borrowers—is more of a challenge. A loan, by itself, is a rather generic product distinguished from its generic competitors only by the service the lender provides. A loan does not, by itself, create shareholder value. Borrowers can be very rate sensitive, so if the lender can't provide any additional value, the lowest price bidder will end up getting the deal. The best loan packages involve more than just a loan.

Creating franchise value will enhance shareholder value. The best way to create franchise value is to **grow low cost core deposits**. Over time, growing core deposits enhances net interest margin, franchise and shareholder value, earnings per share, and stock price. Over the past eight years we've studied banks with a core deposit strategy and compared them to banks with a wholesale or brokered deposit strategy. Banks with a core deposit strategy sold at a higher earnings multiple than banks using a wholesale or brokered deposits strategy. In fact, the difference between the two strategies often results in a two-point difference in earnings multiple. If each bank earned \$1.00 per share, the wholesale/brokered deposit bank sold at \$14.00 per share, while the core deposit bank was \$16.00 per share—a 14% price difference. (Here, it is important to distinguish between brokered deposit *strategies* and brokered deposit *tactics*. Banks successfully use brokered deposit *tactics* when an unexpected spurt in loan growth coupled with a pricing adjustment in the deposit market or a slow down in deposit growth cause a bank to pursue this alternative until an improved, inexpensive core deposit program can be implemented. It happens all the time in established banks. Start-up banks often use large deposits, including brokered deposits and CDs over \$100,000, and advances from the Federal Home Loan Bank to provide funding until core deposit growth catches up with loan growth.)

Finally, **growth in book value per share** is an important metric, especially in today's environment, when the media have their audiences believing all banks are writing off huge sums and are unprofitable. A bank shows profitability by growing book value per share. If it is a dividend paying bank, growth in per share book value means it is earning more per share than the dividend it pays. If per share book value growth is sustained, dividends are likely to increase. In our portfolio of publicly trade banks, the median increase in book value per share was 5.9% in Q108 as compared to Q107. Currently, the market

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undervalues this metric as many of our banks are currently selling at or below book value. The only reasons a bank should sell below book value are that the bank is incurring losses or it is perceived that its current book value could not be sustained if it were liquidated. Apparently the market perceives one or the other of these situations is currently the case. That flies in the face of not only the increase in book value for Q1 but also the median increase in earnings for our banks.

Such are the anomalies we are dealing with today in small bank stocks—emotions trump fundamentals, perception overcomes reality. Earnings multiples are nearing single digits and prices are dropping below 100% of book value. Meanwhile banks are producing double digit earnings increases, and the intrinsic values among the nearly 1,400 publicly traded banks grow daily. And it keeps us in the hunt for the banks with the best metrics. But, according to the article “Regional-Bank Bargains?” in the June 23, 2008 *Wall Street Journal*:

**“[I]nvestors trying to pick the absolute bottom could get left behind. Even a morsel of good news can send [a regional bank’s] shares soaring. Friday [June 20], Atlanta-based SunTrust Banks Inc.’s stock price rose 5.5%, while the Columbus, Ohio based Huntington Bancshares Inc.’s jumped 30%, after both banks said they were sticking by previous forecasts on credit losses.”**

These two banks are more visible than our banks due to their size. SunTrust has a market cap of \$13.2 billion and Huntington’s market cap is \$2.4 billion. We concentrate on banks with market caps of \$500 million or less, which the *Wall Street Journal* apparently finds too small to cover. Take **Bank of the Ozarks**, with a market cap around \$300 million. Its shares rose 13.2% on Friday because it reaffirmed guidance indicating record net interest income in each of the remaining 2008 quarters. We think other banks are also likely to “stick by previous forecasts on credit losses” or simply not add to reserves or write off additional loans. But the media have instead focused on those banks warning about further losses and pundits painting a very bleak picture for banks. In fact, the subtitle of the *Wall Street Journal* article above is “Look at One Metric Reveals Some Value; Ugliness Still Looms.” While bad news about banks appears to be pervasive, nuggets of good news can be found in the refuse. **The media will change their tune only when other bankers follow the example of SunTrust, Huntington, and Bank of the Ozarks, and turn out a “good news” press release of their own.**

We can’t and won’t call this bottom. But experience teaches us that the media are at their gloomiest just as the market is gearing up to recover.

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