

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Bob Ollech and Jon Bruss
Date: October 16, 2006
Subject: The Nobel Peace Prize, The *Gonzo Banker* and a new feature, a once each quarter portfolio bank review

You'll note that we've been a bit tardy in getting our monthly missive to you the past two months. Our principal reason (and excuse) is a good one we think—our clients and fund investors. First and foremost on our minds is making sure that we communicate with them as soon as possible after the month or quarter-end and second, that we pay close attention to all the portfolios under our care.

We learned long ago the veracity of the old saw, "opportunity comes to those who wait." Rarely have we been presented with as many subjects on which to comment as we have in the past few days. On Saturday morning, the 14th of October, the three morning newspapers we read, *The Milwaukee Journal Sentinel*, *The Wall Street Journal* and *Investor's Business Daily*, carried the story (two with photos) of the 2006 Nobel Prize for Peace winner. As we look back over past recipients, we don't think we'd have been moved to comment in a positive way on many of the winners—like the 2005 award winner Mohamed ElBaradei and the International Atomic Energy Agency (for North Korea or Iran, or both?) or 2002 winner, Jimmy Carter (for Iran and North Korea, again or Chavez-led Venezuelan "democracy"?) or Kofi Annan in 2001 (for involvement in and cover-up of UN corruption?)—excuse our cynicism but really, can't the Nobel Committee do better? Well, yes it can and, for that matter, it has in the past done better but its record is terribly spotty as the above three choices in this decade demonstrate—at least to us.

This year the winner is a Bangladeshi economist trained at Vanderbilt University (h-m-m-m, the South), Muhammad Yunus and Grameen Bank, a bank he founded in Bangladesh. This isn't just any old bank. It is what is know as a micro-lender, which lends (in some cases) amounts less than \$10 to street beggars to start a business allowing them to pull themselves out of poverty. According to Dr. Yunus himself in an article entitled "A Hand Up Doesn't Always Require a Handout" from the October 14th *Wall Street Journal* "I started the Grameen Bank 30 years ago by distributing about \$27 (no typo here!) worth of loans to 40 extremely poor Bangladeshis." Our further research informs us that these funds were loaned to 42 women who were basket weavers. According to him, since its official opening in 1983, it has loaned \$5.7 billion in so-called microfinance loans. Naturally, according to his detractors, his record is not as good as he represents. For example Dr. Yunus claims that the bank has had to write-off only 1.5% of its loans since its founding. His critics respond that some loans have been past due 10 months. OK. Our guess is that the Grameen Bank, like many banks in the third world, is a work in progress. And in Bangladesh, where per capita gross national income is \$440, this is, in our estimation, a magnificent start. We have in these pages unashamedly proclaimed the blessings of freedom and free market economies. We have said, and we firmly believe, that the foundation of a free economy is its diverse and competitive banking system. Dr. Yunus was free to start his bank in Bangladesh. We know that he has competitors in Bangladesh, not only in-country competitors but competitors like Citigroup, ABN Amro Holding NV and Standard Bank PLC that are now providing microloans. According to another *WSJ* article, "'Microloan' Father Yunus Is Awarded Nobel Peace Prize", this banking market of micro-lending is so attractive that today there are nearly 10,000 imitators world-wide. Are there any in the US? Well yes, there are. One called Project Enterprise is in New York City and lent \$1,500 to an operator of a skin-care business for a new machine and supplies—her revenue has more than doubled to \$5,000 per month, according to *The Wall Street Journal*. Another, ShoreBank with offices in Cleveland, Chicago and Detroit, services poor clients. Mary Houghton, president of ShoreBank's parent says about Dr. Yunus, "he really did refine this credit methodology and have the vision of it being a sustainable banking institution." Unfortunately, there were none in the Gulf Coast states last year (as Dr. Yunus points out) when we could have avoided huge federal giveaways and all the corruption that went along with them. We applaud the efforts of Dr. Yunus. His Nobel Peace Prize is well deserved. We wonder whether those in this country who are more attuned to giving money to the poor ever heard of Dr. Yunus and understand that to really help the poor and impoverished doesn't mean increasingly large government handouts, but good old fashioned entrepreneurship, allowed to operate in a far less regulated (but not predatory) environment might find solutions to impoverishment on a scale only dreamed of by the Dr.

Yunus. Dr. Yunus has adapted the old Chinese proverb, "Give a man a fish and he will eat for a day. Teach a man to fish and he will eat for the rest of his life." Rather than giving them a handout, Dr. Yunus has lent them funds with an agreement to be paid back. A free economy which allows for diversity in banking helps create and support free enterprise. If you don't believe it, just ask those Bangladeshi basket weavers.

And while we're at it, we receive our weekly dose of common sense banking ideas from the *Gonzo Banker*—that's right, the *Gonzo Banker*. We even have tee-shirts to prove its existence. The *Gonzo Banker* is a weekly publication of Cornerstone Advisors (www.crnstone.com). We like it because, like other publications we trumpet on these pages, many times it agrees with the views we hold about banks. This most recent issue will act as an almost perfect segue to the last section of this issue which will introduce a new once-a-quarter look at one of our portfolio holdings.

"Is Bigger Better?" asks *Gonzo Banker*. The subtitle is "Challenging the Economy of Scale Argument." Does size really make a difference? Or could the same function be performed equally well by an \$800 million bank—the Fortress Partners sweet spot, or a \$5 billion bank and a \$15 million bank. The guys at Gonzo focus on a statement we've all read when banks merge. "The efficiencies from this acquisition will be immediately accretive to shareholders" and "The merging of these two groups will provide an opportunity for significant cost reduction." The wags at Gonzo say, with the Wizard of Oz, "Not so fast! . . . Not so fast!" Exactly, not so fast. Now these folks at Cornerstone have been benchmarking financial institution efficiency and productivity for years and find that "the economy of scale argument is true in some functions and not in others." They cite three trends in their benchmarking that they say "one might not intuitively think are true":

1. ***The closer a function is to the bank's customer, the less the economy of scale theory is true . . . the farther the function is from customers, the more it's true.*** Why is that? Well, according to Gonzo Banker, whether one bank or branch has 10 times the number of customers as the other simply means it has pretty much 10 times the work as the smaller one. Why? A customer is a customer. He or she comes to a bank with a certain amount of "support baggage"—transactions which need to be posted, accounts to service, complaints to resolve and questions to be answered. And here, technology hasn't helped (see #2 below). Specifically, Cornerstone found that this work grows in direct relationship to volumes. They've surveyed banks from \$300 million in assets to \$30 billion in assets and found there to be no relationship between bank size/volumes and transactions posted per teller per month, the number of new accounts opened by platform staff and the number of consumer loans funded per FTE. However, when the function requires little or no customer contact, productivity zooms. For example, at banks with "200,000 deposit accounts, each deposit operations employee supported 4,600 accounts" while banks with over "500,000 accounts, the number was 7,200"—"a productivity jump of 60% for a volume growth of 300% to 400%."
2. ***For the most part, technology does not increase the economy of scale opportunity, it decreases it.*** The Gonzo guys cite the following examples of some of the systems that have had the most impact on productivity in the past few years:
 - ATM cards moved customers from the branch to self-service
 - Internet banking did the same
 - Web-based loan applications and credit scoring reduced the work banks had to do with decision making and funding a consumer or mortgage loan
 - Branch platform systems automated or eliminated steps to open accounts
 - Imaging systems reduced research and statement delivery costs.

And we know this to be a fact because we've done it in recent memory—"Every one of these systems was deployed by smaller banks as fast, or faster than at larger ones." The result is that smaller banks, like the ones we write about on these pages, and invest in, adapted these improvements faster than the larger competitors and gave the same "economies to smaller banks without them even needing the scale."

3. **Often, efficiency improvements are not linear in the sense that every 10% increase in volumes will produce a corresponding 10% increase in productivity.** Instead, the authors say, there is a “plateau effect” in which getting to a certain break point size can result in significant productivity improvements. This same opportunity levels off until the next significantly bigger size provides the second big productivity opportunity. For example, in branches, the minimum break-even was \$15 million in deposits according to the Gonzo guys, but the next size at which productivity seemed to improve was at \$75 million in deposits.

Now all of this is likely pretty boring stuff for those of you not in the banking business—and maybe some of you who are. But it is part and parcel of our backgrounds, which we leverage to find the best performers in class and invest in them. And we have found, just as the authors of the *Gonzo Banker*, that “there are economy of scale opportunities in banks . . . but “to get them, however, will take focus. The trick is knowing. . . where the big ones are.” Indeed. The trick in our business is finding the management team that understands the foregoing and can leverage this knowledge in their market to the benefit of shareholders.

Take **Enterprise Financial Services Corporation** in Clayton (St. Louis), Missouri (EFSC). We became acquainted with EFSC well over two years ago, hearing about it from one of our long-time client/ investors in the St. Louis area. It was just an off the cuff comment and a copy of a *Business Journal* article which set us to looking more closely. Here’s what we found. We’d been investors in the St. Louis market before and done so successfully. We liked that market because of the continued substantial consolidation taking place there. Between Bank of America, Firststar/US Bank, National City and M & I, the independents we were invested in were dropping like flies. And then along came Enterprise—and Pulaski Financial Corp. in St. Louis (but we can only cover one bank this month).

Enterprise was a start-up or, as some said, an upstart, managed by a team which we believe really “gets it” when it comes to taking advantage of a consolidating market and which has a unique perspective of the financial services arena, not only in St. Louis and its other major market, Kansas City, but throughout the US. It understands the nuances of economies of scale, transaction volumes and efficiency. We began buying EFSC in late November of 2004 when it was still a bulletin board stock and generally undiscovered. There was no formal research analyst coverage, little, if any, institutional interest and significant insider ownership participation (from direct purchases not just options)—just the kind of profile we look for. We continued buying during the ensuing 11 months. Our average cost is \$18.57. The stock closed at \$32.44 per share on October 13, for a nifty unrealized gain of 75% (plus dividends).

Have we had enough? We don’t think so. We believe that the bank has just begun growing into its infrastructure, which had been patiently crafted over the past several years by CEO Kevin Eichner, a former insurance consultant turned banker; Chairman Peter Benoist, long-time St. Louis banker and Frank Sanfilippo, CFO. These key managers, along with a team with deep bench strength, have delivered on their promises and representations over the two years of our ownership. To whit:

- **Earnings have grown at a rate of 14% annually** for the last three years.
- **Core deposits have increased by 16% annually** during the same time period while achieving a 19% level of demand deposits and 55% transaction accounts—a low-cost deposit mix, indeed.
- **Interest income** during this period **grew at a rate of 13%** per year.
- **Asset quality has been outstanding** with charge-offs peaking at 0.22% in 2003 and falling to 0.01% currently.
- **Wealth management revenue** (maybe the stealth revenue source) has grown **at a 32% CAGR over the last three years**, and is expected to more than double this year this year.
- **Disciplined expense controls** have helped to drive the company’s efficiency ratio from 78% in 2002 to an expected 56%-58% in 2006.

It is just this kind of performance—a *culture of performance*, the company calls it, that we found and continue to find, so enticing. This performance and management's credibility, underscore our continued ownership of this stock. In an August 21, 2006 presentation we attended, the company said that:

- Its commercial banking business is targeting growth of 12% to 15% per annum over its strategic planning horizon of 5 years.
- Its wealth management business is targeted to achieve annual revenue growth of 15% to 20% and an earnings growth rate of 20% to 25%.
- It will allow non-interest expense to grow at a rate of less than 11% per year, which should
- Produce a 17% to 22% growth rate in earnings per share over this 5-year planning horizon ending with 2011.

This company meets our key governance criteria: No shareholder rights plan. No staggered board. It uses technology well—we'd expect they'd be the pride of the *Gonzo Banker*. And, perhaps most important of all, they have a strong focus on employee acquisition, retention and development and, Enterprise University which it uses to train employees and clients—that's right, clients. We expect that Enterprise Financial Services Corporation will spend a lot more time in our portfolio. It has already dramatically improved shareholder value and, as it further develops its product delivery channels, we think that shareholder value creation has just begun. Oh, and by the way, it also pays a modest dividend.

If you'd like to learn more about EFSC or anything else we've said on these pages, please give us a call or write to us at info@fortresspartners.com.

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