E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
Date: April 25, 2008
Subject: Loan Demand and Deposits; Book Value; Dividends

This month we turn our attention to dividends. But we need to address some background first. We have been traveling to our banks this past month to get a sense for what is going on in their markets, especially the southeast. In the past thirty days we've been to northern Virginia (Washington, DC area), the west coast of Florida (Naples, Sarasota, and Tampa), North Carolina (Charlotte, Statesville, Franklin, and High Point) and finally, New Orleans.

Loan Demand and Deposits The banks we called on are smaller banks—the kind in which we invest—with assets ranging from $200 million to a little over $1 billion. We talked with banks that have seen considerable stress in their loan portfolios and others that have seen little. These banks all agreed, contrary to popular media opinion, that bank loan demand remains robust in most areas. The retreat of super regional banks and money center banks from lending to small businesses that need $250,000 to $25 million is notable. Many large banks abandoned these markets long ago or gave them short shrift. That created opportunities for investment banks and their conduits to step into the fray and "buy" loan business with minimal documentation and unreasonably low rates, considering the risks involved. The syndicates and the conduits are out of business after being hit by the sub-prime crisis and the resulting contraction in the credit markets. The field for strong commercial real estate (CRE) credits and strong commercial and industrial (C & I) loans has been left to community banks, our bread and butter.

Why have credit markets seized up and liquidity disappeared? It has nothing to do with community banks, which rely on their funding from the markets they serve—individuals like you and me, small businesses, school districts, municipalities and charitable organizations. Try as they might, the financial media have not succeeded in convincing these customers, that the small bank down the street is the same as the "bank" called Bear Stearns or, for that matter, Citibank, JP Morgan Chase, or B of A. Those last three, while commercial banks, rely only modestly on core deposit funding. Instead, they use wholesale funding sources, which have proved unreliable in times like these. And yes, core deposits are flowing into community banks, but not as much as we've seen in recent years. In part, that's because super regional banks and money center banks have only lately discovered the blessing of core deposits and are bidding up the rates in an attempt to get back into the game. But, according to our sources, frequently the efforts of the big banks are not working well or simply not working at all.

So, if small banks are able to generate new loan business in the high single digit to low double digit range and find the deposits to support them, they must be profitable, right? Well, yes, most of them are. The few that are not have added substantially to loan loss reserves which, we are told, may be reversed later with the approval of bank regulators.

Book Value This banking metric falls in and out of analysts' lexicons depending on market conditions. These days, it is back in vogue as banks trade at, slightly above, or even below book value. We haven't been down this path for nearly two decades, so for analysts, many of whom are too young to remember, it is almost a new addition to their vocabulary. But no one seems to be connecting the dots of strong loan demand and good deposit flows with profits and profitability. It may be overly simplistic to suggest that banks selling at, slightly above, or below book value are being viewed by investors as banks poised to be unprofitable for the foreseeable future. But we conclude investors have this perception, or at least there is so much uncertainty surrounding the profitability of banks that investors have settled the question of value by concluding that less than book value is a fair price. Currently six of the banks in our portfolio are selling at discounts to book value and two others are selling for less than 110% of book value. As it happens, investors' perception of unprofitability is simply wrong. Of those trading below book value, only two had an unprofitable quarter. Half of those with unprofitable quarters estimate they will be profitable for 2008, and the others estimate they will be profitable before the end of the year and losses will diminish from this point on. Most of the banks selling at less than book value have no research following; hence, there is no one to tell their story. That is precisely where we can claim a significant advantage.

In summary, an analysis of the book value metric among our small banks tells me that there are woefully inaccurate estimates of profitability by investors. Our advantage is finding undiscovered banks or discovering facts about banks that aren't available to investors who aren't bank-savvy. The book value metric is being overlooked!

Dividends In turbulent times dividends can help make sense of a seemingly contrarian investment in small banks. What do dividends have to do with investing? Aren't we, as investors, seeking long term capital gains? It is true we are looking for gains over the long term. Experienced investors have learned, however, that not every year is like hitting a home run. Instead, you hit singles and doubles and sacrifice bunts, or force a walk on a pitcher trying to make you swing at junk. Successful investing stresses fundamentals. And dividends are part of a complete game. Dividends along with capital gains equal total return, and total return is what counts.

Dividends can add as much as two to three percentage points to annual returns on stocks. A two-and-a-half percentage point difference in annual return over a 10-year period results in a significant difference in total return. Take a $100,000 investment in shares that don't pay dividends but grow at a 10% annual growth rate over a 10-year period grows to $270,704 assuming monthly compounding. That same investment with a 2.5% dividend yield delivers $346,785 to an investor—a 28% difference. That's hardly child's play.

Most banks pay dividends. Those that don't are new and fast growing and unable to retain capital sufficient to support growth in assets and pay dividends; or they may be subject to regulatory prohibition; or they have voluntarily chosen to stop paying dividends to rebuild capital after a series of missteps depleted capital. The payment of dividends according to Goldman Sachs strategist, Abby Joseph Cohen, is important because it is a "powerful signal" of the dividend payer's strength. Indeed.

According to an article appearing in *Barron's* four years ago on April 15:

"Academic studies lend some backing to [Cohen's] view. A recent paper by Prof. Alon Brav of Duke University, along with professors John Graham, Campbell Harvey and Roni Michaely, surveyed almost 400 executives and found that they view dividend payouts as a step that conveys 'management's confidence about the future.' Since executives are reluctant to cut dividends, they only raise them after becoming more upbeat about the outlook for their companies."

Moreover, according to research conducted and published by Robert Arnott and Clifford Asness, the payment of dividends helps reign in silly acquisitions and other undisciplined investments by executives. To be sure, even dividend paying companies sometimes make dumb investments. The payment of dividends does not prevent poorly thought out acquisitions. But it does cause the executive to think about how cash is being spent and whether it will be possible under all circumstances to continue to pay the dividend or even increase the payment of dividends, as a good number of our banks have done in the past year. In fact, Arnott and Asness state that higher dividend payments portend higher earnings growth.

Hank Paulson, the Secretary of the Treasury and former CEO of Goldman Sachs, has recited a phrase about dividends told him by a business school professor that has become a mantra for bank investors, “Dividends are real, earnings are opinion.” This goes directly to Abby Joseph Cohen’s point: the payment of dividends does speaks volumes about the underlying strength of the dividend payer.

Without earnings dividends can’t be paid by banks. Small banks are continuing, almost without exception, to pay dividends. Many have even increased dividends in 2008. Bank earnings act to increase the book value of banks and banks are creating earnings by responding to the very current demand for loans as we found in our visits over the past thirty days. We see the prices of bank stocks relative to book values as a tremendous and rare opportunity to achieve significant capital gains while being paid attractive dividends .

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