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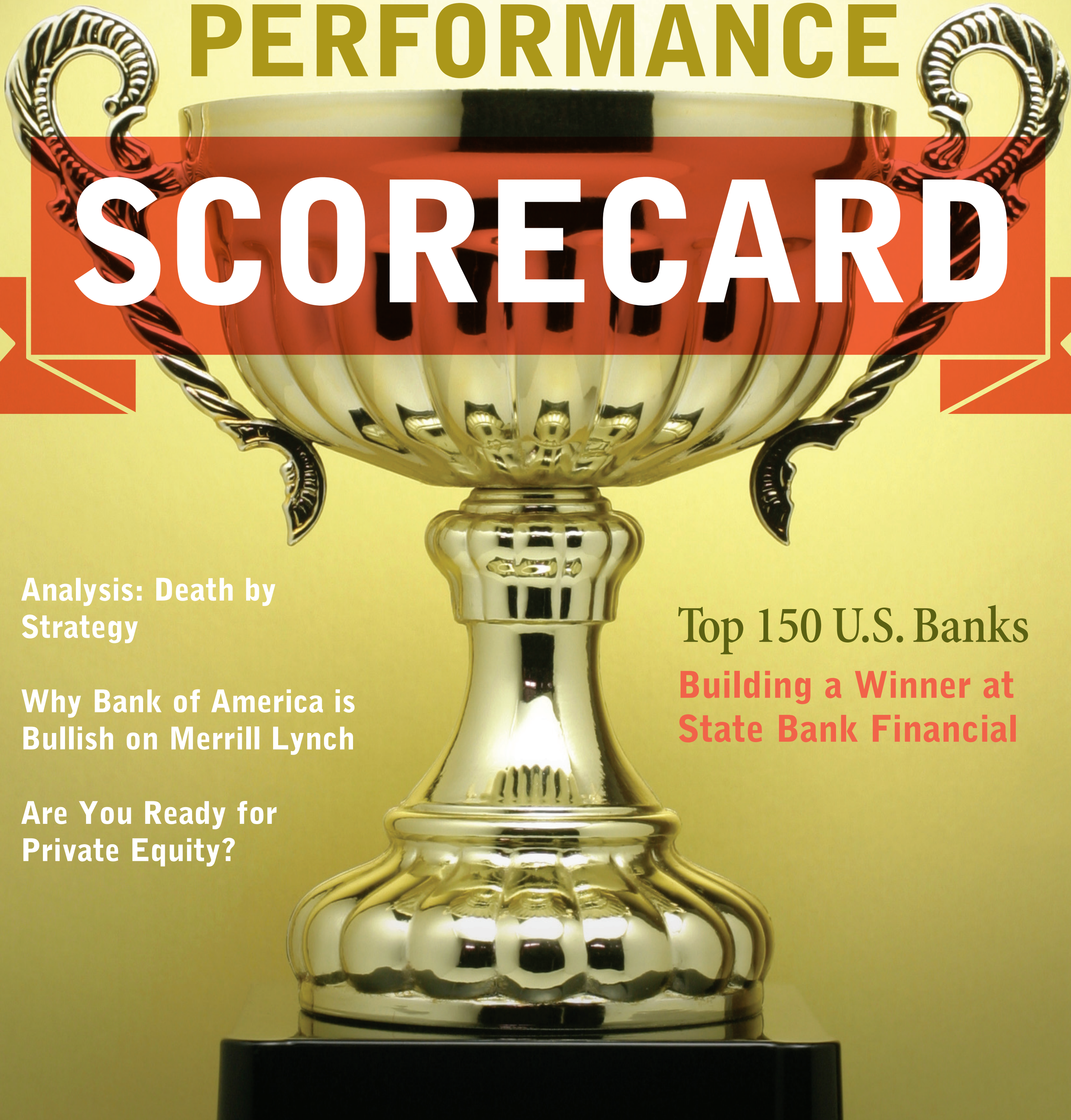
BANK PERFORMANCE SCORECARD



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What Does It Take TO BE GREAT?

by **JACK MILLIGAN**

PROFITABILITY, CAPITAL AND ASSET QUALITY ARE THE MAIN INGREDIENTS IN A CAN'T-MISS RECIPE FOR *GREATNESS.*

What it takes to be a great bank in today's in-your-face business climate is pretty much what it always has, only more so. Consistency, strong management, a deep understanding of one's core market and careful risk taking benefited most of the top place finishers on Bank Director's 2011 Bank Performance Scorecard, a ranking of the 150 largest U.S. publicly traded banks and thrifts based on 2010 calendar year earnings.

"We did the same things (in 2010) we've done every year for the last 10 years," says Charles Hageboeck, president and chief executive officer at City Holding Co., a $2.6-billion-asset bank in Charleston, West Virginia, which finished third on this year's ranking. And what City Holding did in 2010 was combine impressive profitability with a high level of capital and excellent asset quality, which are the three categories that the Bank Performance Scorecard takes into account.

A great bank might stumble as Commerce Bancshares Inc. did in 2009 when loan losses spiked, just as they did at many other banks and thrifts during the financial crisis a few years back. But Commerce's loan problems were not nearly as serious in comparison to most other institutions, and it dealt with the situation quickly. The Kansas City, Missouri-based bank dropped to 26th place last year after finishing seventh two years ago—but bounced back to place seventh again on the 2011 ranking. "We do well in good times and pretty well in bad times," says Chairman and CEO David W. Kemper.

Of course, there are exceptions to every rule—and two of them occurred this year. The winner of the 2011 Scorecard—Atlanta-based State Bank Financial Corp.—is truly a product of the industry's turbulent times. In 2009, State Bank Chairman and CEO Joseph W. Evans acquired the assets and deposits of Security Bank Corp., a failed institution in the Macon market, from the Federal Deposit Insurance Corp. The deal was backed by a $300 million investment from an array of institutional investors, which gave State Bank plenty of capital. And the bank received loss share assistance from the FDIC, which partly explains its outstanding asset quality. But FDIC-assisted deals have been one of the industry's best growth options in a stagnant economy—Evans has now done five deals with the FDIC— and he deserves credit for building a strong institution out of the remains on several failed banks. (For more on State Bank Financial, see "Opportunity of a Lifetime" on page 32).

"There are more failed banks in Georgia than in any other part of the country and Evans has capitalized on that," says Mark Fitzgibbon, a principal and director of research at Sandler O'Neill + Partners in New York.

Likewise, this year's sixth place finisher—Miami Lakes, Florida-based BankUnited Inc.—also is the product of an FDIC-assisted deal. In 2009, former North Fork Bancorp. CEO John Kanas acquired the remains of BankUnited FSB in Coral Gables, Florida, from the FDIC. The deal was backed by $900 million in capital from various private equity funds. As with State Bank, BankUnited scored high on both capital and asset quality on this year's ranking.

Small banks dominated this year's Scorecard, a trend which has been evident in previous rankings. Of the top 10 finishers, only four institutions had more than $4 billion in assets. And the highest scoring bank with more than $250 billion in assets was Pittsburgh-based PNC Financial Services Group Inc. at 44th. This performance bias might simply be a function of size: Smaller institutions are easier to manage and benefit from being closer to their geographic markets and customers. Still, Fitzgibbon was surprised that there weren't more large banks with high rankings since as a group they were able to access the capital markets sooner than smaller banks, rebuild their balance sheets and charge off a bigger percentage of their bad loans. "I would have expected them to have fared much better because they took a lot of pain early on," he says.

This year's Scorecard also saw a significant shift in the factors which drove bank performance in 2010. As the economy has slowly improved, profitability has become more important. "Over the last two to three years, profitability wasn't that important," says Fitzgibbon. "Capital and credit drove the ranking. But this year, profitability drove the results. We saw a significant separation between the men and the boys."

It's hardly news that capital levels have also been rising as federal banking regulators have put considerable pressure on banks to strengthen their balance sheets. Fitzgibbon believes there has been a permanent shift in the regulatory expectations for bank capital. "The old normal was a 6.5 percent TCE ratio," he says. "I think that 8 percent is the new normal." Of course, ROAEs will invariably fall as capital increases for most institutions. "I think the new normal will be 10 percent ROAE over the next couple of years," he says.

The Bank Performance scorecard is designed to identify banks and thrifts that are strong in three critical areas: profitability, capital and asset quality. "I think conservatively, well managed banks thrive on this ranking when they do a good job of balancing risk and return," Fitzgibbon says.

The Scorecard uses two standard measurements of profitability, return on average assets (ROAA) and return on average equity (ROAE). Unlike past rankings, this year's Scorecard uses only one measurement of capital—the ratio of tangible common equity (TCE) to tangible assets—in recognition of how important that metric has become as federal bank regulators pressure banks to significantly boost their levels of common equity. Tangible common equity is defined as a company's GAAP book value minus goodwill and other intangibles. It is, in other words, the actual hard dollar amount of common equity that a company has available to it.

Asset quality is also critically important since lending is the banking industry's bread-and-butter business, and this is gauged using two metrics—the ratio of non-performing assets (NPAs) to loans and other real estate owned, and the ratio of net charge offs (NCOs) to average loans.

Banks that place high on the Scorecard generally do well in all three areas, rather than dominating a single area. As capital ratios have increased in recent years, the interplay between capitalization and profitability is especially telling. A bank that scores well on the two profitability metrics in part because it has leveraged its capital could end up with a lower overall score than a bank that has a higher level of profitability and higher capital.

Two high finishers on this year's Scorecard provide an interesting example of the relationship between profitability and capital, and how that can impact an institution's ranking. Westamerica Bancorp. in San Rafael, California, which finished 11th overall, ranked number one for both ROAA and ROAE—but only 59th for TCE, suggesting that the bank's impressive profitability was due in part to higher leverage. On the other hand, Topeka, Kansas-based Capital Federal Financial Inc., which finished 12th overall, had the top TCE ranking but ranked much lower—57th and 65th, respectively—for ROAA and ROAE. Clearly, Capital Federal's overall ranking would have been higher if its TCE ratio hadn't been a Mt. Everest-like 20.61 percent.

BANK PERFORMANCE SCORECARD TOP 150 BANKS

						Profitability				Capital Adequacy		Asset Quality				
Rank	Company Name	Ticker	State	Total Assets ($000)	Industry Type	Core ROAA (%)	ROA Rank	Core ROAE (%)	ROE Rank	Tang Common Equity/Tang Assets (%)	TCE Rank	NPAs/ Loans & OREO (%)	NPA Rank	NCOs/ Avg Loans (%)	NCOs Rank	Final Score
1	State Bank Financial Corp.	STBZ	GA	2,828,579	Bank	1.66	4	13.07	10	12.42	10	1.20	17	0.13	5	35
2	First Financial Bankshares, Inc.	FFIN	TX	3,776,367	Bank	1.73	3	13.55	7	9.97	25	1.40	20	0.35	17	53.5
3	City Holding Company	CHCO	WV	2,637,295	Bank	1.59	6	13.38	9	10.01	22	1.07	13	0.41	21	54
4	First Republic Bank	FRC	CA	22,377,633	Bank	1.39	9	18.00	2	8.81	44	0.11	2	0.05	2	57
5	Republic Bancorp, Inc.	RBCAA	KY	3,622,703	Bank	1.85	2	17.97	3	10.00	23	3.08	57	0.83	55	84
6	BankUnited, Inc.	BKU	FL	10,869,560	Thrift	1.66	4	15.50	4	10.97	12	0.00	1	5.67	142	91.5
7	Commerce Bancshares, Inc.	CBSH	MO	18,502,339	Bank	1.22	17	11.26	17	10.27	20	1.66	25	0.96	61	97
8	Bank of the Ozarks, Inc.	OZRK	AR	3,273,659	Bank	1.36	10	13.75	6	9.57	31	2.96	53	0.81	53	100
9	Cullen/Frost Bankers, Inc.	CFR	TX	17,617,092	Bank	1.23	16	10.46	24	8.90	43	2.03	32	0.52	30	114
10	Brookline Bancorp, Inc.	BRKL	MA	2,720,542	Thrift	1.04	29	5.58	74	16.83	4	0.58	5	0.24	11	115

Analysis for the Bank Performance Scorecard was performed by Sandler O'Neill, using 2010 data provided by SNL Financial in Charlottesville, Virginia. For scoring purposes, the ROAA, ROAE and TCE scores were given a full weighting, and the two asset quality metrics were both given a half-weighting. The five category scores were then added across and the sum equaled each bank's final score.

Abilene, Texas-based First Financial Bankshares Inc. finished second on the 2011 Scorecard after placing first and second on the 2010 and 2009 rankings, respectively. "There is a scarcity of mid-sized banks in Texas and the few remaining ones are doing extremely well," says Fitzgibbon.

Chairman and CEO F. Scott Dueser says his bank's biggest problem in 2010 was finding other banks to acquire, which is an essential element in First Financial's growth strategy. "Our challenge is finding people who want to sell their bank so we can utilize our capital, because we're overcapitalized," Dueser says. "Last year was a hard year to grow loans in an economy that remained flat," he continues. "There wasn't a lot of loan growth out there, and that hurt, and we weren't able to buy a bank until November, and that hurt." (In November 2010, First Financial acquired Sam Houston Financial Corp., a $163-million-asset bank in Huntsville, Texas, for $22.2 million.)

Charleston, West Virginia might seem like an unlikely market to power City Holding's 3rd place finish. But home values in the Mountaineer State didn't become overinflated during the real estate bubble, which spared it some pain later on. Also, while City Holding does go head-to-head with the likes of retail banking goliaths Winston-Salem, North Carolina-based BB&T Corp. and New York-based J.P. Morgan Chase & Co., West Virginia's modest economic outlook hasn't attracted an abundance of out-of-state competitors. "The market is not well understood, and that's one of our strengths," says president and CEO Charles R. Hageboeck.

City Holding also benefited from an impressively deep penetration of its local markets. According to Hageboeck, the bank averaged 2,200 households per branch compared to an industry average of 1,200. "That gave us a lot of low-cost deposits and a high level of fee income," he explains. "We have a lot of people walking into our branches looking for services." That deep penetration helped the bank in another way last year. "We know our markets very well and that has helped us with asset quality," Hageboeck adds.

Although the other top place finishers are traditional retail banks, San Francisco-based First Republic Bank—which placed 4th on the 2011 Scorecard—provides private banking and investment management services to wealthy clients in six California markets, along with New York City, Boston, Portland, Oregon, and Greenwich, Connecticut.

Founded in 1985, First Republic sold itself to Merrill Lynch & Co. in July 2007 for a 360 percent premium over its book value at the time, although the company kept its name and the existing management team continued to run it. When Merrill later got into trouble during the 2008 financial crisis and was acquired by Charlotte-based Bank of America Corp., First Republic's management team decided it preferred to be an independent company again rather than the subsidiary of the country's largest bank, which resulted in a buyout by a management-led investor group in July 2010, and a $110 million public stock offering that December. (First Republic's Scorecard ranking for 2010 was based on its earnings for the first three quarters of 2010, as disclosed in its offering prospectus, and its reported fourth quarter 2010 earnings after going public).

Katherine August-Dewilde, the $22-billion-asset bank's president and chief operating officer, says First Republic's biggest challenge in 2010 was managing a complicated divestiture process while continuing to focus on the needs of its high-end clientele. August-Dewilde says the spinoff received broad support from First Republic's client base. "Our customers were pleased because many of them had once been a customer of a large bank and preferred something different," she explains.

First Republic's private banking strategy combines credit (often in the form of a jumbo mortgage) with an array of traditional wealth management products and services, including asset management, brokerage, trust administration, estate planning and custody. Although wealthy entrepreneurs and successful business owners of all stripes are its core customer group, First Republic also provides business banking services like cash management and deposit services to a variety of professional service firms.

"We offer a level of service that most banks abandoned long ago," August-Dewilde says.

The Scorecard's 5th place finisher, Louisville, Kentucky-based Republic Bancorp, benefited in 2010 from what Chairman and CEO Steven E. Trager described as a flight to quality as many customers in the Bluegrass State sought out what they perceived to be a sounder, more reliable institution. Republic has beefed up its treasury management capability, which has been something of a magnet for business customers in the state. "We seem to be a very certain option in a very uncertain environment," says Trager. "There seems to have been more willingness to consider a new bank."

Republic had the 2nd best ROAA and 3rd best ROAE on this year's Scorecard. Unfortunately, 57th and 55th place finishes in the NPA and NCO categories, respectively, pulled down its final score. Had the bank posted better asset quality metrics it might have won this year's ranking, and should be a solid contender for top honors in 2012. **|BD|**

Jack Milligan is editor of *Bank Director.*