HCP NOTES

Case Study – U.S. Banking

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Citizens Republic: A Recovering Mid-Cap Bank

Case Study Prologue

On July 13, 2011, we published a case study on **Citizens Republic Bancorp** (**CRBC**), a U.S. mid-cap bank recovering from the severe credit downturn, and facing many unique valuation issues. At the time we wrote the case study, CRBC was trading at $7.85 per share – a deep discount to both its tangible book value and our assessment of fundamental value.

In this case study, we attempted to address the conceptual issues with respect to bank valuation during a credit cycle, using CRBC as an example.

- **First**, we addressed how and why market efficiency and bank valuation breaks down during a credit cycle (particularly in less followed banks).

- **Second**, we explained the two stages of value destruction and the three stages of recovery from the cycle, as well as why banks often trade below tangible book value (i.e. their liquidation value).

- **Third**, we addressed a number of technical issues related to credit and capital that were impacting fundamental valuation, and to highlight the potential for M&A.

The purpose of the case study was to highlight that there is opportunity for specialist investors willing to dig deeper into the financial statements.

How did we do?

In the subsequent five quarters, CRBC recovered to full 'normal' profitability. Trapped capital in several places on the balance sheet was unlocked.

By September 2012, CRBC was sold to FirstMerit Corporation (FMER) for ~$22.50 per share, or almost exactly the $24.00 per share we estimated to be fair value at the time of writing the case study.

With hundreds of banks, the U.S. mid-cap banking sector is very large universe of companies, offering a variety of investment themes, including ongoing M&A (see our note *"100 Bank Mergers"*, dated December 13, 2012).

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Citizens Republic: A Recovering Mid-Cap Bank Case Study

The health of the U.S. banks has been restored; valuations have not … at least not yet. Reserves have quadrupled, tangible capital has doubled, and leverage in the U.S. banking system is now half that of the Canadian banks (yes, half). The U.S. banks continue to experience substantial improvements in profitability as one would expect in a cyclical recovery, especially one of this severity. Core earnings have reached 90% of pre-cycle levels, as quarterly bank profits have increased by $20 bln in just five quarters (despite bearing the weight of substantial transient expenses). Moreover, a full normalization of profitability would add another $10 bln/quarter to this level, likely by the end of next year[1].

Despite these significant improvements, the average U.S. bank's market capitalization is still ~45% below its all-time high. Moreover, there are over 200 banks trading below tangible book value (TBV), which is effectively their liquidation value. This universe includes over 130 banks trading below 0.7x TBV, and over 70 banks trading below 0.5x TBV, many of which are in the less well covered mid-cap sector. While not necessarily forecasting a return to these levels, we would note that banks traded above 1.5x book value in the twenty years leading up to the credit cycle[2]. In our view, the scope and quality of these opportunities will be materially reduced in the next twelve to eighteen months.

Therefore, to highlight one the opportunities in this subsector of the financials, we prepared a case study of one such bank: **Citizens Republic** (CRBC). The case study is structured as follows:

Part I: Some Background Observations

Part II: Not Exactly an Efficient Market (Made Less So by the Credit Cycle)

Part III: Creating (or Destroying) Value in Stages

Part IV: A Closer Look at Citizens Republic

Part V: What is the Appropriate Market Capitalization for CRBC?

Part VI: What Accounts for CRBC's Discount to Liquidation Value?

Part VII: What Causes CRBC's Shares to Rise, and When?

Part VIII: What are the Risks to CRBC's Investment Thesis?

Conclusion: A Portfolio of "Recovering" U.S. Mid-Cap Banks is a Good Use of Capital

1. **Note, this case study reflects share prices in early July 2011. It has not been updated for subsequent changes in share prices, or other factors.**

<u>Part I:</u> Some Background Observations

We begin by making three observations with respect to banking, and "recovering" mid-cap banks in particular. **First**, the mid-caps are not well covered by the Street, and in some instances, are not covered at all. When they are covered, the analysts are often rewarded for establishing good relationships with management (to help facilitate underwriting and advisory fees), versus being

[1] Pre-tax pre-provision earnings have risen nearly 25% since the downturn began. Therefore, "normal" earnings have increased from about $25 bln to over $30 bln per quarter. In Q1-11, core earnings last quarter were $23 bln,

[2] Tangible book value and book value were largely the same over this period.

great research analysts. Mid-cap bank analysts tend to be younger than their large-cap peers, and often have coverage universes in excess of 20 companies, which, combined with a heavy marketing and travel schedule, can reduce their effectiveness.

Second, we believe that the U.S. market has a much shorter time horizon than Canada, given it has so much more breadth, and portfolio managers have many more sectors in which to invest. **Third**, while stocks for both U.S. large and small banks are suffering from heightened regulatory risk, we would note that the politicians through the legislative process have been explicitly trying to favour the smaller banks. For example, the Durbin amendment, which successfully legislated significantly lower fee caps for interchange (or swipe) fees, exempts banks with assets of less than $10 bln (including CRBC).

Part II: Not Exactly an Efficient Market (Made Less So by the Credit Cycle)

Banking is cyclical. However, analyst estimates are not. Therefore, as credit costs are rising (falling), the market routinely underestimates the deterioration (improvement). Bank analysts simply do not forecast large changes in earnings, even when reported earnings are changing dramatically. For evidence of this, note that over the last four years (i.e., during the credit cycle) the average annual error in estimating earnings of the largest and best covered banks has been an astounding $50 bln[3] (which compares to pre-cycle earnings of $100 bln). In a downturn, the most quarterly earnings reports by analysts start with "credit was worse than expected". In a recovery, they start "credit was better than expected".

This also means the market tends to not price in large increases or declines until they are confirmed by reported results. For example, during the downturn, there were numerous opportunities to short banks that had catastrophic credit exposures, but nevertheless still traded at high share prices and were considered BUYs by many analysts. While at NBC, we even shorted two Las Vegas-based banks at or around $10 per share that had residential construction lending exposure in excess of ***eight times*** their capital base[4]. Amazingly, Keefe Bruyette and Woods, a highly respected U.S. broker-dealer specializing in mid-cap banks, even initiated research coverage on one of these banks with a HOLD during this time. Ultimately, they both failed.

Although these and many other failures may seem extremely obvious in hindsight, it still took nearly two years for this process to play out (which in some instances, included higher volatility). For whatever reason, the market did not generally reflect certain predictable outcomes in advance in share prices, until the "event" happened.

Part III: Creating (or Destroying) Value in Stages

During the credit crisis, we assessed solvency by estimating cumulative losses, velocity of loss realization, and the resultant impact on capital and reserves. In effect, we were trying to determine when "the event" would occur – i.e. when the market realized the bank might actually fail. Today, we are focused on the recovery.

[3] See our **HCP Note** *"Myths (and Realities) in U.S. Banking"* on May 19th, 2011, which includes a reference to the lack of accuracy of analyst estimates.

[4] By way of background, residential construction loans are – by far – the most risky loan category, even more so than subprime mortgages. These loans have little collateral and their collectability is highly sensitive to falling real estate prices, and their deterioration in credit quality is not always immediately apparent owing to complex accounting rules.

Two Stages of Deterioration in a Downturn …
During the downturn, the decline in share prices of a failing bank really happened in two stages. **Stage #1** was the market recognizing the bank's credit problems were a mortal threat (which typically took the banks down 50% or more that quarter to around $5.00 range). **Stage #2** was the subsequent slide to failure, which took the bank to below $1.00 per share until it was finally seized. Lots of volatility was experienced in the intervening time as the process played out.

… And Three Stages of Recovery
With respect to the recovery, we believe it will impact bank valuations in a two or three stage process. **Stage #1** will include recognition that the bank will no longer be degrading book value with losses, and that capital funding is more predictable (i.e. dilution, or lack thereof, can be better quantified). **Stage #2** will include the visibility (and predictability) of earnings returning and eventually a full normalization of earnings. This stage will also begin the debate about what the appropriate multiple should be. For many "recovering banks", there will be a **Stage #3**, which will be a sale.

So, let's consider an example.

<u>Part IV:</u> A Closer Look at Citizens Republic

In our view, one of the more interesting "recovering banks" in the U.S. mid-cap banking sector today is **Citizens Republic Bancorp (CRBC)**. It has assets of ~$10 bln, over $5 bln in loans, and as of early July, a market capitalization of just over $250 mln. Based in Flint, Michigan it is the 65th largest bank in the U.S., the 7th largest bank in Michigan (by deposits), and one of the largest "in-state" banks. It has some exposure in Ohio and Wisconsin, but it is basically a Michigan bank, with over 80% of its revenues coming from that state. Although not apparent at the time, CRBC is the product of an ill-fated merger in 2006, in which a "good bank" (Citizens) bought what turned out to be a "bad bank" (Republic). It has had a (mostly) new management team since 2009, who in our opinion has done a tremendous job turning the company around.

CRBC has a relatively diversified loan mix, which we strongly favour. Crucially, the bank has no material exposures to those loan categories most likely to produce extreme loss severities, reducing the margin of error for estimating cumulative losses. The bank has acceptable capital ratios, though they are on the low end of what we prefer. However, there are two very good reasons for these lower ratios, namely the bank has very substantial excess loan loss reserves and a full valuation allowance against its deferred tax asset, both of which imply a degree of conservatism.

Coincident with its Q3 2010 earnings release, the bank surprised the market, and announced a "loss acceleration" plan, with the objective of writing off substantial non-performing assets (NPAs, or "bad loans", which include both non-performing loans as well as restructured loans – more on that later) in two quarters in order to target a return to profitability by Q3 2011. CRBC is regulated by the State of Michigan, and management has stated many times that the regulator supports its plan.

The market reacted poorly to the introduction of unknown capital risk, and the bank's share price declined materially in the days that followed. Fast forward two quarters, and the bank has successfully executed its plan, and its credit metrics have, not surprisingly, improved dramatically. However, in completing this substantial clean-up, the bank decided not to use its considerable loan loss reserves to shelter capital from the expected losses, and as a result, it experienced a large decline in both its tangible book value and capital ratios[5].

So, where is CRBC now?

As of early July 2011, CRBC traded at ~$6.90. Its tangible book value is ~$8.50 per share, for a price-to-tangible book value of 0.8x (note, its book value is ~$16.80). Of great significance, it has a full deferred tax valuation allowance (DTVA) of about $7.30 per share, or ~90% of its current tangible book value (and over 100% of its share price), pushing its pro forma price-to-TBV down to an exceptionally low 0.4x. Except for a handful of micro-caps and mutual converts, CRBC has the lowest NPA (i.e. "bad loan") ratio[6] at 3.26% of any bank trading below tangible book value (even "conservative" banks like JPM and PNC have a higher percentage of "bad loans").

Before we consider the future for this bank, we need to consider the success of its "loss acceleration plan". Through write-offs and loan sales, CRBC reduced its "bad loans" by 67% in just two quarters. It now has loan loss reserves equal to 120% of its "bad loans", an extremely high level for a "recovering bank". As mentioned, this rapid credit clean-up came at a cost, as the bank's key capital declined to a comparatively low level – not serious, but low by U.S. standards (although it is roughly equal to that of a Canadian bank).

A quick aside: all banks restructure loans, which introduces the risk of accusations from many industry cynics of "extend and pretend", i.e. concerns that many banks are essentially delaying recognition of their problems (or worse, hiding them). This is an oft-cited reason by many to avoid the sector. In the U.S., where disclosure for the banks is vastly superior to that of their Canadian peers, restructured loans are part of regulatory disclosure. Therefore, to take into account the much higher re-default risk of these loans, we include restructured loans in our analysis of non-performing assets, ***even if those loan balances are current*** on interest and principal. That said, CRBC has very little restructured loans.

Part V: What is the Appropriate Market Capitalization for CRBC?

Before we layer in a repayment of TARP preferreds, the reversal of the bank's deferred tax valuation allowances or excess loan loss reserves (which we address in Part VI), it makes sense to first establish an appropriate market capitalization for the company excluding these items. After that, we can address how this market capitalization can be divided up in terms of the most likely share count. CRBC currently generates pre-tax pre-provision earnings (PTPPE) of about $30 mln per quarter. This number will be less than "normal", since in a recovery banks benefit from higher revenues (as NPAs and the inventory of foreclosed properties decline), and lower expenses (from disbanded workout and foreclosure teams, and the elimination of losses on the disposition of foreclosed properties). For CRBC, there should also be (short-term) margin expansion that arises from deposit shrinkage catching up with loan shrinkage.

If we use this current level of PTPPE as a base, and assume credit costs that are still about ***twice*** the long-term historical rate, annual normalized earnings are between $40 mln and $50 mln. This

[5] Obviously, had CRBC not undertook this loss acceleration plan, the impact on its book value would have not been as severe, since more losses would have been absorbed by pre-tax pre-provision earnings over a longer period of time.

[6] NPA ratio is non-accrual loans plus other real estate owned and restructured loans, all divided by the sum of total loans and other real estate owned.

would mean CRBC currently trades at between 5.0x and 6.0x "normalized" earnings. In our view, these multiples are an absolute bottom range, since credit costs are very conservative, expenses are elevated, and revenues are depressed. If we assume a more normal profitability level – i.e. a return on assets (ROA) of 85 bps – we arrive at earnings for CRBC of closer to $85 mln[7]. This equates to an even lower price-to-normalized earnings of just over 3.0x, and an ROE in the low double digits, albeit, on an unsustainably low capital base and share count.

Therefore, using these two valuations as a range, we believe CRBC trades somewhere between 3.0x and 5.0x normalized earnings, which we believe includes some forecast dilution for an eventual TARP repayment. Put another way, the above equates to a fully recovered market capitalization of ~$750 mln, or three times larger than its current market capitalization (and an adjusted price-to-tangible book value of roughly 1.0x).

<u>Part VI:</u> What Accounts for CRBC's Discount to Liquidation Value?

To understand how value is recognized, it is important to first explore why CRBC trades below tangible book value, its presumed liquidation value. Right now, for better or worse, this is the dominant metric for the sector, which is creating anomalies within this huge universe of nearly 500 publicly traded banks. It is unusual that P/TBV would still prevail (over price-to-earnings) now that the sector has recaptured nearly 90% of its pre-cycle core profitability, especially given its ascendance is generally inversely correlated with earnings visibility.

So, what are the factors holding back CRBC's share price?

<u>Factor #1:</u> Trapped Capital of Over $400 mln, or 150% of its Market Capitalization

Arguably the most important reason for CRBC's discounted share price is its massive amount of trapped capital during a time when the market is valuing banks on a multiple to tangible book value. This trapped capital is in the form of excess loan loss reserves and a full deferred tax valuation allowance (DTVA). Assuming a more "normal" loan loss reserve ratio (higher than pre-cycle, tax effected), and a full reversal of its DTVA, tangible capital would increase by over $400 mln, or ~$10.00 per share (using the current share count).

This is a highly material ~150% of its current share price. Even though CRBC is likely to bring <u>all</u> of this balance back into its tangible book value over time, the market does not appear prepared to pay for any of it, in our opinion.

<u>Factor #2:</u> CRBC is Not Profitable … Yet

Banks that have not been profitable for a sustained period of time do not – and should not – trade at TBV (to account for the fact that "book" is not really "book"), but some lower amount. CRBC has not been profitable since Q1 2008, or a full three years, so we are not suggesting it is Royal Bank of Canada. Since 2007, CRBC's tangible book value has declined dramatically, as it issued

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[7] Virtually all U.S. banks believe they can generate an ROA of at least 1.0% in a normal environment. There are various arguments for why post-cycle ROAs will be higher or lower than the industry level of over 130 bps before the downturn began. Although we do not assume it, we believe ROAs will ultimately be higher as margins will be higher for three reasons. **First**, the yield curve will be steeper than it was before the downturn (it was basically flat for the 2 years leading up to the cycle). **Second**, those institutions that were considered prone to irrational deposit pricing (the national thrifts and construction banks) suffered heavy failures and are much less prevalent in the market. **Third**, we also believe that coming out of the cycle, loan losses will be lower than "normal" for a period of time, as net recoveries rise (which is very typical following a credit cycle).

stock twice and incurred substantial losses from deteriorating credit quality. These losses were amplified by goodwill write-downs (which do not impact TBV), establishing (and building upon) a full DTVA, and building substantial loan loss reserves. As a result, there are insufficient investors willing to pay TBV for the shares, given this period of losses and the resultant lack of visibility.

Post Script (12/11): *CRBC was profitable in Q2-2011 and again in Q3-2011 and TBV is now $9.98*

Factor #3: Expected Share Dilution to Repay TARP
For banks with TARP preferreds outstanding, their valuation include some discount applied for expected dilution, since most banks are required to raise some amount of common stock coincident with TARP repayment. CRBC has $300 mln in TARP preferreds owned by the U.S. Treasury, which, if it had to repay today, would result in ***substantial*** EPS dilution. If CRBC had to repay TARP at its current share price – which we believe is very unlikely – it would dilute TBV to about $7.50, from $8.50, or just 12%. However, EPS dilution would be much greater, at close to 50%. Of course, even in this arguably worst scenario, if CRBC issued equity now to repay 100% of its TARP, it would still trade at just pro forma ~7.0x earnings. **As we will explain, there are many compelling reasons for the bank to wait before it repays TARP.**

Factor #4: Macro Factors Perceived to Increase Risk
The bank is located in Michigan, a state which has performed **very** poorly this downturn, and still has one of the highest unemployment rates in the U.S. (although employment levels have started to recover). Rising unemployment leads to lower nominal growth, which leads to lower revenue growth. It also results in higher loan losses.

As for concerns over home prices, a review of FHFA home price data reveals that CRBC's key geographies have been holding in over the past year. That said, falling home prices are having an indirect impact on valuations, as they are keeping some investors away from the sector, especially banks in states with high unemployment

Factor #5: Emphasis on TBV Valuation Ignores Value of Acquisitions
When investors value a bank on a multiple to TBV, they are assuming the bank's goodwill is worth zero, an extremely conservative, and sometimes outright inaccurate, assumption. As mentioned, CRBC is the product of a 2006 merger/acquisition. This acquisition incurred significant goodwill and core deposit intangibles, which have subsequently been written down, but still represent close to 50% of the bank's common equity.

While this acquisition turned out to be ill-fated (and ultimately resulted in most members of its management team being replaced in 2009), if one believes CRBC has worked through the bulk of its legacy loan problems (through its loss acceleration program) and its branch system is now generating profitable loans, this helps explain at least a portion of its very low price to normalized earnings, since these earnings would be captured in a price-to-earnings valuation but not by price-to-tangible book valuation.

Part VII: What Causes CRBC's Share Price to Rise, and When?
In our view, the above five factors explain why CRBC trades at such a low multiple. Now investors need to determine how and when these factors will be neutralized. **Stage #1** is a return to profitability followed by the resolution of its capital overhang. **Stage #2** is determining normalized

earnings, and the appropriate P/E multiple, and **Stage #3** is its takeout valuation should the bank decide to sell.

<u>Stage #1 (a):</u> Returning to (Sustained) Profitability
In our view, a return to sustained profitability is likely the first contributor to improving CRBC's share price. Although the bank has told the market it expects to be profitable by Q3 2011, we believe it will likely return to the black, or be close, this quarter (i.e. Q2 2011). With ***excess loan loss reserves equivalent to between one and two years of "normalized" earnings***, CRBC can be profitable in basically any quarter it wants for the foreseeable future.

Net income aside, the market will be looking for some normalization of credit costs now that the loss acceleration plan is complete. We believe this could occur this quarter for two reasons. **First**, we believe it is **<u>very</u>** far along in its recognition of cumulative losses. One of the very first things we calculate for any "recovering bank" is the percentage of its pre-cycle loan book that has been written off (or reserved for). We then use this and other factors to make the very important assessment regarding how far along the bank is in cleaning up its legacy loan problems. On this basis, we believe CRBC is very far advanced.

Second, the bank's NPA (or "bad loan") ratio is now just 3.26%, a very low level for a "recovering bank". Unless one believes there is a large new inflow coming, losses should normalize relatively quickly. This should make intuitive sense since the bank resolved the bulk of its challenged loans in just two quarters, and not all of them were non-performing. As a result, its watch list of "at-risk" loans has declined dramatically, implying that its inflows of non-performing loans (NPLs) are also likely to decline materially. Of great importance, its early stage delinquencies – a key indicator for future credit quality – declined by over 50% sequentially last quarter, and are concentrated in lower loss severity loan categories (and are almost zero in the highest loss severity loan categories).

It is possible CRBC decides to write off another large batch of its remaining non-performers as the "final-final" clean up, but as long as NPL inflows are manageable, it is not likely to make much of a difference. We believe Q2 2011 will be the first quarter in three years where reported credit costs are not at very elevated levels. That said, our expectations are for write-offs to remain well above "normal" for the remainder of the year. However, we also fully expect CRBC to report an "Ah Hah!" quarter perhaps as early as next year, where the improvement in credit quality is so substantial that the market concludes the bank has definitively emerged from the credit cycle. If write-offs came in at say, $20 mln in any quarter, we would expect its shares to rise materially.

Therefore, the first stage for the bank's recovery in share price should come from a return to sustained profitability, which would allow its shares to trade at (or close to) tangible book.

If the bank's shares were to recover back to tangible book value, it would result in share price appreciation of ~25%. Starting either this quarter or next, the bank will likely begin to release excess loan loss reserves into earnings equivalent to over $2.00 per share. This would increase its TBV by another 30% over the 6 to 8 quarters. Augmenting growth in book value over this same period would be any earnings generated excluding reserve releases.

<u>Stage #1 (b):</u> Capital Planning Resolution for TARP
We believe CRBC's shares would be attractive to many patient investors with a medium term time horizon, just from a return to sustained profitability, and the TBV accretion that will come from the immediate blend of higher core profitability and excess reserve releases. However, another very important event will be the reversal of its deferred tax valuation allowance (DTVA), which as mentioned is ~$7.30 a share, or over 100% of its current share price. For most banks with large DTVAs, their focus is on reversing them as soon as possible. Most banks do **<u>not</u>** believe they will be able to get their DTVA back all in one accounting entry (even though in many instances the associated assets were impaired that way). Rather, their hope is for gradual reversals as their profitability recovers.

CRBC is different. Management wants all of it back at once (and sooner, rather than later). However, unlike most other banks, CRBC has a much stronger argument since it took a different approach with its loss acceleration plan (which – all things being equal – should expedite its return to sustained profitability). The successful execution of this plan should also make it less likely that credit quality regresses, as the release of its excess loan loss reserves (which equate to about a third of its DTVA) provide a powerful cushion. As a result, we believe CRBC will bring these reserve releases back into earnings in such a way as to demonstrate stable and consistent earnings. This should be made easier by the fact that: (a) its loan loss reserves are substantial, and (b) its percentage of bad loans is now comparatively low.

Of equal importance is that, assuming its DTVA is reversed all at once, CRBC's key capital ratio – ***and its TBV*** – would almost double and the company would benefit from a huge infusion of non-dilutive common equity capital. As a result, it is highly likely the bank's share price would rise materially at the same time. Therefore, it is very much in shareholders' interest for management to wait for this reversal ***<u>before</u>*** seeking to repay TARP since it would significantly reduce EPS dilution (something we believe management understands).

If the bank is successful in recapturing its full DTVA at one time, <u>and</u> the market continued to value the bank on TBV, its shares would rise ~$7.50 (to $16.00), or over 100% from current levels. If the reversal of this allowance is instead gradual, it is likely that the share price appreciation would also be gradual (although still likely material).

Unlike their systemically important peers, many mid-cap banks exiting TARP are not being required (by the regulators) to issue an equivalent amount of common stock as a pre-condition (i.e. issue $1 of common stock for every $1 of TARP repaid). With a large infusion of trapped capital expected in the coming quarters, it is ***<u>less</u>*** likely that CRBC will be required to issue common stock equal to 100% of its TARP in order to exit the program. However, this will depend on the lift to its capital ratios that come from earnings over the next several quarters, which itself will depend on the bank's willingness to recapture its very large excess loan loss reserves.

So, what is the potential dilution?

If the bank repaid 100% of its TARP with a common equity raise at a share price equal to its new pro forma TBV, we estimate it would dilute EPS by about 30% (***less likely***). If it issued capital equal to 50% of its TARP balance, its dilution to normalized earnings would be about 15% (***more likely***). Both of these dilution estimates would be reduced by the growth in core earnings achieved in the meantime.

In our view, CRBC's share price is reflecting "worst case" EPS dilution, which is that the bank repays all of its TARP at its current depressed share price even though the bank has indicated that its intention is to wait for resolution of these capital issues before doing so.

We would also note that post-TARP common equity raise, the bank's capital position would be extremely high and, as ridiculous as it sounds, it would then have to start on the path of either buying back stock, or worse, buying another bank.

Stage #2: What is CRBC Worth in a "Normal" Environment?
In general, we consider the debate over an appropriate fully recovered valuation multiple to be "tomorrow's question" because we do not expect profit normalization until early 2013 for the mid-cap banks (we expect the large banks to reach normal quarterly profitability sometime next year). As we explained in Stage #1, a return to profitability and a DTVA reversal will influence CRBC's share price by a significant amount, well before normalized earnings arrive. That said, we forecast the environment will eventually normalize, likely within the next six to eight quarters. And when it does, the market will have to determine the appropriate market capitalization.

We Estimate a Market Capitalization of between $750 mln and $1.0 bln with an ROA of 0.85%
In a normal environment, we believe CRBC would have a market capitalization of between $750 mln and $1.0 bln – i.e. approximately three to four times its current market capitalization. To arrive at this value, we make two primary assumptions: (i) an ROA of 0.85% and (ii) some modest balance sheet growth between now and full recovery, say two years. This would mean the bank would trade at about 8x earnings, and generate a return on equity of 8% to 10% – assuming no buybacks.

Notably, the small and mid-cap banks traded at much higher multiples than their larger peers prior to the cycle because of their takeout potential ***despite being noticeably less profitable***. For example, pre-cycle price-to-earnings multiples for mid-caps were closer to 15x with ROEs in the low-teens. And while we do not foresee those types of multiples anytime soon, we would not rule them out.

Stage #3: What is CRBC Worth as a Takeout?
One scenario that would get valuation multiples for the entire U.S. banking sector rising quickly would be a return of M&A. Heightened activity has had a history of driving up valuations, often dramatically. In fact, in the M&A surge after the commercial real estate downturn in the early 1990's, valuations ultimately reached price-to-book values of 3.7x (overall, the sector currently trades below 1.0x book value).

If M&A activity becomes elevated, which we believe is very likely[8], CRBC would benefit since it is an attractive takeout candidate for the several reasons: (i) it has a large core deposit base for its size; (ii) it has a top 5 market position in about 60% of its markets; and (iii) it holds a solid market position in the 8th largest state in the U.S. (which has a population of nearly 10 mln).

Most bank M&A transactions are priced based on a combination of premium-to-deposits and price-to-book multiple. Assuming the sale took place after CRBC was clearly past its credit

[8] Please refer to our **HCP Note**: *"Why We Expect M&A to Accelerate in 2011"* from March 11, 2011.

problems, and using a conventional deposit premium, we estimate that it could sell for as much as $1.5 bln. Depending on the eventual share dilution resulting from a capital raise to repay TARP, this could be between $24.00 and $28.00 per share, or about 1.2x its pro forma price-to-book value[9].

Part VIII: What are the Risks to CRBC's Investment Thesis?

Obviously, there are risks to this thesis, as there is with any individual stock. In our view, should CRBC not maximize shareholder value from its current share price, it will most likely be for one of four reasons. **First** and foremost, management issues equity (in a rush to repay TARP), or worse, sells the bank outright at its current depressed share price. As we have outlined, the benefits to shareholders from management postponing these actions until the bank is clearly profitable and its capital has improved are overwhelming and all of their public comments suggest they understand this.

That said, they would not be the first management team to destroy shareholder value trying to get out of TARP and away from the U.S. government as soon as possible. Here again, we believe it is very important to note that CRBC is state regulated. Local regulators are more paternalistic, less confrontational and have a vested interest in fostering stronger banks in their state. CRBC management has consistently stated that their regulator (the State of Michigan) supports the direction of the bank (and implicitly its capital plans).

Second, the bank suffers a regression in credit quality. Despite writing off a substantial amount of its legacy portfolio, it could turn out to just not be enough. As a result, book value could degrade from current levels. We believe this risk is mitigated by roughly $150 mln of excess loan loss reserves, and a very low NPA ratio. Of course, this risk would rise if the U.S. entered another recession.

Third, by telling the bank's auditors (and the market) they want their entire DTVA reversed all at once, management may end up causing their accountants to delay the reversal in the interest of their own conservatism. This would reduce the present value of this incremental capital, which is, in our view, a very real possibility. As a result, there is the potential that they do not reverse this allowance until late 2012.

However, we believe the more likely scenario is that CRBC gets it back in stages, perhaps a bit more front-loaded. If the auditors presented the bank with a choice; reverse some of its allowance earlier (say $3.00 to $4.00 per share), or all of it (the full $7.30) much later, we believe they would opt for the former.

Fourth, some exogenous event, including a sovereign debt crisis, could emerge and drive down all bank stocks, including CRBC, even though its exposure to such an event is very tangential.

Conclusion: A Portfolio of "Recovering" U.S. Mid-Cap Banks is a Good Use of Capital

In our opinion, this credit cycle has created many investing opportunities (for specialist investors in particular) and we hope that this case study provides some insight into these opportunities, particularly for "recovering banks". The fundamentals for the banking sector continue to improve,

[9] Before the cycle began, banks routinely sold for 2.0x to 3.0x book value.

and we expect quarterly earnings to rise another 50% by the end of next year, as credit continues to normalize.

In the meantime, the market's emphasis on tangible book value as the dominant valuation metric for the near 500 publicly traded banks is creating many anomalies. Moreover, more than 200 banks trading below 1.0x TBV including over 130 trading below 0.7x TBV, and 70 below 0.5x TBV.

As we have explained in many of our other writings, it is our opinion that the chance to buy this many recovering banks below TBV represents a very rare opportunity.

And by rare, we mean every 20 years or so.

Disclaimer