HCP NOTES

Banking – United States

March 11, 2011

Why We Expect M&A to Accelerate in 2011

Since the downturn began in 2007, there has been very little true M&A activity (i.e., premium transactions) in the U.S. banking sector, with the vast majority of deals being FDIC-assisted takeovers of failed banks. However, ***within the next six months***, we expect premium transactions to accelerate in a significant way in the U.S. for the following reasons:

- **Still Too Many Banks:** The U.S. banking sector has been consolidating for nearly 30 years and, with 6,500 banks, it is still over-branched (Exhibit #1). We forecast there will be less than 5,000 banks by 2015.
- **Dodd-Frank/Basel III to Weigh on Returns:** Basel III (which will essentially double pre-credit cycle required capital) and Dodd-Frank (which includes several regulatory changes that will increase expenses and/or reduce revenues) are both expected to weigh on profitability and spur M&A.
- **Improving Credit Quality Restoring Earnings Visibility**: Falling credit losses and "bad loans" are rapidly improving earnings visibility, with sector earnings now almost 70% of "normal". This, combined with the improving economy, has materially reduced acquisition risk.
- **Bank Failures Ebbing:** With the equivalent of 1 in 7 banks (by assets) having failed this cycle, the process of cleansing the banking sector through FDIC-assisted transactions has largely run its course (there are essentially only micro-caps remaining). Therefore, acquirers desiring to grow through acquisitions are increasingly left with market deals, including premium transactions. Importantly, last cycle, the start of M&A was marked by the decline in bank failures (Exhibit #2).
- **Run-off Portfolios Still Weighing on Revenue Growth:** The severity of the credit cycle has created significant run-off portfolios (particularly in 1-4 family and commercial real estate). The run-off of these very large portfolios continues to weigh on loan (and revenue) growth, which we believe will provide the impetus for many banks to sell.

The consolidation of a banking sector during and after a severe credit cycle occurs in three distinct, but overlapping stages. First, premium deals vanish with exploding loan losses, and the only M&A is FDIC-assisted transactions. This process has been ongoing since late 2007 and is largely complete. Second, takeunders of distressed banks follow with deals where the equity holders are often wiped out. There have been several of these transactions (including TD's takeunder of TSFG) and we expect many more.

Third and finally, as the recovery gains traction, premium deals – which are the "norm" – resume. In the past four months, we have seen four prominent premium deals (including BMO/MI). We expect the number of these deals to accelerate in 2011. As Exhibit #3 highlights, this process can be very beneficial to shareholders as it was following the last major credit cycle.

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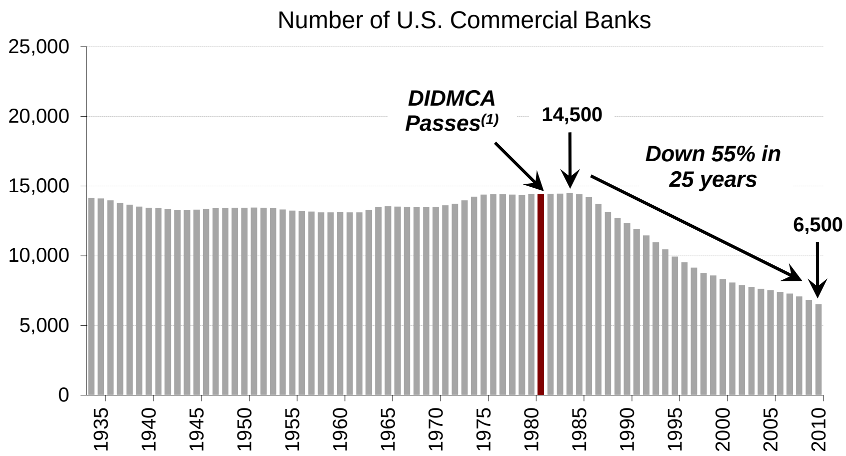
Exhibit #1

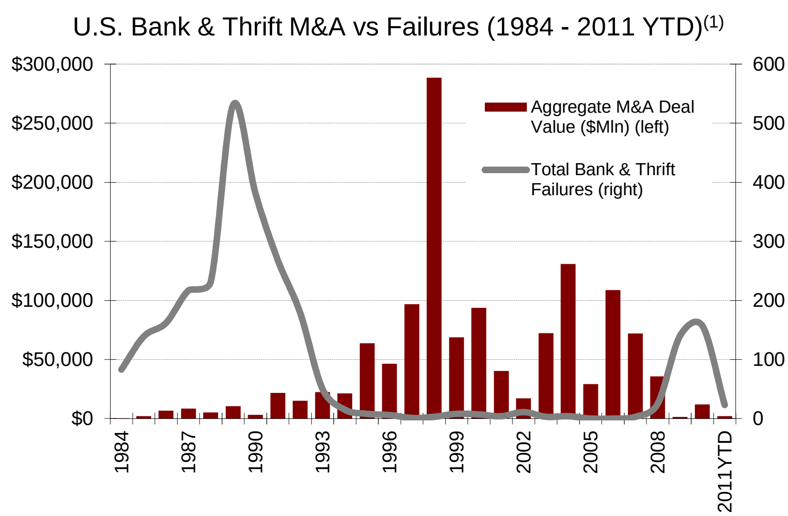


The number of banks following the Great Depression remained fairly stable until the early 1980's.

With legislative changes and a reduction in interstate banking restrictions, the number has declined by 55% in the last 30 years.

(1) Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) provided for, among other things, the phasing out of interest rate ceilings. It also extended nationwide the authority to issue NOW accounts (i.e. deposit accounts that pay interest and on which cheques can be written), and expanded the powers of federal savings and loans.

Exhibit #2



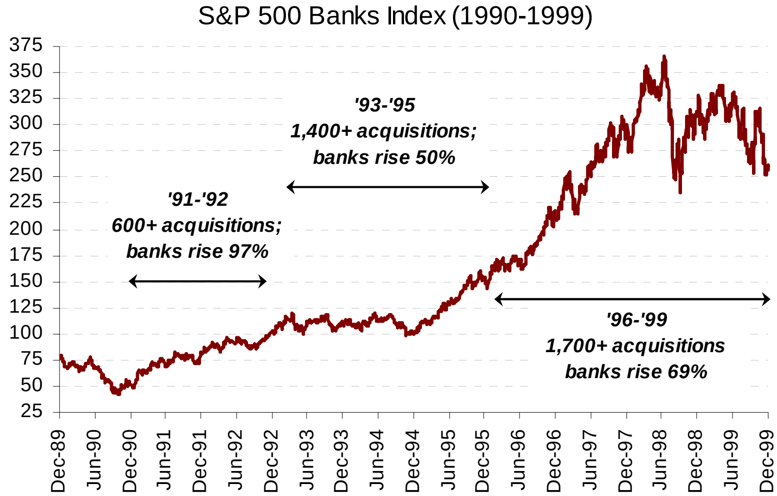
1. As of February 28, 2011.

Source: SNL Financial, FDIC, HCP

Following the last downturn, M&A deal value increased dramatically, as the decline in failures essentially marked the beginning of a multi-year M&A cycle.

This cycle, the number of failures increased significantly, peaking in dollar value in 2008. Although the number of failures remains elevated, the dollar value has declined dramatically, which we believe will contribute to a resumption in M&A.

Exhibit #3



Source: SNL Financial, Bloomberg, HCP

Following the last major credit cycle, elevated M&A activity continued for approximately ten years.

This process was extremely beneficial for shareholders, who benefited not only from premiums, but also from multiple expansion for the entire sector.