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Big Opportunities at Small Banks

When the stock market starts pounding a sector, such as banks, the pummeling can be merciless

So far this year, the Standard & Poor's (MHP) Financial Services index is down some 17%, and some of the megabanks are doing far worse. Citigroup (C) is off 39% and Wachovia (WB), 31%. There's a reason to be beating up these behemoths. They've taken billions in losses for mortgage-backed securities gone bad, and the sense on the Street is more write-offs will come.

In its manic ways, the market makes little distinction between the giants like Citi and Wachovia and the small and midcap banks, many of which have market caps the size of a rounding error in a big bank's write-off. That indiscriminate selling creates an investment opportunity in smaller banks that never made subprime mortgages or invested in a collateralized debt obligation (CDO) or a structured investment vehicle (SIV).

Of course, smaller banks have their own challenges. Their assets are often less diversified than the giants, and so their fortunes are tied to their local economies. More of their earnings come from the interest rate spread—the difference between what they make from loans and what their funds cost them—which leaves them more sensitive to changes in monetary policy. And when big banks want to offer above-market “teaser” rates to gather deposits, it's tougher for them to compete.

Still, some smaller banks find a way to thrive. One of them is Colonial Bancgroup (CNB), says Robert Maneri, managing director of Cleveland-based Victory Capital Management. Based in Montgomery, Ala., Colonial also extends into Georgia and Florida, where it is now the state's fifth-largest bank. Some might argue that's little to boast about, given the well-publicized plight of overbuilding in the Sunshine State, but Maneri says the bank's management is smart. “[CEO] Robert Lowder is a savvy real estate guy,” says Maneri. “He's early to recognize [loan] problems and get them off the books.” Another plus, says Maneri, is that Lowder owns just over 4% of the bank's shares himself. The stock trades at 16.93 and pays a generous 4.4% dividend.

Unlike Florida, where the economic growth is spotty, southeast Texas is on a tear. That makes Houston-based Prosperity Bancshares (PRSP), at 30.69, an attractive stock. Houston's economy is more than just energy, says SunTrust Robinson Humphreys' analyst Jennifer Demba, who points to the Port of Houston, the second-busiest port in the nation, and the University of Texas Health Science Center, the biggest medical facility in the world. Prosperity boasts the third-largest branch network in the state.

What's more, says Demba, the loan-to-deposit ratio is 66%, compared with the industry norm of 100%. “Prosperity has excess deposits to fund future loans,” says Demba, meaning it doesn't have to lure deposits with higher-than-market rates.

Another Texas bank fitting a similar profile is Cullen/Frost Bankers (CFR), which has the largest market share in San Antonio, one of the fast-growing cities in the country. Between July, 2000, and July, 2006, San Antonio's population surged 13.3%, to 1.4 million. Cullen/Frost derives 34% of its income from wealth management, insurance, and service fees, vs. a 20% industry average. That explains perhaps why Cullen/Frost trades at a somewhat higher price-book value ratio than the others.

Also on Demba's buy list is East West Bancorp (EWBC) in Pasadena, Calif., which uses deposits from its predominantly Asian American retail banking clients to fund commercial real estate loans and loans to businesses. Exposure to the residential mortgage market has hurt East West's stock, but Demba says it is not a big problem. “The average loan size is fairly small and the size of the loans relative to the value of the properties is more conservative than its peers.” Another plus for East West: Its Chinese connections make it a go-to bank for middle market U.S. companies trying to establish business in China, says David Klaskin, chairman and chief investment officer of \$4 billion Oak Ridge Investments based in Chicago.

SAFER LOANS

One area that so far has defied the real estate slowdown is New York City, where Westbury (N.Y.)-based New York Com-

munity Bancorp (NYB) operates. The bank lends to landlords who own rent-controlled and rent-stabilized apartment buildings. Those loans are based on predictable cash flows, not on the value of the buildings. In fact, in its third-quarter investor presentation the bank said it had not had any losses in the multifamily loan portfolio in 28 years.

New York Community's strength has not gone unnoticed: Its stock is up 11% in 2007. But the best may be yet to come: Two competitors in lending to landlords, North Fork Bank (NFB) and Independence Community Bank (ICBC), were acquired by bigger financial groups this past year and are no longer focusing on this niche. The stock also pays a healthy 5.6% dividend.

Pinnacle Financial Partners' stock, now at 28.17, was as low as 21.62 in August, when traders first pounced on the sector. But the Nashville-based bank's main business is not residential or commercial real estate lending. It's making commercial and industrial loans, which is up 16% this year. "Pinnacle has been penalized as if it was a mortgage lender," says Kevin B. Reynolds, a bank analyst for Janney Montgomery Scott. That's yet another example of how Wall Street sometimes gets it wrong.

SIZING UP THE LITTLE GUYS

COMPANY	SYMBOL	PRICE*	YEAR-TO-DATE RETURN*	52-WEEK HIGH	52-WEEK LOW	MARKET CAP (BILLIONS)	DIVIDEND YIELD	PRICE-BOOK VALUE RATIO
Colonial Bancgroup	CNB	16.93	-34.2%	26.80	15.92	\$2.59	4.4%	1.2
Cullen/Frost	CFR	50.95	-8.7	57.05	47.55	2.98	3.1	2.1
East West Bancorp	EWBC	27.74	-21.7	42.3	27.74	1.75	1.4	1.5
N.Y. Community Bancorp	NYB	17.87	11.0	19.87	15.80	5.78	5.6	1.4
Pinnacle Financial Partners	PNFP	28.17	-15.1	34.65	21.62	0.44	0.0	1.6
Prosperity Bancshares	PRSP	30.69	-11.1	37.11	27.70	1.35	1.6	1.2

*Nov. 16 Data: Yahoo! Finance, Bloomberg Financial Markets