



TM

Investing In The Tradition of
Graham, Buffett, Klarman

Year III, Volume X
October 29, 2010

When asked how he became so
successful, Buffett answered:
"We read hundreds and hundreds
of annual reports every year."

Top Five Ideas In This Report

Barclays (London: BARC, NYSE: BCS)	62
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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors. Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

VALUE OPPORTUNITIES IN BANKS?

- ▶ The crisis: Where we are, where we are headed
- ▶ Five ways of identifying opportunities in banking
- ▶ Thrift conversions: Is anyone paying attention?
- ▶ 100 profitable banks — and other banking screens
- ▶ Top 5 ideas, based on proprietary *MOI* methodology
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 - ▶ Plus: Favorite stock screens for value investors
 - ▶ Plus: Exclusive interview with Scott Proper
 - ▶ Plus: Exclusive interview with Michael Godby

Banks mentioned in this issue include Arrow Financial, Bancolombia, BancorpSouth, Bank of America, Bank of Montreal, Bank of Marin, Bar Harbor Bank, Barclays, BB&T, BBVA Frances, BNP Paribas, Boston Private, Brookline Bancorp, Century Bancorp, CIT Group, Citigroup, Citizens & Northern, City National, CNB Financial, Columbia Banking, Commerce, Community Bank System, Community Trust, Credicorp, CVB Financial, Danvers Bancorp, Deutsche Bank, Dime Community, East, First Bancorp, F.N.B., Fifth Third Bancorp, First Bancorp, First Busey, First Commonwealth, First Community, First Financial, First Financial Bank, First Interstate, First Merchants, First Midwest, First Niagara, FirstMerit, Fulton Financial, German American, Hancock Holding, HSBC Holdings, Huntington, Iberiabank, ING Group, JPMorgan Chase, KeyCorp, M&T Bank, MB Financial, Meridian Interstate, Mitsubishi UFJ Financial, NASB Financial, National Penn, NBT Bancorp, NewAlliance, Northern Trust, Northwest Bancorp, NY Community, Old National Bancorp, Park National, Peapack-Gladstone, People's United, Prosperity Bancshares, Renasant, Rockville Financial, Roma Financial, Royal Bank of Scotland, S&T Bancorp, Santander Brasil, Santander Chile, SCBT Financial, Signature Bank, Southwest Bancorp, State Bancorp/NY, State Street, Sterling Bancorp, Susquehanna, TFS Financial, Tompkins Financial, TrustCo Bank NY, UMB Financial, Umpqua Holdings, Univest Corp. of PA, Valley National, Wainwright B & T, Washington Federal, Waterstone Financial, Webster Financial, Wells Fargo, WestAmerica, Wintrust Financial, and more.

(analyzed companies are underlined)

LAST-MINUTE EXTRA:
Favorite Bank Investments of Buffett Pick Todd Combs
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Editorial Commentary

Our task this month has seemed quite daunting at times: We set out to rummage through the wreckage of the banking sector in search of investment opportunities for value-oriented investors. While doing so, we were mindful that many of the latter have viewed banks with suspicion, branding them as “black boxes” whose asset quality is impossible to ascertain. In a time of weak real estate prices and unusual strains on consumers, asset quality has become perhaps more important than ever.

While the “black box” critique of banks has merit, we did not simply want to dismiss the beaten-down sector and move on. After all, the following superinvestors have found apparent value in banks: David Tepper in **Bank of America (BAC)**, **Citigroup (C)**, **Wells Fargo (WFC)**, **Royal Bank of Scotland (RBS)**, **Fifth Third Bancorp (FITB)**, and **SunTrust Banks (STI)**; John Griffin and Steve Mandel in **JPMorgan Chase (JPM)**; Glenn Greenberg in **U.S. Bancorp (USB)**; Francis Chou in BAC; Eddie Lampert in **Capital One (COF)**; Bruce Berkowitz in C and BAC; Phil Falcone and Bill Ackman in C; John Paulson in BAC, C, JPM, COF, and STI; Tom Brown in **Synovus (SNV)** and several other banks; Mason Hawkins in **Bank of NY Mellon (BK)**; and Prem Watsa and Warren Buffett in WFC and USB. All of these positions are among the top ten largest holdings of each investor, suggesting meaningful commitments to the sector by these investment managers.

Our research effort has yielded five potential ways of approaching the banking sector in search of compelling investment ideas:

1. Too-big-to-fail “national champions” that remain historically cheap;
2. Strong institutions poised to benefit from the weakness of others;
3. Troubled banks with the most upside in a survival scenario, as gauged primarily by equity market value to total assets;
4. Banks that may outperform in an inflationary scenario due to relatively large long-term, fixed-rate liabilities; and
5. All-but-forgotten thrift conversions, with shareholder value yet to be unlocked in a second-step conversion.

The following is a snapshot of companies highlighted this month, along with classification by above category:

Top 5 Investment Ideas in This Report

	“National Champion”	“Strong Get Stronger”	Low MV to Assets	Inflation Beneficiary	Thrift Conversion
Barclays / BCS London, United Kingdom	✓	✓	✓		
Deutsche Bank / DB Frankfurt, Germany	✓		✓		
Mitsubishi UFJ / MTU Tokyo, Japan	✓	✓	✓	✓	
Roma Financial / ROMA Robbinsville, New Jersey		✓			✓
Waterstone Financial / WSBF Wauwatosa, Wisconsin			✓		✓

Source: The Manual of Ideas.

Historically Cheap “National Champions”

Much has been made about institutions perceived to be “too big to fail.” While the latter does not mean that common stockholders will be made whole in a bailout, such too-big-to-fail banks do enjoy advantages that may help them accrete value at an above-average rate over time. The perception that a bank is too big to fail may boost confidence among those providing it with money, whether it is lenders or depositors. Such institutions also enjoy significant political clout in their respective countries, putting them in a position to tilt regulation in their favor.

We slot the following banks, among others, into this category: BAC, C and JPM in the U.S.; **Barclays (BCS)** and RBS in the U.K.; **BNP Paribas (Paris: BNP)** and **Credit Agricole (Paris: ACA)** in France; DB in Germany; **ING Group (ING)** in the Netherlands; **Mitsubishi UFJ Financial (MTU)** in Japan; and **Credit Suisse (CS)** and **UBS (UBS)** in Switzerland.

Selected “National Champions” *(sorted by estimated P/E for 2011)*

		Price (\$)	MV (\$bn)	Assets (\$bn)	MV/ Ass.	EPS (\$) ¹		P/E ¹	
						2010	2011	2010	2011
ING Group / ING	NED	11.15	42	1,782	2%	1.68	2.33	7x	5x
Deutsche Bank / DB	GER	58.69	36	2,696	1%	5.16	9.11	11x	6x
Barclays / BCS	GBR	17.89	52	2,492	2%	2.04	2.74	9x	7x
Credit Agricole / CRARY	FRA	8.34	40	2,472	2%	0.77	1.25	11x	7x
Credit Suisse / CS	SUI	42.00	50	1,089	5%	5.00	5.89	8x	7x
BNP Paribas / BNPOY	FRA	37.00	88	3,132	3%	4.38	4.87	8x	8x
Bank of America / BAC	USA	11.44	115	2,364	5%	1.08	1.47	11x	8x
JPMorgan Chase / JPM	USA	37.70	149	2,014	7%	3.84	4.62	10x	8x
UBS / UBS	SUI	17.93	68	1,488	5%	1.88	2.18	10x	8x
Citigroup / C	USA	4.11	119	1,938	6%	0.39	0.46	11x	9x
Mitsubishi UFJ / MTU ²	JAP	4.71	67	2,512	3%	0.34	0.45	14x	10x
Royal Bank Scotland / RBS	GBR	14.48	78	2,482	3%	0.31	0.94	46x	15x

¹ Based on consensus analyst estimates as of October 25, 2010.

² Fiscal years ending March 31, 2011 and 2012.

Sources: Company filings, Manual of Ideas analysis.

Strong Institutions Poised to Benefit From the Crisis

The saying “the strong get stronger” has much applicability to today’s banking landscape. Institutions with significant troubled assets are simply struggling to stay ahead of the demands of regulators, forced to raise capital at unfavorable terms. In many cases, weak banks are gently—or not so gently—shepherded into the hands of stronger competitors.

Sometimes this has occurred even before banks were forced to take writedowns that would render them critically undercapitalized. For instance, in April the FDIC shut down Westernbank Puerto Rico, which had \$1 billion of equity and \$13 billion of assets, “gifting” large deposits to Puerto Rico’s “strong” bank, **Popular (BPOP)**. John Paulson and Roberto Mignone are among BPOP’s largest shareholders.¹

Strong institutions exploiting the weakness of others include JPM, WFC, **Northern Trust (NTRS)**, and **Toronto Dominion Bank (TD)**, among others.

¹ A Value Investors Club write-up on BPOP, dated December 2009, is available at <http://bit.ly/aMApiR> (no registration required). A more recent VIC write-up on BPOP, dated September 2010, is available at <http://bit.ly/94A17L> (free guest registration required).

Troubled Banks with Attractive Risk-Reward Tradeoffs

Whereas the previous two categories have received ample attention by investors looking for “safe” values in the banking sector, investors continue to shun troubled institutions. They are doing so virtually without regard for the at times enticing risk-reward tradeoffs implied by battered stock prices. Naturally, we find this category worthy of closer investigation.

In an exclusive interview inside this report, former Colorado community banker Scott Proper comments on the opportunity in troubled small banks:

“I think that significant concentration within a particular community bank is risky, but that a significant concentration within a basket of community banks is attractive. I am surprised we have not yet seen a community bank ETF for banks with tangible equity of less than \$1 billion. They are the most significantly mispriced class of banks... I think that worst case, 20% of them will fail, but that these worst-case losses will be more than offset by appreciation in the others. As always, only time can tell. Most of these community banks are currently trading at ten-year, if not historic, lows.”

How to identify banks with potentially asymmetric risk-reward profiles? To do so, we borrow a page from the reclusive but highly successful Chandler brothers. According to a 2006 title story in *Institutional Investor* magazine, “Over the past 20 years, the New Zealand-born brothers [Richard and Christopher Chandler] have turned a modest family fortune of \$10 million into a powerful \$5 billion fund — all of it their own money — by making bold bets in risky markets around the world.”² One such “bet” was an investment in the troubled Japanese banking sector. Wrote *II*:

“Japanese banks had no earnings on which to base multiples, and uncertainty about the extent of bad loans made it difficult to forecast a turnaround. So **Richard and his analysts looked at market capitalization as a percentage of assets; on this basis they determined that UFJ and other megabanks traded at about 3 percent, compared with 15 percent for Citigroup at the time.**³ The Chandlers concluded that Japan would have to nationalize the banks or reflate the economy with low interest rates, and bet — correctly, as it turns out — on the latter scenario. ‘Most fund managers are focused on what can go wrong rather than on what can go right and were too afraid to make that call,’ says Richard. ‘We were not.’”

On page 28 of this report, we present a table ranking U.S.-traded banks by the Chandler metric, market capitalization as a percentage of assets. The idea is to identify banks that would have large upside in a normalization scenario (assuming no massively dilutive equity offering in the meantime). If a bank can earn a 1% net spread on assets, then a 3% MV-to-asset ratio implies a “normalized” P/E of 3x. Indeed, the Chandlers may envy the opportunity in today’s banking sector, as numerous small banks trade at MV-to-asset ratios of 1% and 2%, implying greater potential upside than the Chandlers had enjoyed in Japan.

Of course, many banks trade at MV-to-asset ratios of 1-3% because dilutive equity offerings may be imminent, rendering the *pro forma* MV-to-asset ratios much higher than 1-3%. Nonetheless, there are still plenty of institutions that meet the regulators’ “well-capitalized” thresholds, suggesting a non-negligible probability that those banks may escape material equity dilution.

² *Institutional Investor* magazine, “Secrets of Sovereign,” March 2006.

³ Emphasis added.

Playing into this investment case is the thesis that the government, broadly defined, wants to slow the pace of bank failures to minimize the adverse impact on lending and employment. The Fed has subsidized banks with nearly free money, allowing them to earn attractive spreads by investing in longer-dated Treasuries. The FDIC and other regulators are undercapitalized and understaffed to deal aggressively with the problem of “zombie” banks. Everyone seems to be waiting — and hoping and praying — that “quantitative easing” and other Fed measures will prove somewhat inflationary, helping to stabilize real estate prices. The latter would mark a turning point for troubled banks, as collateral values would stop falling and perhaps start creeping higher, eliminating many banks’ imperative for more capital.

In a recent confirmation of the regulators’ “kid gloves” approach, on October 19 the FDIC canceled a scheduled bank fee increase. “I am pleased that we are able to provide some (insurance fee) relief now in light of our lower loss projections,” stated FDIC Chairman Sheila Bair.⁴ An industry expert told us the following: “The spinning of the message is pretty telling. The real bottom line is that after requiring banks to prepay three years’ worth of FDIC insurance fees last year, they don’t think banks can handle the expense again, according to my regulator friends.”

Investing in community banks in the face of bad fundamentals reminds us a bit of the approach David Tepper took in the spring of 2009 when he bought large stakes in several U.S. banks. Tepper’s thesis rested simply on what he believed regulators would do, or as Tepper puts it, on what they *told* him (and others) they would do. The FDIC’s cancellation of a scheduled fee hike, coupled with the justification of lower loss projections, tells us quite strongly which path regulators are taking. Mr. Market’s valuation of many small banks still reflects on entirely different path.

Banks that may have attractive risk-reward tradeoffs based on low ratios of MV to assets include **BankAtlantic (BBX)**, **Capitol Bancorp (CBC)**, **Commonwealth Bankshares (CWBS)**, **First Bancorp (FBP)**, **First Place Financial (FPFC)**, **United Community Financial (UCFC)**, and **United Western Bancorp (UWBK)**.

Small Banks, Big Rewards? *(sorted by market value to total assets)*

	State	Price Δ Since 12/29/06	Market Value (\$mn)	MV/ Total Assets	Tang. Book/ MV	TBV/ Tang. Assets	Insider Own.
First Bancorp PR / FBP	PR	-97%	30	.2%	1563%	2.6%	16%
FNB United / FNBN	NC	-97%	7	.3%	292%	1.0%	7%
Superior Bancorp / SUPR	AL	-98%	11	.3%	1191%	4.0%	15%
United Western / UWBK	CO	-98%	11	.5%	999%	5.0%	6%
Capitol Bancorp / CBC	MI	-98%	25	.5%	69%	.4%	12%
BNCCORP / BNCC	ND	-87%	6	.6%	664%	4.1%	14%
Centrue Financial / TRUE	IL	-93%	9	.7%	536%	3.8%	28%
PAB Bankshares / PABK	GA	-97%	9	.8%	294%	2.3%	36%
Cascade Bancorp / CACB	OR	-98%	15	.8%	42%	.3%	15%
Intervest Banc / IBCA	NY	-94%	18	.8%	923%	7.6%	33%
Carver Bancorp / CARV	NY	-80%	8	1.0%	522%	5.0%	4%
Tidelands Banc / TDBK	SC	-91%	6	1.0%	286%	2.9%	34%
First Mariner Banc / FMAR	MD	-96%	15	1.1%	296%	3.2%	23%
Broadway Financial / BYFC	CA	-67%	6	1.1%	330%	3.6%	31%
Fentura Financial / FETM	MI	-93%	5	1.1%	351%	3.9%	24%
Northern States Fin. / NSFC	IL	-92%	6	1.2%	372%	4.3%	44%
BankAtlantic / BBX	FL	-99%	54	1.2%	119%	1.4%	55%
Village B & T / VBFC	VA	-88%	7	1.2%	693%	8.0%	20%
Patriot Nation. Banc / PNBK	CT	-92%	10	1.2%	333%	3.9%	50%
Bank of Granite / GRAN	NC	-96%	12	1.2%	295%	3.5%	7%

Sources: Company filings, Manual of Ideas analysis.

⁴ Marcy Gordon, “FDIC lowers expected cost of bank failures by \$8B,” *The Washington Post*, October 19.

Potential Inflation Beneficiaries

Inflation is not generally considered beneficial to the health of banks. Long-term fixed-rate loan assets may collapse in value while the cost of deposits may skyrocket, destroying bank equity and profitability. Nonetheless, under current circumstances, rising prices may benefit certain banking institutions in two primary ways:

First, price inflation, whether accurately reflected in the CPI or not, may help to stabilize real estate prices. As many U.S. banks have in effect morphed into non-operating REITs, a turnaround in real estate prices is critical to the recovery of the banking sector. Banks with large residential real estate portfolios in areas in which prices would respond most favorably to inflation stand to benefit the most from the Fed's reflationary efforts. For example, a depreciating dollar may induce non-U.S. residents to buy cheap vacation homes in states such as Florida, potentially helping to reverse the dynamic of declining prices. Similarly, banks operating in areas that would benefit from a boom in commodity prices could see inflation positively impacting the health of their depositors and borrowers.

Second, inflation would have a positive impact on banks sitting on variable-rate loans, funded in part with long-term, fixed-rate borrowings. Some banks sold large amounts of trust preferred securities (TruPS) when capital markets were receptive to such issuances. TruPS are generally long term in nature and often carry fixed interest rates. Banks with material long-term, fixed-rate borrowings include **CBC**, **KeyCorp (KEY)**, **PNC Financial Services (PNC)**, **SunTrust (STI)**, and **USB**.

Overlooked Thrift Conversions

Grizzled value investors will recognize thrift conversions as one of the more conservative, time-tested ways of earning positive risk-adjusted returns in banking.

In a first-step thrift conversion, an institution that has been technically owned by its depositors may become a stock corporation and raise capital in an IPO. In these offerings, new investors are essentially "buying" their own capital and getting the existing institution's assets and business for "free."

Meanwhile, in a second-step thrift conversion, an institution that is partly owned by a mutual holding company (MHC) typically completes a transition to full public ownership by offering MHC-owned shares to investors.

For purposes of this report, we are particularly keen on institutions that have completed a first-step conversion but have yet to announce a second-step conversion. Shares in these thrifts are readily available for purchase in the public markets. Still, some of them appear to be inefficiently priced. "While thrifts are often most undervalued at the time of conversion, they occasionally fall to acceptable discounts because of market forces," according to Seth Klarman.

Ideally, the vast majority of the common stock of a publicly traded thrift is held by an MHC. While those shares are considered to be outstanding, the economics belong entirely to the non-MHC shareholders. The analogy would be treasury stock held by a corporation that had completed a share repurchase. The major difference is that treasury stock is not considered to be outstanding. This MHC-related peculiarity causes many investors to overlook thrift conversions, as the relevant institutions may not appear to be particularly cheap at first glance.

Thrift conversions had their zenith in the 1980s and '90s. Some savvy investors such as Seth Klarman, who had participated in conversions, have since moved on to

bigger opportunities as their funds have grown in size. In addition, bank-focused investment funds as a category were decimated in the recent financial crisis, making it plausible that thrift conversions may not be as closely followed as before.

We are particularly pleased to bring you an exclusive interview with an analyst who follows thrift conversions, perhaps more closely than anyone in the industry — Mike Godby of FIG Partners. We have devoted a meaningful portion of this report to thrift conversions, and two of this month's five featured ideas — **Roma Financial (ROMA)** and **Waterstone Financial (WSBF)** — fall into this category.

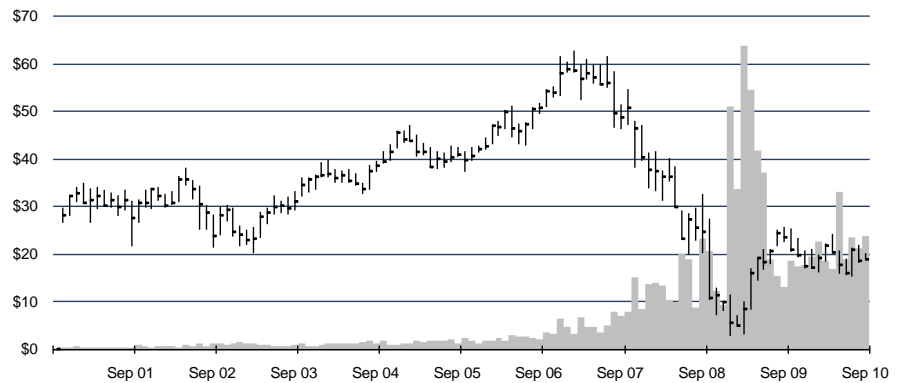
Selected Thrift Conversions *(sorted by market value to tangible assets)*

	State	Price Δ		MHC-adjusted Metrics			Insider Own.	TBV/Tang. Assets
		Since YE'06	MHC Own.	MV (\$mn)	TBV/MV	MV/TA		
Atlantic Coast Fed / ACFC	GA	-90%	65%	9	623%	.9%	15%	6%
Brooklyn Federal / BFSB	NY	-86%	72%	\$7	1087%	1.3%	17%	14%
Magyar Bancorp / MGYR	NJ	-75%	56%	9	489%	1.7%	15%	8%
Waterstone Financial / WSBF	WI	-78%	74%	33	531%	1.7%	17%	9%
Pathfinder Bancorp / PBHC	NY	-37%	64%	7	282%	1.9%	14%	5%
PSB Holdings / PSBH	CT	-67%	57%	10	357%	2.1%	23%	8%
Naugatuck Valley / NVSL	CT	-59%	60%	14	354%	2.6%	13%	9%
Malvern Federal / MLVF	PA	n/m	56%	18	383%	2.6%	2%	10%
Heritage Financial / HBOS	GA	-50%	76%	21	282%	3.2%	25%	9%
Hometown Bancorp / HTWC	NY	n/m	56%	5	366%	3.4%	6%	12%
Laporte Bancorp / LPSB	IN	n/m	55%	15	270%	3.5%	6%	9%
SI Financial / SIFI	CT	-44%	62%	31	249%	3.5%	13%	9%
Prudential Banc / PBIP	PA	-49%	71%	20	283%	3.7%	10%	10%
FedFirst Financial / FFCO	PA	-45%	57%	14	301%	4.0%	9%	12%
Oneida Financial / ONFC	NY	-42%	55%	24	134%	4.2%	21%	6%
Lake Shore Bancorp / LSBK	NY	-36%	60%	20	293%	4.3%	18%	13%
MSB Financial / MSBF	NJ	n/m	59%	16	252%	4.4%	10%	11%
Alliance Bancorp / ALLB	PA	-67%	59%	20	242%	4.5%	9%	11%
United Community / UCBA	IN	-39%	59%	23	240%	4.7%	21%	11%
Charter Financial / CHFN	GA	-84%	61%	60	180%	5.2%	6%	9%
Meridian Interstate / EBSB	MA	n/m	58%	99	196%	5.8%	4%	11%
Roma Financial / ROMA	NJ	-36%	73%	88	247%	6.0%	4%	15%
Greene County Banc / GCBC	NY	11%	56%	31	143%	6.3%	24%	9%
Capitol Federal / CFFN	KS	-36%	70%	541	178%	6.3%	9%	11%
Rockville Financial / RCKB	CT	-35%	55%	102	157%	6.4%	8%	10%
Investors Bancorp / ISBC	NJ	-25%	57%	589	146%	6.7%	8%	10%
Kearny Financial / KRNY	NJ	-45%	75%	152	266%	6.7%	22%	18%
Northeast Community / NECB	NY	-52%	55%	35	304%	6.8%	1%	21%
TFS Financial / TFSL	OH	n/m	74%	741	238%	6.8%	1%	16%
Beneficial Mutual / BNCL	PA	n/m	56%	323	164%	6.8%	5%	11%
Clifton Savings / CSBK	NJ	-30%	64%	80	219%	7.2%	20%	16%
Cheviot Financial / CHEV	OH	-36%	62%	29	243%	8.2%	22%	20%
Northfield Bancorp / NFBK	NJ	n/m	56%	216	178%	9.8%	7%	17%

Sources: Company filings, Manual of Ideas analysis.

With that context to our search for bank investments in mind, we highlight the following five ideas for closer consideration:

Barclays (London: BARC, NYSE: BCS; \$17 per ADR; MV \$50 billion)



Barclays is one of the three largest banks in the U.K., along with RBS and **HSBC (London: HSBA, NYSE: HBC)**, which are also profiled in this report. With \$2.5 trillion in assets, Barclays also ranks among the ten biggest banks in the world. Deposits are growing, and customer accounts amounted to \$575 billion on June 30th.

Retail banking, however, is not the company's primary earnings engine, as the investment bank, Barclays Capital, has accounted for a majority of assets and, more recently, income. In H1 2010, Barclays Capital ranked #1 in global debt (8% market share), #3 in global forex (11%) and #4 in global, completed M&A (15%).

Key Contributor: Barclays Capital

FYE December 31	2007	2008	2009	1H10
Assets (in trillions)	£1.0	£1.2	£2.1	£1.4
<i>% of total assets by selected segment:</i>				
Barclays Capital	68%	79%	74%	76%
U.K. retail banking	7%	5%	8%	8%
<i>Pretax income by selected segment (in billions):</i>				
Barclays Capital	£2.3	£1.3	£2.5	£3.4
Other businesses (incl. overhead)	3.9	3.8	2.1	0.5
Total pretax income	£6.2	£5.1	£4.6	£3.9

Sources: Company filings, Manual of Ideas analysis.

The downside, of course, to Barclays' deriving such a large portion of profits from Barclays Capital is the cyclical nature of the investment banking businesses. On the other hand, one could argue that the other businesses — U.K. retail banking, Barclaycard multi-brand credit card and consumer lending, and South African financial services leader Absa — have simply been under-earning relative to their potential. If those businesses can improve their profitability, the parent's dependence on Barclays Capital will decrease while overall income should increase.

Importantly, unlike some other U.K.-based banks, Barclays has managed through the financial crisis without requiring government aid. The company did raise funds from Qatar and Abu Dhabi in 2008/09, but these investors rank equally with other common stockholders. Since it did not take government aid, Barclays is free to operate outside the confines of the U.K. Asset Protection Scheme.

Barclays' financial position has improved in important ways over the past three years. Core Tier 1 capital has grown from 4.7% in 2007 to 10% in 2010, gross leverage has fallen from 33x to 20x, while the "liquidity buffer" has grown from £19 billion to £160 billion. With shares trading at just under 80% of tangible book value and less than 7x 2011E EPS of \$2.74 per ADR, we find the risk-reward interesting.

Deutsche Bank (Frankfurt: DBK, NYSE: DB; \$56 per ADR; MV \$55 billion)



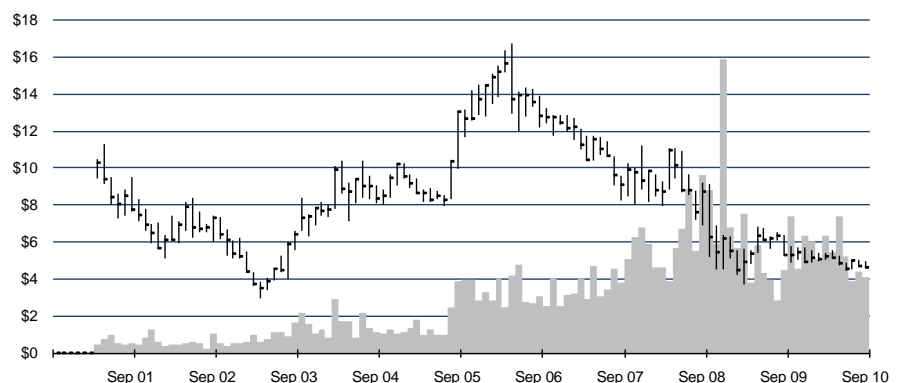
Deutsche Bank, with \$2.7 trillion in assets, is the top corporate and investment bank in Germany and one of the five largest investment banks in the world.

The bank completed a €10 billion (\$14 billion) rights offering at €3 per share (\$46 per ADR) in October, strengthening the capital base ahead of the pending **Postbank (XETRA: DPB)** acquisition.

Postbank is one of Germany's largest retail banks, with 1,100 branches and \$340 billion in assets. Deutsche's offer for the 70% of Postbank it does not already own implies a \$7.5 billion equity value for an entity that will boost Deutsche's retail deposits by ~\$150 billion to ~\$350 billion. The deal will not only move Deutsche's funding and earnings mix toward the more stable retail banking business, but it may also provide some medium-term capital relief, as Postbank has close to \$170 billion in non-core assets that will be put into runoff. Management is targeting synergies of €1 billion, which could prove conservative given the two entities' large overlap in non-revenue generating functions.

Our valuation analysis suggest that, after adjusting for deal synergies, a potential capital release from running off Postbank's non-core assets, and Deutsche's roughly \$15 billion in principal investments, the "core" investment banking franchise may be trading at an implied low single-digit multiple of run-rate earnings. Pro forma for the Postbank acquisition, Deutsche Bank trades roughly in line with tangible book value, which we find quite attractive given the combined entity's potential to earn mid-teens normalized returns on equity. Finally, consensus estimates call for Deutsche to earn \$9.11 per share in 2011, implying a forward P/E of 6.3x.

Mitsubishi UFJ (Tokyo: 8306, NYSE: MTU; \$4.60 per ADS; MV \$65 billion)



Mitsubishi UFJ Financial (MTU) enjoys an enviable position in Japanese retail banking, where it is the dominant player with roughly ¥100 trillion (>\$1 trillion) in deposits. The company was formed in 2005 via the merger of Japan’s second-largest banking group, Mitsubishi Tokyo, and number-four UFJ Holdings, based in Osaka.

Unlike the other two megabanks among this month’s five featured ideas—Barclays and Deutsche Bank—MUFJ is primarily a retail and commercial bank and only secondarily an investment bank. This makes the franchise relatively more valuable, in our view, as customer deposits tend to be a higher-quality asset than line items such as trading securities and derivatives.

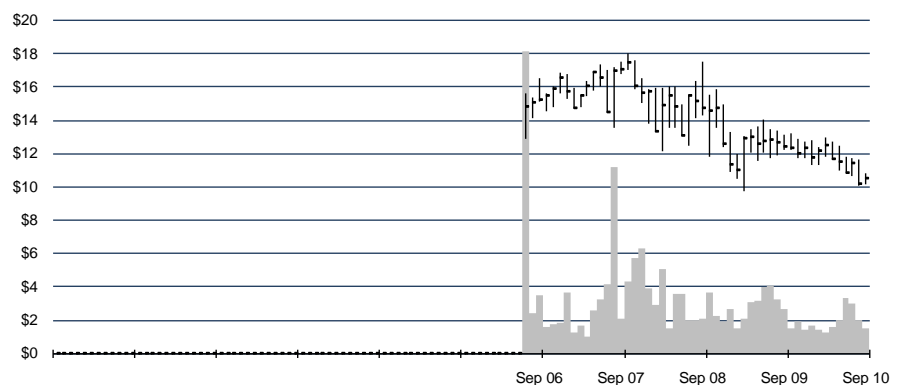
MUFJ has had a foothold in the U.S. banking industry ever since Mitsubishi Bank acquired The Bank of California in 1984. That investment has evolved into full ownership of Union Bank, which ranks fifth and twenty-first in deposits in California and the U.S., respectively. In its pursuit of the U.S. market, MUFJ has departed somewhat from Japanese banks reputation for paying top dollar for acquisitions at cycle peaks. Rather, MUFJ made a \$9 billion preferred equity investment in Morgan Stanley in 2008, giving it a 20% diluted equity stake. MUFJ aims for a “global strategic alliance” with the investment bank. This year, Union Bank took over FDIC-seized Everett, WA-based Frontier Bank and San Rafael, CA-based Tamalpais Bank.

One of the reasons MUFJ shares have remained cheap, trading at roughly 80% of tangible book value, is the bank’s history of relatively low returns on equity—not dissimilar from other large Japanese companies. While it is impossible to predict when returns may start creeping toward their considerably higher potential, we note the appointment of Katsunori Nagayasu as CEO in April. While Nagayasu has been with MUFJ since 1970, he has communicated an intention to “shift focus from risk management to growth acceleration.” Now certainly seems to be a better time to do so than it was a few years ago.

In our valuation exercise, we arrive at an equity value range of \$6 to \$10 per ADS by examining fair value under the following three valuation assumptions: (1) value in line with tangible common equity; (2) value based on ten times net income, assuming an admittedly optimistic 15% return on tangible common equity; and (3) value based on six times pre-provision, pretax profit for the past twelve months.

Roma Financial (Nasdaq: ROMA; \$10 per share; MV \$310 million*)

* includes MHC-owned shares



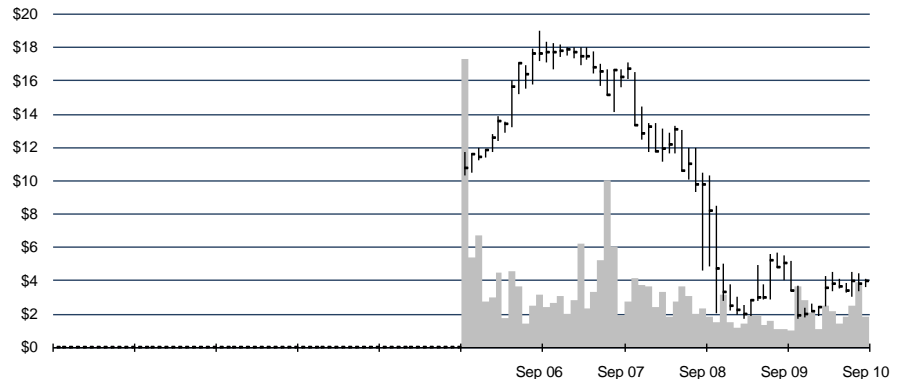
Robbinsville, New Jersey-based Roma Financial is the parent of Roma Bank, a federally-chartered stock savings bank with \$1.1 billion in deposits. The parent company is nearly three-fourths owned by an MHC, implying that the economics attributable to non-MHC shareholders are more attractive than they initially appear.

When adjusting for the MHC ownership and the post-Q2 acquisition of roughly \$370 million in assets from troubled Sterling Bank, Roma trades at a market value to total asset ratio of less than 5%. We find this valuation attractive for a well-capitalized, well-managed bank in New Jersey.

Roma has remained profitable throughout the crisis and is not subject to a regulatory order. The bank pays a dividend, and has been buying back stock at prices well below estimated fair value. We view the investment case as compelling.

Waterstone Financial (Nasdaq: WSBF; \$3.80 per share; MV \$117 million*)

* includes MHC-owned shares



Wauwatosa, Wisconsin-based Waterstone Financial is the parent of Waterstone Bank, a Wisconsin chartered savings bank with \$1.2 billion in deposits.

Waterstone is one of the most intriguing “thrift conversions” we have come across, as the related MHC holds nearly 74% of shares outstanding, implying large “leverage” for the true owners of the company.

When adjusted for the MHC ownership, Waterstone trades at a market value to tangible asset ratio of less than 2%. This implies large upside for equity holders in a more normalized earnings environment.

A second-step conversion in which shares held by the MHC would be sold in a public offering would strengthen Waterstone’s capital ratios, which remain above the regulatory “well capitalized” thresholds (notwithstanding a cease-and-desist order in 2009). While a second-step conversion would in all likelihood represent a positive catalyst, there is some residual risk that the Lamplighter shares could be offered at a “below-market” price, diluting the upside for current holders.

We view the risk-reward as compelling but acknowledge that this opportunity likely comes with more risk than any of the other four ideas featured this month.



The following two tables compare the large banks profiled and analyzed in this report. First, we present key statistics on asset size and balance sheet strength. We then compare the relative market valuations of the various banks.

It is interesting to note that the major banks as a group trade at less than 4x recent pre-provision pretax income and roughly 7x “normalized” net income. The median market value to tangible book value multiple is 1.0x, with Wells Fargo trading at 2.1x tangible book value on the high end and Barclays and Mitsubishi UFJ trading at 0.8x tangible book at the low end.

Capital Position, Asset Quality and Returns on Equity¹

	Local Ticker	Assets (billions)	TCE / Assets	(TCE + LLR) ³ / Assets	Tier 1 Capital Ratio ⁴	Recent ROTCE ⁵
Bank of America	BAC	\$2,328	4.9%	6.8%	11.2%	11%
Barclays	BARC	£1,587	2.6%	3.3%	13.2%	14%
BNP Paribas	BNP	€ 2,237	2.6%	3.9%	10.6%	14%
Citigroup	C US	\$1,983	6.3%	8.5%	12.5%	11%
Deutsche Bank	DBK	€ 1,043	3.7%	4.1%	11.3%	22%
HSBC	HSBA	\$2,419	4.5%	5.4%	9.9%	12%
ING	INGA	€ 1,273	1.8%	n/m	11.2%	23%
JPMorgan Chase	JPM	\$2,142	4.8%	6.4%	11.9%	15%
Mitsubishi UFJ	8306	¥200,084	3.5%	4.1%	10.6%	6%
Royal Bank Scotland	RBS	£1,581	3.6%	4.6%	10.5%	n/m
Wells Fargo	WFC	\$1,221	5.3%	7.3%	10.9%	10%
		<i>Average:</i>	4.0%	5.4%	11.3%	14%
		<i>Median:</i>	3.7%	5.0%	11.2%	13%

Trading Multiples and Dividend Yield

	Market Value (billions)	Market Value /				Dividend Yield ⁹
		TCE ²	Pre-prov. Profit ⁶	Norm. ⁷ Net Inc.	Recent ⁸ Net Inc.	
Bank of America	\$115	1.0x	2.8x	6.7x	10.4x	.3%
Barclays	£34	.8x	2.4x	5.6x	7.0x	1.4%
BNP Paribas	€63	1.1x	3.3x	7.2x	7.5x	2.8%
Citigroup	\$119	1.0x	3.2x	6.4x	13.8x	–
Deutsche Bank	€39	1.0x	5.5x	6.7x	8.4x	1.8%
HSBC	£183	1.7x	4.9x	11.3x	13.8x	.7%
ING	€31	1.3x	n/a	8.7x	7.0x	–
JPMorgan Chase	\$150	1.5x	3.8x	9.7x	9.3x	.5%
Mitsubishi UFJ	¥5400	.8x	2.8x	5.2x	13.5x	3.1%
Royal Bank Scotland	£50	.9x	3.7x	5.8x	n/m	–
Wells Fargo	\$137	2.1x	4.0x	14.1x	10.8x	.8%
	<i>Average:</i>	1.2x	3.7x	7.9x	10.2x	1.0%
	<i>Median:</i>	1.0x	3.5x	6.7x	9.9x	.7%

¹ Balance sheet figures as of September 30, 2010 or latest available date. Deutsche Bank data reflects October 2010 rights offering. Deutsche Bank assets stated on U.S. GAAP basis. Mitsubishi UFJ figures on U.S. GAAP basis, except for Tier 1 capital and net income-driven data, which is based on JGAAP.

² TCE: tangible common equity. ³ LLR: loan loss reserve.

⁴ Tier 1 capital divided by risk-weighted assets, as reported by each company for the latest respective balance sheet date. RBS based on "core" Tier 1. ING based on Basel II Tier 1 for banking segment.

⁵ ROTCE: return on tangible common equity. Based on annualizing returns from latest available interim period. Mitsubishi UFJ figure based on ROTCE using FYE 3/11 JGAAP net income guidance.

⁶ Based on annualizing pre-provision profit for a recent interim period. Pre-provision profit is stated before the provision for credit losses, income taxes, minority interests, and preferred dividends.

⁷ Based on the implied net income to common assuming a 15% return on tangible common equity.

⁸ Based on annualized net income to common for a recent interim period.


⁹ Based on annualized dividends for recent interim period, except Mitsubishi UFJ (FYE 3/11 guidance).

Sources: Company filings, Manual of Ideas analysis.



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Sincerely,



John Mihaljevic, CFA

and *The Manual of Ideas* research team

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