



**THE
MANUAL
OF
IDEAS**

TM

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

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

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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
 - ▶ Plus: Superinvestor holdings update
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 - ▶ 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 Capital Markets, BBVA Frances, BNP Paribas, Boston Private, Brookline Bank, Century Bancorp, CIT Group, Citigroup, Citizens & Northern Indiana City National, CNB Financial, Columbia Banking, Commerce Bancorp, Community Bank System, Community Trust, Credicorp, CVD Financial, Danvers Bancorp, Deutsche Bank, Dime Community, East West Bancorp, F.N.B., Fifth Third Bancorp, First Bancshares, First Busey, First Commonwealth, First Commercial Bank, First Interstate, First Merchants, Fulton Financial, German Banc, Huntington, Iberiabank, JPMorgan Chase, MB Financial, Meridian Bancorp, National Penn, NBT Bancorp, NY Community Bancorp, Gladstone, People's Choice Financial, Roma Financial, Santander Brasil, Southwest Bancorp, Susquehanna, TFS Bancorp, UMB Financial, Umpqua, Wainwright B & T, Wasieleski Financial, Wells Fargo,

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Favorite Bank Investments of Buffett Pick Todd Combs

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Exclusive Interview with Michael Godby, Principal, FIG Partners

With compliments of The Manual of Ideas

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Exclusive Interview with Michael Godby

We are pleased to present an exclusive interview with thrift conversion expert Michael Godby, principal at Atlanta, Georgia-based FIG Partners. Mike has close to fifteen years of extensive mutual-to-stock conversion experience. He served as a vice president in an eight-year career at Capital Resources, managing over two dozen mutual thrift conversions and participating in at least 25 more conversions. Mike served as a vice president of investments for Legg Mason for three years prior to joining ASG Securities. His background includes extensive experience serving high net-worth and institutional clients who primarily invest in banks and thrifts. He is a graduate of the University of Pittsburgh.

The Manual of Ideas: For those of us who may not be experienced with thrift conversions, could you give us a primer on the types of conversions and why you think they are generally fertile ground for finding value investment opportunities?

Michael Godby: First, let's just make sure that your reader understands what a thrift conversion is. It is when a mutual thrift sells some or all of their mutual interest to the public in a stock offering. These shares are offered first to the depositors of the thrift, and then to the community or through a syndicate offering. Subscription rights are given to the depositors of the thrift and those rights are governed by federal regulations that were written to protect those depositors. These priority rights are non-transferable, and violators of that have been prosecuted in the past.

Depositors who have carved a niche in investing in these conversions have been seeding accounts over the course of the last 25+ years. Their deposit balances influence the amount of stock they receive when a conversion oversubscribes. Professional depositors in the early days could simply mail a check to the thrift, and the thrift was happy to open an account for them. However, since the mid-1990s most thrifts have placed local restrictions to keep professional depositors out. As of this past quarter there were roughly 700 mutual thrifts in 45 states.

There are multiple types of conversions: the standard or full conversion where 100% of the thrift converts to a public company, a mutual holding company (MHC) conversion where a minority stake converts to a public company, a partial MHC where additional minority shares are sold in the public company, and a second-step MHC where the remaining majority of an MHC converts and is sold in the public company.

“Professional depositors in the early days could simply mail a check to the thrift, and the thrift was happy to open an account for them. However, since the mid-1990s most thrifts have placed local restrictions to keep professionals out.”

<u>Types of Conversion</u>	<u>Post Conversion Mutual Status</u>	<u>% Company Public</u>
Standard	No	100%
Mutual Holding Companies (MHC)	Yes	< 49.99%
Partial Second MHC	Yes	< 49.99%
Second Step MHC	No	100%

Number of Thrift Conversions

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total	As %
Total Conversions	16	13	13	15	24	24	15	27	8	7	19	181	100%
Type of Conversion													
Standard	9	8	7	6	4	2	2	7	3	3	11	62	34%
Mutual Holding Companies	5	3	3	3	17	15	9	12	4	2	0	73	40%
Second Step MHCs	2	2	3	5	3	7	4	7	1	2	8	44	24%
Partial Seconds	0	0	0	1	0	0	0	1	0	0	0	2	1%
Current Public Status													
Still Public	5	6	7	8	20	22	14	27	8	7	19	143	79%
Acquired	11	6	5	6	4	2	0	0	0	0	0	34	19%
FDIC Seized	0	1	1	1	0	0	1	0	0	0	0	4	2%

Source: Michael Godby, FIG Partners.

The statistics supporting this niche for the last twenty years make conversions reasonably predictable and attractive investments depending on the type of conversion, the pricing cycle and market conditions. Only during very bullish times do all types of conversions work from an IPO pop perspective.

The pricing cycle vacillates like any other depending on appraisals. If in a given quarter appraisals for conversions are too high, the appraisals are lowered the next quarter and so on until the conversions are priced accordingly with market conditions. Market forces win out as the buyers post-offering support only those offerings that are priced with reasonable value. Sometimes a conversion fails to raise the funds needs as stated in the prospectus and at that point management may choose to cancel the conversion, or reappraise and re-solicit those who previously subscribed for the offering, as is currently occurring for **Capital Federal (CFN)**.

The number of professional depositors that have meaningful deposit accounts has varied in the sector for years based on the success or failure of first-day pops over periods of quarters. Quite often, if a conversion is priced reasonably, the professional depositors will oversubscribe the offering. This is also magnified when the local depositors subscribe heavily due to market conditions and/or expectations that the bank is only converting to sell out sooner than later.

MOI: Is there a way to generalize which types of conversions are best to own, and whether it is better to invest in a conversion-related capital raise or to buy stock in the open market. Are there any studies that have looked at the historical data?

Godby: The best types of conversions to participate in are typically based on which part of the cycle we're in. The last time we had a major credit cycle similar to today was during the early 1990s. There were a limited amount of professional depositors at the time, and the values were lower than we have today. Currently, the pricing of offerings is at pre-1994/95 levels.

Standard conversions have typically offered the greatest value over the years. The statistics not only support that, but whether or not you're a subscriber, the greater returns occur for investors who hold them past the first-

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day pop, or purchase them in the market post-conversion. Also, standard conversions move the earliest in a recovery as they are offered at greater discounts to their peers. The MHCs will follow eventually, but naturally the time to own them is no different than any other stock — buy them when no one wants them. For the patient investor today, there are deeply discounted micro-cap MHCs that trade at implied low valuations. Although, I would suggest waiting until at least pricing has bottomed in second-step MHC conversions first, given that valuations for MHCs are driven by second-step valuations and their supply and demand. Because MHCs are leveraged plays on increasing valuations for their second-stage conversion price, the lower the public shares as a percentage of the total MHC shares, the greater the leverage on increasing valuations.

Thrift Conversion Investment Returns, 2000 – 2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
All Conversions												
Day 1 IPO Pop or Return	12%	21%	13%	27%	17%	7%	11%	6%	4%	12%	4%	12%
Return Since IPO Date	100%	28%	-4%	-33%	-40%	-25%	-33%	-11%	3%	26%	4%	1%
Standard Conversions												
Day 1 IPO Pop or Return	23%	11%	NA	NA	16%	27%	26%	13%	4%	17%	8%	16%
Return Since IPO Date	90%	42%	NA	NA	-31%	-35%	-3%	2%	41%	39%	6%	17%
MHC's												
Day 1 IPO Pop or Return	0%	37%	20%	35%	18%	5%	11%	3%	3%	1%	NA	13%
Return Since IPO Date	110%	7%	51%	-34%	-47%	-29%	-39%	-29%	-15%	-5%	NA	-3%
Second Steps MHC's												
Day 1 IPO Pop or Return	NA	NA	7%	27%	7%	3%	1%	2%	5%	11%	1%	7%
Return Since IPO Date	NA	NA	-28%	-26%	-21%	-17%	-44%	-2%	-8%	21%	0%	-14%
S&P 500 Annual Return	-9%	-12%	-22%	29%	11%	5%	16%	5%	-37%	26%	0%	1%

Source: Michael Godby, FIG Partners; SNL Securities.

MOI: Once a second-step conversion has occurred and an MHCs owns no more shares of a thrift, is there generally still a window of opportunity to invest because the market may not be fairly valuing the post-conversion thrift?

Godby: Yes, at times, but what has occurred for the last two years, is that there is a declining market for their pricing, led by excess supply and weaker demand in general by syndicate buyers for second-step MHCs. This has led to most professional depositors stepping away from investing in second-step MHCs.

Due to the fact that the OTS [Office of Thrift Supervision] is being absorbed by the OCC [Office of the Comptroller of the Currency], MHCs are running for the door to convert because of fears of dividend waivers going away, and grandfathering of plans and buybacks, to name a few. This has pressed management to convert now with the regulator you know, and not the latter.

Coincidentally, the quality of the second-step MHCs has declined in the last year as well, which has led to lower pricing, and naturally one begets the other. There will be a quarter when all second steps are priced accordingly and work, but for now, it's clearly deal dependent.

“...the quality of the second-step MHCs has declined in the last year, which has led to lower pricing...”

MOI: What are the main variables to analyze when deciding whether a pending conversion constitutes an attractive investment?

Godby: During the recent banking crisis, the safest financials to own were the over-capitalized thrifts. As far as I'm concerned, very little has changed to suggest otherwise. Like any value investor, I focus on price to tangible book, excess tangible capital, asset quality, deposits per share, earnings multiples, and terminal values for the thrift based on being acquired, and in roughly that order.

Of course, this is all relative to a peer group, and you can never rely on the peer group in the prospectus. In standard and MHC conversions, the appraisal typically reflects a low-valued peer group, because management wants to buy stock at a relatively cheap price. For partial and second-step MHC conversions, it is quite to the contrary. Management already owns stock and has an interest in pricing it as overvalued as possible, so the peer group reflects that.

One of the major reasons over-capitalized thrifts perform so well is because six to nine months after their conversion, the shareholders typically approve a management recognition plan for 4% of the company's stock. Then, at the one-year anniversary the board usually approves a repurchase. Depending on whether the thrift is a state-chartered or OTS-chartered institution there's the potential for repurchases of up to 20% of their stock in a given year. These are events that typically move stock prices higher in the worst of markets. Even if the thrift is not a meaningful earner, what better return on equity is there than repurchasing stock below 95% of book and quite often, well below that.

Quite often, investors have a misperception of what a bank is worth when it sells out. Most sell-side analysts tout price-to-tangible book as be the most important factor in calculating acquisition prices, which simply is not true. All too often investors are overly optimistic on what thrifts will do with excess capital, hence anticipating greater earnings growth, which often doesn't occur.

Deposit premiums or multiples on deposits, core or otherwise, is the basis by which acquirers justify the profitability of an acquisition. In bull markets for financials, deposit premiums naturally move up. What has remained true in the past twenty years is that core deposits are hard to grow, and thrift deposits are stickier post acquisition than are community bank deposits. I think your typical banker would have learned that through previous cycles, yet they haven't.

When it comes to MHCs, you have to pay close attention to pricing of the second-step conversions and the current implied fully converted values (price to tangible book, P/E, equity to assets, deposits per share and deposit premium deltas). The main mistake MHC investors have made in the past was not understanding the degree of leverage when markets shift valuations lower. The leverage works great going up, but awful going down!

MOI: It is generally understood that management incentives play a big role when it comes to how quickly and at what terms second-step conversions are consummated. Can you expand a bit on the impact of management and how investors can evaluate this variable?

Godby: First, let's talk about how the typical thrift converts. What was said to me two decades back is that in ten years all thrifts will have converted. Well, not so fast, there is a bastion of mutuality in the minds of many management teams that run the typical mutual thrift (socialism at its finest!). In their eyes, there

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aren't enough incentives to ever convert their thrift. Unfortunately for some of them, board members retire and members change, retirement closes in, and sometimes, just capitalism occurs.

Incentives? Eight percent ESOPs, four percent management recognition plans, ten percent option plans and, most importantly, cheap relative values to invest their own money in their company at the IPO price. By the way, like everything else that happens in the market, fear or greed kick in. The investment bankers and attorneys that specialize in the space work these well. "Convert now, before the regulator changes." "Happy birthday, Mr. CEO, isn't this your 60th, time to convert, you can't leave your mutual thrift to your grandchildren."

The real variables beyond the financial impact for an MHC converting through a second step are age of management, need for capital, and the grand scheme of empire building by management. All simple to get, but you need to understand the management of each institution. CEO hits age 65, can't be acquired because of OTS regulations for three years, so five years out he needs to sell—time to convert. A thrift levers up to 7% tangible equity to assets, management thinks it has to convert. The board knows of a local thrift or bank that wants to sell out, and it would fit their branch network perfectly, but they need more capital—nothing to do but convert. There may be other reasons but these are the most common.

MOI: Have you seen an increase in thrift conversions as a result of banks need for additional equity capital?

Godby: There have been a number of companies that have converted for this reason in the past two years, one even failed to raise capital and was seized. If a thrift does need capital and there are too many problems, such as rising non-performing assets, investors may back away. Also, size plays a role in pricing of the conversions, and the illiquidity is being discounted to 1992-1993 pricing. But this cycle will shift as well, as it did in the early nineties.

In 1991 and 1992, the thrifts that had problems got aggressive with their writedowns, converted, and most were extremely successful. During that period, I can recall only one thrift failing post-offering due to problems. This is the type of environment we're in today, but you have to be very selective!

MOI: Before the financial crisis, it seems like a second-step conversion was almost always a positive catalyst for a stock, so owning a thrift in anticipation of a second step seemed like a good strategy. However, post-crisis, we have observed some thrifts using a second-step conversion as a way to raise desperately needed capital. In some cases, the exchange ratio is set in a way that significantly dilutes the interests of existing shareholders, creating a negative catalyst. Is this assessment fair, and if so, how can investors guard against the destruction of value in a second-step capital raise?

Godby: Can you say tulip bulb? Then again, timing is everything! When **Peoples of Connecticut (PBCT)** converted at 142% of tangible book, at a 17% implied deposit premium, it just had to be over. I have not been an avid shorter of overpriced thrifts, but when I did short, I based my shorts on relative implied deposit premiums. When thrifts trade above takeout value, shouldn't you short them? I pay close attention to the deltas on implied deposit premiums from a fully converted perspective for these institutions. At the peak, it seemed easy to

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see that the relative upside to downside was clearly against investing in these companies.

As for MHCs that have a desperate need for capital, there haven't really been any, but there will eventually be one that does. Let's remember the term desperate is relative. Your assessment is fair, but when a thrift does need that capital, what to do? Raise capital, dilute investors, what else is there? Management rationalizes the dilution in ways stated above. I did make one mistake this past year in the MHC space, and that was staying in **TFS Financial (TFSL)** too long, but I was fortunate to get out of the rest of the MHCs close to the peak of the market with my clients. Even I was rationalizing the dividend, excess capital, leverage... I was fortunate to buy the MHCs when few wanted them, so I really can't complain. (I currently own TFSL.)

MOI: Could you talk about a recent thrift conversion you've found particularly interesting or surprising in terms of valuation or other features of the deals?

Godby: This past quarter there was a standard conversion, **Standard Financial (STND)**, Monroeville, Pennsylvania, with a market cap of \$35 million. It was issued at \$10 per share, 55% of tangible book, 11x earnings, 14.5% tangible equity/assets, with 0.62% non-performing assets at a 25% discount to its peers. It currently trades at \$12 per share and has performed better than other recent conversions. The most interesting thing about it is its terminal value upside. At the peak of the market for our thrifts a few years ago, the typical thrift converted at a level where terminal value upside offered 50-100% in three to five years. Today those percentages have doubled, and as is the case of STND there is still significant five-year upside. Also, a recent 13D was filed by a known activist investor [*ed. note:* Joseph Stilwell], which can't hurt.

MOI: Do you have a favorite investable situation at this time, and why?

Godby: Yes, most of the time there are investable ideas that are value-based. As with any of these ideas, though, it helps when there are catalysts that make [the thrifts] more attractive. A catalyst such as an activist investor pressing management to improve shareholder value through stock repurchases and selling out eventually. Other catalysts would be quarterly timing of stock repurchases and MRPs. Another would be discounted values of new conversions to peer pricing. From time to time I'm buying [a thrift] because of supply/demand reasons that cause stock prices to soften. We are now in a cycle where the performance of conversions from three quarters ago has underperformed the market, and the thrifts have to vote on their benefit packages. This should cause their stock supply to dry up and their stock prices to rise. An example would be **OBA Financial (OBAF)**, which converted on January 22nd. Also, a known activist investor has filed a 13D on it [*ed. note:* Lawrence Seidman].

MOI: Is there a book on this subject or another way for investors to learn more about thrift conversions?

Godby: Peter Lynch had mentioned conversions in his book *Beating The Street*. But since that time, MHCs and second-step MHCs have become a significant portion of the conversion market, and I don't know of any book that discusses them properly.

MOI: Thank you very much, Mike.

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