

HCP NOTES

Banking – United States

December 13, 2012

100 Bank Mergers

In the following pages, we explain why we believe M&A within the U.S. banking sector will be one of the most significant and compelling investing opportunities in the financial services sector over the next three years, and why we expect over 100 mergers among the publicly traded banks during this time.

HIGHLIGHTS:

- **Dominant 30 Year Secular Theme Resumes:** Bank consolidation, a 30 year secular trend, has restarted, and we believe it will accelerate. We predict that in the next 36 months, 100, or ~25%, of all U.S. publicly traded banks will be acquired. We believe the bulk of this merger activity will occur within the 400+ mid and small-cap banks. Our thesis is supported by five reasons:
 1. **“Deals Begets Deals” ... and Deals Have Already Started:** Merger activity tends to come in waves/cycles. With healthy banks beginning to sell, the universe of potential sellers has now expanded to encompass the entire sector, a crucial sign that the broader secular trend of bank M&A that began in the early 1980's is resuming.
 2. **U.S. Bank Profitability Has Completely Recovered:** Bank profitability has returned to pre-cycle levels. With visibility of credit and earnings restored, a key impediment to bank mergers has been removed.
 3. **Deeply Discounted FDIC Banks are Now Gone:** The inventory of banks available through the FDIC failure process has dried up, leaving healthy bank M&A as the only method of consolidation.
 4. **Overcapitalization of Sector is Hurting ROEs (of Buyers and Sellers):** With the sector now over-capitalized, generating satisfactory ROEs (before mitigation efforts) is very difficult. Removal of excess capacity via mergers will, in our opinion, be an important driver for ROE improvement.
 5. **Valuations Recovering, But Still a Lot of Room to Go:** As mid and small-cap bank stocks continue to recover, it becomes easier for boards and managements to sell their banks. Up to this point, banks have not wanted to sell at cyclically depressed prices.
- **Why is this a Powerful Theme? U.S. Still Has Far Too Many Banks:** The U.S. still has ~450 publicly traded banks. With a significant trend of re-regulation and higher capital levels emerging from the credit crisis, we see the resumption of M&A activity, particularly among mid and small-cap banks, as inevitable as banks look to boost returns.

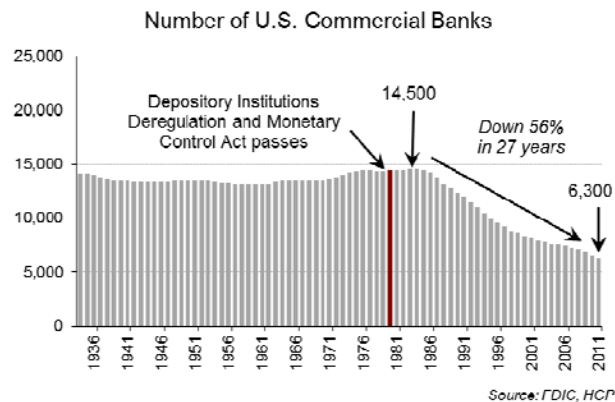
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Refer to important disclaimer on last page

Why We Expect 100+ Bank Mergers in the Next Three Years

Forecasting M&A activity in the U.S. banking sector is not a bold prediction. As shown in the chart, bank M&A has been a secular trend since the early 1980's, with the number of commercial banks having fallen by over half, from ~14,500 to ~6,300 today (or ~7,100 including thrifts with ~450 publicly traded).



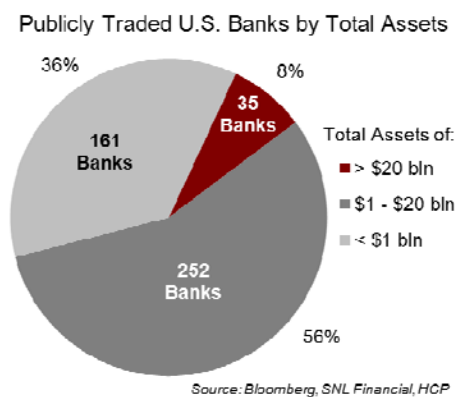
During the credit crisis, M&A did not stop; it merely took the form of bank failures. In fact, from 2007 to 2010, over 300 banks were seized by the FDIC. As a response to the credit crisis, and the damage it inflicted, a powerful trend toward re-regulation has emerged, significantly increasing compliance costs and intensifying oversight (primarily from Dodd-Frank).

This, combined with the massive sector recapitalization, has made generating satisfactory returns on capital significantly more difficult for the small and mid-cap banks (which lack the scale of their larger competitors to substantially mitigate these negative effects). As a consequence, we expect M&A activity to rise dramatically over the next 3 years, particularly among banks with total assets of less than \$20 bln – and there are *a lot* of banks in this category.

How many?

Over 400, or ~90%, of the publicly traded banks have total assets of less than \$20 bln (see chart). This includes ~250 mid-cap banks with total assets between \$1.0 bln and \$20 bln (average market cap of ~\$500 mln; median, ~\$280 mln), and ~160 smaller banks with assets of less than \$1.0 bln (both average and median market cap of ~\$50 mln)¹.

By contrast, the largest banks (i.e., with total assets of \$20+ bln) total just 35. These banks are much larger (in total assets and market cap) and are therefore better able to use their scale advantage to mitigate the negative impacts of regulations/higher capital. Moreover, with regulators focused on “too big to fail”, we **expect minimal merger activity among the 35 largest banks to be allowed** (with perhaps less than 6 selling).



So, why do we expect M&A activity in the U.S. banking sector to re-accelerate?

Five reasons.

¹ As of December 7, 2012.

Reason #1: “Deals Beget Deals” ... and Deals Have Started

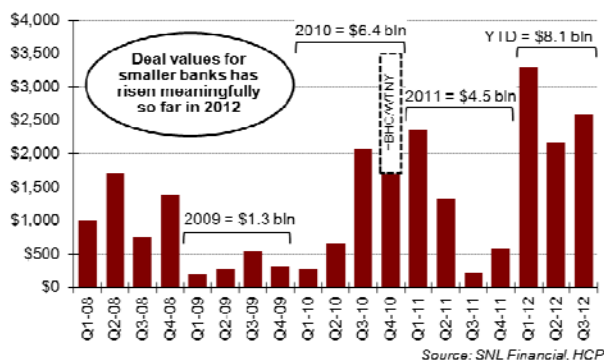
It is axiomatic in the banking sector that “deals beget deals”, and indeed, a review of historical trends suggest bank merger activity is cyclical. The growing consolidation of *healthy* banks is a crucial sign that the broader secular trend of bank M&A is resuming. It is significant because it implies the potential universe of sellers now encompasses the entire banking sector, not just damaged or failing banks (which dominated M&A activity over the past 5 years).

In fact, for banks with assets of less than \$20 bln, deal value is already double 2011 levels and significantly greater than 2010 (which was skewed higher by one transaction – Hancock/Whitney).

Notable transactions in 2012 within this group² include: First Merit acquiring **Citizens Republic** (deal value of \$1.3 bln), **Mitsubishi UFJ Financial** buying **Pacific Capital Bancorp** (\$1.5 bln), **Columbia**

Banking buying **West Coast Bancorp** (\$510 mln), and early in the fourth quarter, **Pacific Western Bank** buying **First California** (\$235 mln), to name just a few. Importantly, the sellers were all healthy when they sold.

Aggregate M&A Deal Value (\$Mln): Bank Assets < \$20 bln



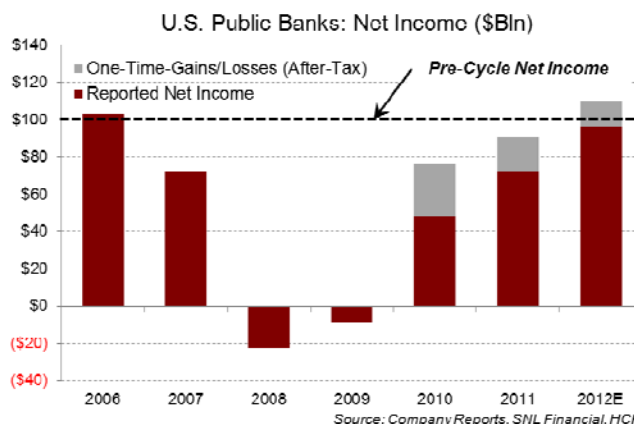
Reason #2: U.S. Bank Profitability Has Completely Recovered

One of the most important drivers of *healthy* bank M&A is the sector’s return to normalcy, as evidenced by the sector’s complete recovery in profitability (but not, we would add, in market cap). Given that annual earnings declined from \$100 bln in 2006 to a loss of \$20 bln in 2008 (i.e. in just two years), this recovery is a major milestone.

In 2012, we expect the banks will safely exceed the pre-crisis level. Quarterly profitability is now over \$25 bln, and we expect 2012 earnings will be in excess of \$100 bln, implying a full earnings recovery (see chart). We anticipate earnings for the public banks to normalize at ~\$120 bln.

So why is this important?

The restored health of the sector, visibility of earnings, and perhaps most importantly, the ability to reasonably estimate the cumulative losses of a target’s loan book provide clarity and confidence to acquirers that they know what they are buying.



² This does not include M&T Bank acquiring Hudson City, with a deal value of \$3.8 bln, since the seller had assets of over \$40 bln.

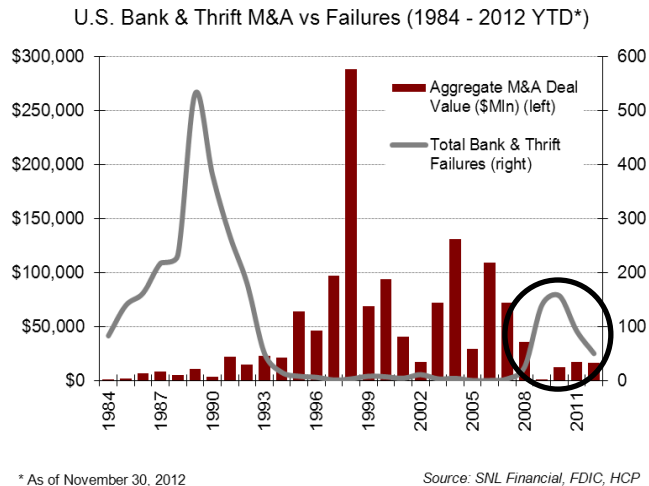


Reason #3: Deeply Discounted FDIC Banks are Gone

Up until now, one of the main impediments to a resumption of more traditional bank M&A was the abundance of failing banks available through the FDIC. These failed banks, which could essentially be acquired at deeply discounted prices, allowed the acquirer to mark the target's loan portfolio to market, with the FDIC capping losses above a certain level. This made for a highly attractive risk-reward.

However, as the chart of public and private banks highlights, the number of failures has declined dramatically. In our view, there are less than 10 *publicly* traded banks left to fail/be seized.

With the "free" banks gone, acquirers must now focus on healthy banks. As also shown in the chart, this sequence is consistent with the previous failure driven-cycle, the Savings and Loan (S&L) Crisis in the late 1980's/early 1990's. Bank merger activity literally exploded once the FDIC failures were exhausted, with deal activity eventually peaking at over \$250 bln in 1998.

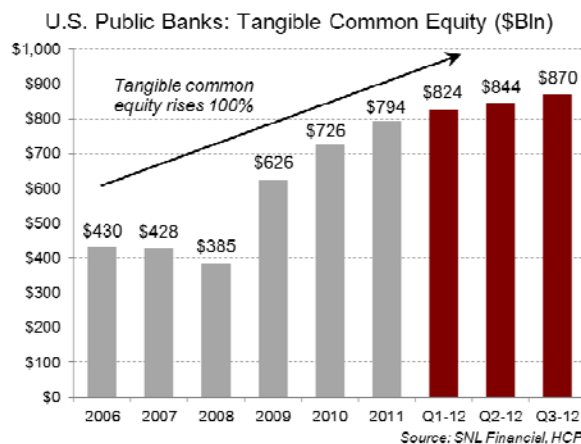


Reason #4: Overcapitalization is Hurting ROEs (of Sellers AND Buyers)

The virtual elimination of dividends and the massive equity raises during the credit crisis have fortified the U.S. banking system with an astonishingly large amount of capital. As highlighted in the chart, tangible common equity for the system is approaching \$900 bln, versus a cycle-low of \$385 bln in 2008, and about \$430 bln before the cycle began⁴.

The benefit of this increased capital is that the U.S. financial system is obviously meaningfully stronger, and the risk of financial contagion has been virtually eliminated.

The downside is that U.S. banks are now significantly over-capitalized, and their ability to generate a satisfactory return on capital has been greatly hindered. In 2006, the



⁴ We believe most Canadian investors would be surprised to learn that this capital build-up has resulted in the leverage of the U.S. banks now being significantly lower than that of the Canadian banks.

last pre-crisis year, the banks generated an ROE of ~16% (with the larger banks more profitable than the smaller banks). In the most recent quarter, Q3-12, it was ~9% (using core earnings). We believe sector ROE will normalize at ~10% before mitigation efforts. However, **this “average” conceals the greater negative ROE impact to the smaller banks that lack the scale to absorb a steep increase in regulatory expenses and compliance costs.** This is one of the main reasons we expect the 400+ banks with assets less than \$20 bln to drive consolidation.

In fact, the huge excess capital within the U.S. banking system presents a double motivation for mergers. The sellers cannot generate a satisfactory return. And buyers, with their substantial excess capital to invest, can partially alleviate their own ROE pressures through M&A expense synergies.

Reason #5: Valuations Recovering, But Still a Lot of Room to Go

When the sector traded at less than tangible book value (TBV), it should have surprised no one that traditional healthy bank M&A was at a standstill. Boards and management do not want to sell their banks at cyclically depressed levels. However, sector valuations have begun to rebound.

As the chart highlights, the largest banks and the regional/large mid-cap banks had a solid 2012. However, the small and mid-cap banks – i.e., outside the top 35 – where we believe virtually all of the likely sellers reside, have risen nearly 30% year-to-date.

While valuations have not completely recovered, and in some instances, have a very long way to go, we believe many bank's stock prices are reaching levels where management and boards can sell their banks. And selling becomes easier each quarter their valuations and financial conditions continue to improve.



The stock price performance stands in stark contrast to the Canadian banks, which have not only fully recovered all of their lost profitability, but seen their market capitalization rise even further. This is the primary reason we continue to believe U.S. banks will outperform Canadian banks for the foreseeable future.

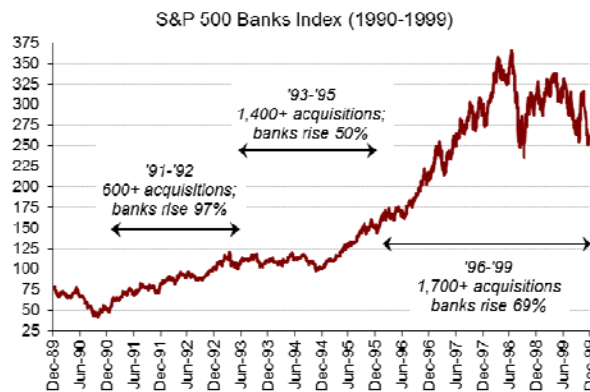
Why is this a Powerful Theme? U.S. Still Has Far Too Many Banks

There is no question that the U.S. still has far too many banks, and that ROEs suffer from over-capacity. The removal of this excess capacity, through bank mergers, has been a consistent theme since the early 1980's.

With declining ROEs from higher capital levels and a heightened regulatory environment resulting from the credit crisis, we see traditional M&A not only resuming, but accelerating. We believe the sector will lose ~25%, or ~100, of its publicly traded banks in the next three years, largely within the ~400+ mid and small-cap banks.

As shown in the chart, the last time the sector emerged from a failure driven cycle – i.e., the S&L Crisis – the ensuing consolidation resulted in a significant increase in stock prices.

As a result, we expect consolidation among the mid and small-cap U.S. banks to be one of the most significant and attractive investing opportunities in financial services over the next few years.



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