

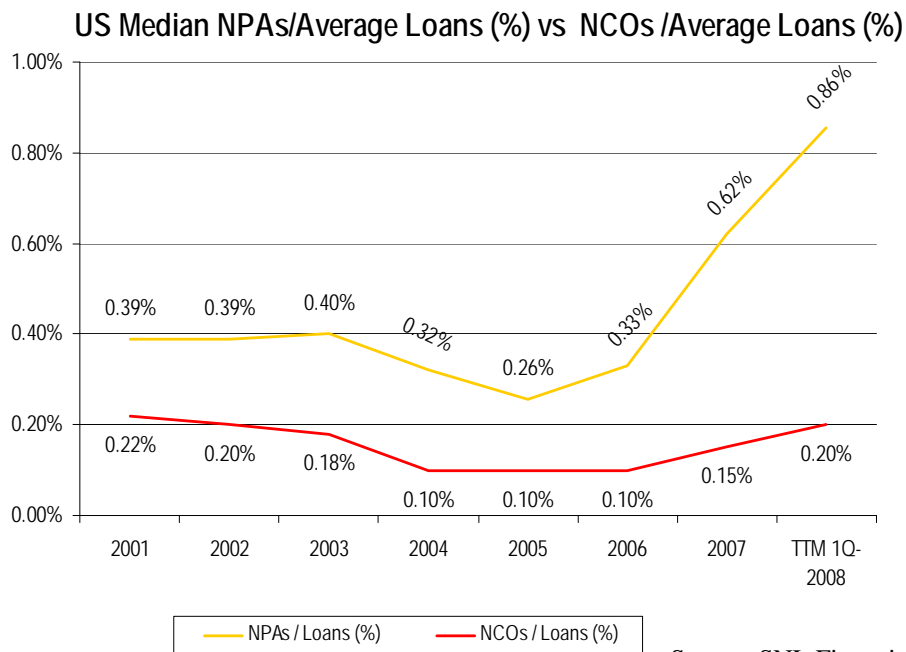
# Today's AFS Market Overview

July 2008

***“Well, everybody in Casablanca has problems. Yours may work out.”***  
*Humphrey Bogart*

The movie, *Casablanca*, tells a tale of our world during the most trying times where the characters face geopolitical upheaval and the absence of safe harbors. The characters in the movie embrace a fatalistic view that they will somehow survive whatever may come their way. While the story line differs, the current credit and liquidity crisis is just as dire for banks. Some in banking have the same fatalistic approach to their survival, but the growing list of failed banks hints that a disciplined, reliable approach to portfolio management may be the preferred path.

**Increase in NPAs & NCOs:** Fast forward to the present and banks facing potentially-grave circumstances may benefit from Bogart’s bearish outlook when he notes that, *“Things are never so bad they can't be made worse.”* Simply put, the following chart suggests that community banks facing tough times may see the credit environment deteriorate further before any marked improvement.



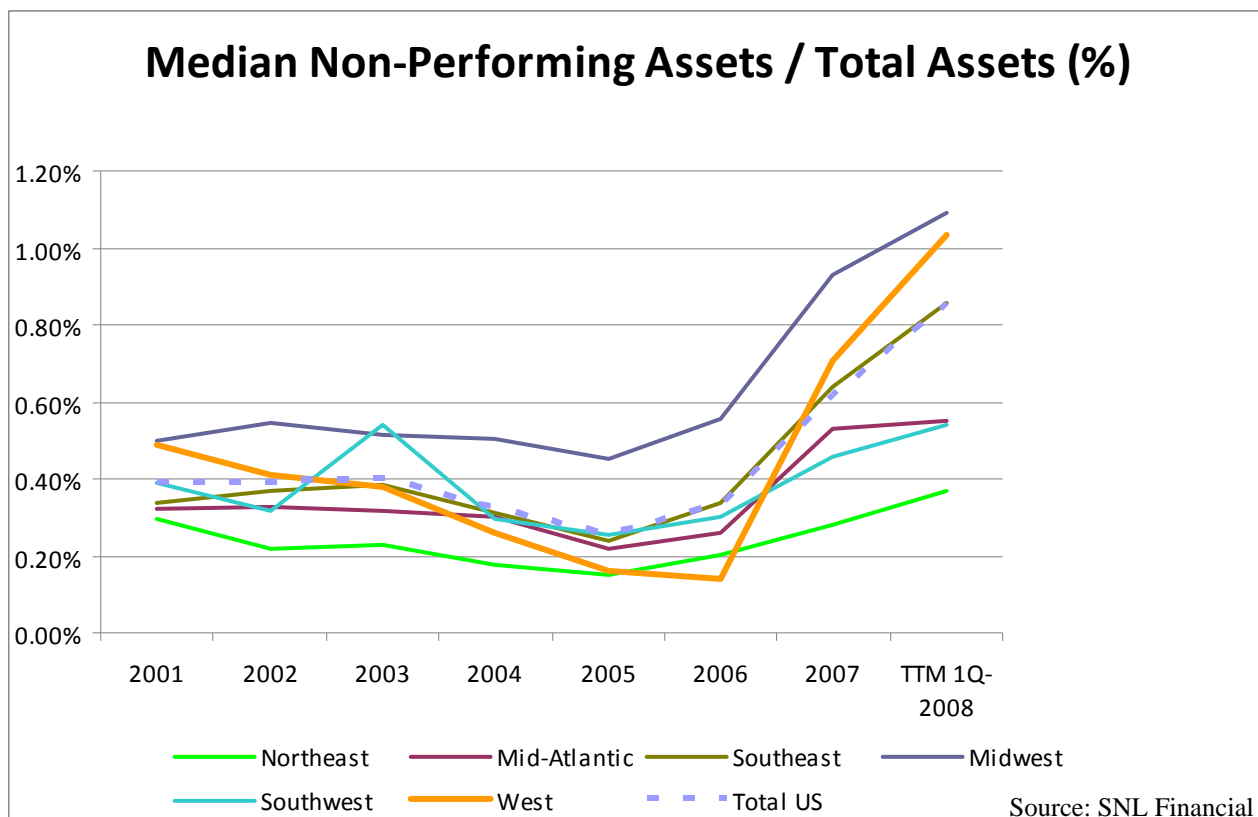
**The Asset Finance Service (AFS)** division of **Howe Barnes Hoefler & Arnett** continues to track relatively flat-to-rising net charge offs (“NCOs”) and spiking levels of nonperforming assets (“NPAs”). During the last two years, nonperforming assets (NPAs) rose at an alarming rate while relatively stable net charge offs (NCOs) have trended upwards during the same period. Rising NPAs must ultimately abate either through loan work-out, asset sales or be converted to NCOs before our peer group can be considered on the road to recovery. The above chart is derived from SNL-sourced data of publicly traded banks across the U.S. with assets ranging from \$250 million to \$10.25 billion.

AFS continues to address the issues that banks are facing every day. In the *AFS Market Overview (April 2008)*, we use both SNL data and the compilation of hundreds of calls with bankers, investors, and interested parties to sort through the current situation.

*“Tradition is the illusion of permanence.” Woody Allen*

**Regional Trends:** While more of a pessimist than the *Casablanca* crew, Mr. Allen teaches us that permanence is a relative term. Despite the best intentions, most banks have made lending decisions that have performed below expectations. The economic slowdown, rising fuel prices, and the ongoing housing slump have exacerbated and redefined worst-case scenarios. The Mortgage Bankers Association noted recently that foreclosures through the first quarter 2008 are at the highest levels since the association began tracking the statistic in 1979. More bank executives are both realizing and openly admitting that the worst is yet to come.

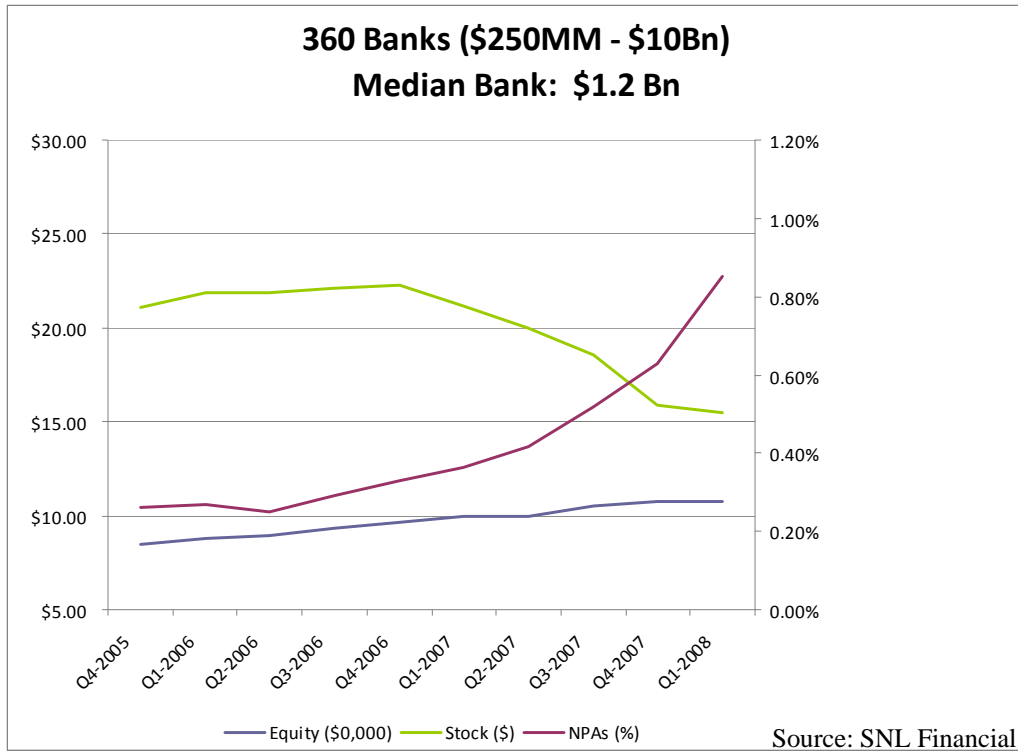
As the following SNL-sourced data suggests, the ongoing surge in NPAs is adversely affecting banks in virtually all regions. The Southeast and the Midwest have been dealing with the greatest brunt of the economic storm over the last several years as regional NPAs are above the U.S. median (the blue dashed line in the chart below). Of greatest concern is the continued trends in the West that have incurred a fivefold increase in NPAs since 2006 (thicker gold line in the chart below).



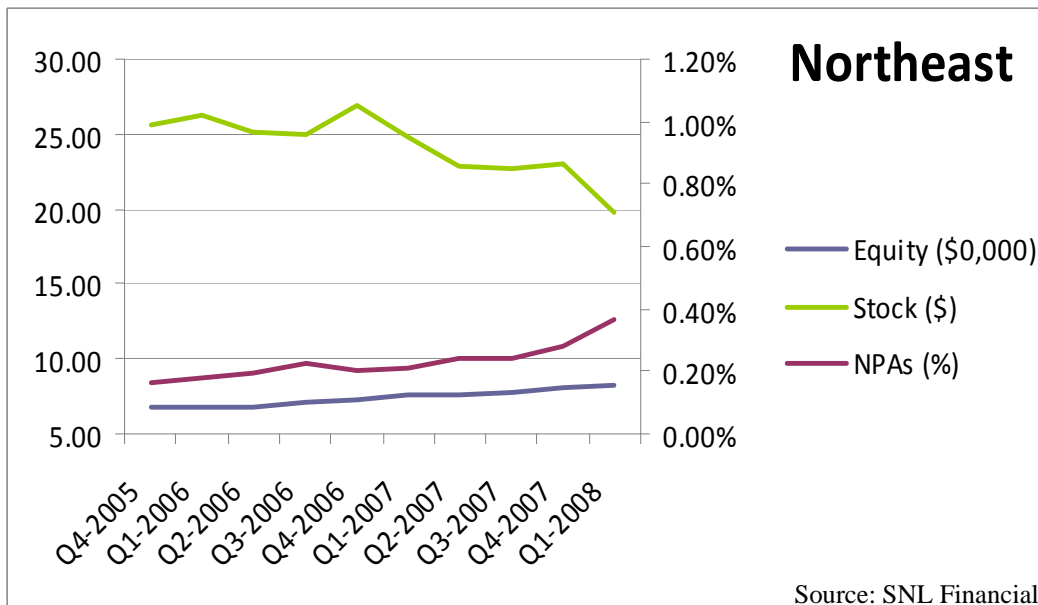
To survive, bank executives must recognize that they may endure tougher times for periods longer than originally anticipated. As a result, many must create a proactive game plan to reposition their bank as a survivor from the current downturn by shedding non-performing assets.

**How relevant is Book Equity?** Many bankers have been evaluating NPAs with a sole view of how these potential write-downs will ultimately impact their reported book value of equity. However, the following SNL-

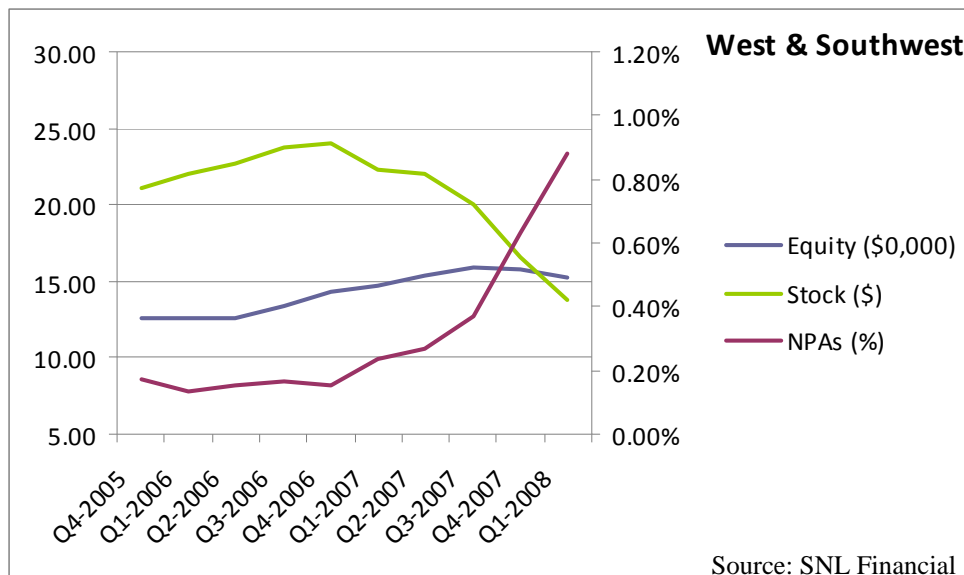
sourced data suggests that market value of equity may be a more relevant equity measure as the inversed correlation between NPAs and stock price is markedly apparent in the following charts.



On a national basis, the above chart confirms the hypothesis that equity values have been negatively affecting banks with rising problem assets. On a regional basis, however, the results are even more profound. In the Northeast, NPAs have been relatively modest and stock prices have decreased slightly.



In the West and Southwest, however, the significant spiking NPAs appear to have a more marked impact to the decline in stock prices.



Since 2005, the book value of peer equity has been gradually rising. This encouraging GAAP entry, however, is muted by the contemporaneous happenings in the equity markets. Despite reported book values of equity, market values of equity more accurately describe the purchase price to acquire a bank’s equity. As the above chart suggests, the market value of equity appears to be inversely correlated to credit quality. Consequently, bank executives may better serve their shareholders by proactively addressing NPAs with a greater focus on market than book values. Regardless of reported GAAP equity values, the equity markets appear to be already applying estimates to NPA values that are reflected in quoted share prices. So the data suggests that greater shareholder value can be created by managing NPAs with less focus on their impact to book equity and more on the arguably more efficient equity markets.

***“Success is usually the culmination of controlling failure.”*** Sylvester Stallone

With many banks struggling to remain solvent, liquid, and viable, conventional wisdom that portfolios should get better before they get worse does not appear likely in today’s market. Now is the time to proactively assess the current and anticipated health of your loan portfolio. The banks that can “return to being a bank” will be those that address their problems head on and aggressively focus on the true valuation and liquidity of their loan portfolios.

The good news is that banks are still selling loans to the secondary markets. Liquidity may be tight and sale economics are not as predictable as in the past but **AFS** remains successfully diligent in serving our clients in a host of asset classes. From selling portfolios for gains to advising on the best strategies for NPA divestitures, **AFS** remains committed to creating successful, market-driven solutions for our clients.

***The Asset Finance Services division of Howe Barnes Hoefler & Arnett provides loan portfolio assessment, advisory and brokerage services as well as expertise in valuing and trading an array of consumer and commercial loan assets for community banks.***

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