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10 banks to bet against -- and 10 to buy

Bulls say rising interest rates won't hurt regional banks, but that might be wishful thinking. Here are some bank stocks to avoid, and others that might still fly.

By Michael Brush

Will rising interest rates bring high-flying regional bank stocks back to earth where they belong? To listen to market pundits and money managers who should know better, you wouldn't think so.

For months, as regional bank shares have soared higher partly because of merger speculation, the bulls on banks have rejected the tried-and-true textbook analysis, which offers the following bearish scenario.

Regional banks earn a lot of their profits by borrowing money short term at lower interest rates and investing in long-term securities at higher rates. This means that as the Federal Reserve hikes short-term rates, banks' costs rise. But they still earn the same amount from investments they've locked in for the long term.

Bye-bye profits.

In classic "this time it's different" style, however, bank bulls insist the regional banks learned their lesson last time around, so they now do a better job protecting against this kind of trouble.

Maybe the 12% drop in the shares of **Fifth Third Bancorp** (FITB, news, msgs) earlier this month will wake up the banking-sector bulls. It trades at the high end of its historical valuation range even though rising rates and other risks loom. Fifth Third shares fell to $46 from $51.50 in a matter of days earlier this month when it announced it would have to take about $340 million in charges because -- you guessed it -- rising interest rates are driving up costs.

Developing a hit list

Which bank is next? For help with that question, I turned to Legg Mason analyst Adam Barkstrom, who has been warning clients for months that regional banks may be headed for trouble because of rising short-term interest rates.

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"I think earnings for the fourth quarter and 2005 are going to be challenging for the industry," says Barkstrom. "The Street is pricing in 13.5% earnings-per-share growth next year. I think that is a pipe dream."

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In a note published earlier this month, Barkstrom shared a list of 15 banks he says are most exposed to damage in a scenario where the Federal Reserve moves short-term interest rates up and long-term rates stay the same or decline, exactly what's playing out now.

Barkstrom looked for a host of risk factors, including:

- A high concentration of assets in long-term securities like bonds or mortgage-backed securities, as opposed to a diversified loan portfolio;
- A significant level of borrowing as percentage of investments;
- A high level of short-term borrowing.

I took Barkstrom's final 15 and pared it down to get 10 where the risks may be highest, using the following approach.

Risky regionals

Regional bank stocks exposed to rising interest rates

Name	Price-to-earnings ratio*	Debt-to-investment ratio	Insider buying or selling
Colonial BancGroup (CNB, news, msgs)	14.9	151%	big selling
Compass Bancshares (CBSS, news, msgs)	14.7	121%	big selling
Associated Banc-Corp (ASBC, news, msgs)	13.9	115%	very big selling
South Financial Group (TSFG, news, msgs)	14.6	95%	very big selling
Banknorth Group (BNK, news, msgs)	14.3	85%	very big selling
Citizens Banking (CBCF, news, msgs)	17.7	83%	some selling
Valley National Bancorp (VLY, news, msgs)	16.4	73%	mixed
First Midwest Bancorp (FMBI, news, msgs)	16.4	66%	big selling
FirstMerit (FMER, news, msgs)	16.9	58%	big selling
Commerce Bancshares (CBSH, news, msgs)	15.3	43%	big selling
Median, 45 regional banks	16	66%	sales rising

*Based on 12-month forward estimates
Source: Legg Mason, Thomson Financial

Narrowing it down

First, I looked for the banks on his list with the highest amount of debt compared to investments, perhaps the most telling risk factor. Next, I looked for the most expensive bank shares, since they have further to fall if problems arise. Finally, I cut out any banks where insiders are buying heavily and not selling.

For example, **Popular** (BPOP, news, msgs) nearly tops the list for debt to investments at a massive 148%. But insiders are snapping up shares, so I wouldn't be too worried that the bank is sitting on any sort of a time bomb. Since May, they've bought $4.3 million worth of Popular shares.

In contrast, **Colonial Bancgroup** (CNB, news, msgs) has an equally high debt-to-investments ratio of 151%. But insiders are selling big time. The stock also has a fairly high forward price-to-earnings ratio of 14.9. So it tops my short list of banks with the potential for trouble ahead.

To be sure, because merger fever may continue to grip the regional banking group, it could be risky to short the 10 stocks on our list. (Short selling involves borrowing stock and selling it in the hope that you can buy it back later at a lower price to return to the lender.) One way to handle this problem might be to build a long-short portfolio, going short the banks on my hit list and going long an equal amount of regional banks that seem better off.

On the other side

To come up with a list of regional banks that may continue to do well, I turned to Michael Painchaud, president and research director at Market Profile Theorems. He looked for 10 regional banks that have the strongest insider buying relative to the group. He also screened for strong buying compared to historical patterns. For cultural reasons, there tends to be a lot of insider buying at regional banks, so it pays to look for ones where insider buying rises above the normal background level.

Better buys

Regional bank stocks with exceptional insider buying

Name	Price earnings ratio*	Earnings estimate revision
Pennsylvania Commerce Bancorp (COBH, news, msgs)	18.3	
Flag Financial (FLAG, news, msgs)	18.2**	
Commonwealth Bankshares (CWBS, news, msgs)	17.8**	
Tompkins Trustco (TMP, news, msgs)	15.7	positive
Columbia Bancorp (CBBO, news, msgs)	14.3	positive
Pacific Capital Bancorp (PCBC, news, msgs)	15.2	positive
BOE Financial Services of Virginia (BSXT, news, msgs)	12.4**	
Republic Bancorp (RBCAA, news, msgs)	14	positive
Hancock Holding (HBHC, news, msgs)	16.7	positive
Greater Community Bancorp (GFLS, news, msgs)	16.8	

*Based on 12-month forward earnings estimates

**Based on trailing 12-month earnings
Source: Market Profile Theorems, Thomson Financial

Five banks on his list also have good upward earnings estimate revisions. When analysts move their estimates up, it's often a sign of more good news and higher stock prices to come.

It's worth noting, however, that Painchaud isn't very bullish on regional banks now, in part because overall insider activity looks bearish.

The ratio of insider selling to buying for the savings and loan group, for example, shot up in November and December, according to Thomson Financial. The ratio rose to 46 in November and 52 in December, after hovering between 18 and 26 for most of the year. Out of 78 sectors in the Thomson Financial database, banks get the fifth lowest score and savings and loans rank poorly, too, at 14.

Besides rising short-term interest rates, medium-size banks face several other potential problems, says Barkstrom.

Reasons to fret

- **Deposit mix is turning unfavorable.** As rates go up, more consumers will put money in interest-earning instruments like certificates of deposit, and take it out of savings or checking accounts where it earns little to no interest. This costs banks more.

- **Competition is getting intense.** Because of greater competition, banks are paying higher interest rates to win deposits. This was one of the factors cited by Fifth Third when it revealed its problems earlier this month. At the same time, banks have to cut rates to win lending business, which hurts income. "We are hearing in multiple markets that deposit pricing and loan pricing are becoming increasingly competitive," says Barkstrom.

- **Valuations are very high.** Regional banking shares typically trade for 12 to 16 times forward earnings, except when they hit 19 times during the merger boom of 1998. Currently, the group trades for 16.3 times forward earnings, says Barkstrom, the top of the trading range.

Mark Fitzgibbon, research director at Sandler O'Neill, has a more telling way to show how banking shares trade at risky valuations. He points out that financial stocks represent 21% of the **Standard & Poor's 500 index** ($INX), by far the highest weighting of any group. The last time that any industry hit that level was in 2000, when technology made up about 25% of the index.

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.

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