

5 January 2010

## Client Letter for Quarter Ending 31 December 2009

Our results are modest for the month, with the USA account suffering from the strength of the US dollar and the Australian dollar account benefiting commensurately. We again underperformed versus global indices.

Since we started in June we have had four sequential outperforming months and three months of slight underperformance. The good months however were very good and the bad months only slightly bad. The overall results are adequate – but we would prefer getting a few more things right.

It was however a month of two halves – with the first two weeks being down a few percent and with a recovery in the latter part of the month. The recovery started about the time that John departed for a couple of weeks summer holiday. [John would have more holidays if they were profitable!]

Seriously though, idea generation is tough. A month ago we reported some hope – however more detailed examination has quashed some of our expectations.

In particular, we spent a good proportion of the last two months looking at small American regional banks. Not the \$30-150 billion balance sheet variety (like BB&T) but the really beaten up small banks whose market caps have now fallen below \$100 million. Most of these companies are down over 90 percent since peak – and survival rather than profitability is the issue. However some do have franchises – and those franchises can be highly valuable under different economic circumstances.

For example several of these banks have maintained near a billion dollars in deposit accounts which have (almost regardless of the cycle) paid little or no interest. *What is the loan of \$1 billion worth – if you do not have to pay the depositor for it?* At the moment – we guess – very little – because interest rates are around zero so the cheap funds can't earn a spread without risk. But we think the deposits could increase in value dramatically. We are hopeful of finding multi-baggers amongst the rubble.

Unfortunately almost all the banks really are cactus (as reflected in their share price). The biggest culprit (by far) has been real estate construction loans. These usually contain an interest draw-down facility so they never show as delinquent. Interest payments are made by drawing down the loan. What tends to happen is that the finished buildings are handed back empty to the banks unless the bank negotiates out of the loan prior. However, until the loan actually fails it does not even show as suspect in the accounts – which means that the actual realised losses are explosive relative to prior reported delinquencies. These banks are collapsing with amazing rapidity.

The really distressed banks do not negotiate out of the loan prior because they can't afford to take the charge without attracting (warranted) attention from the FDIC. Willingness to negotiate out of loans prior to completion of the project is, in our view, a sign of a strong bank **and we would be very grateful if people will report to us banks that are doing such negotiation.**

Some of the banks we are looking at will “survive” but their survival is dependent on very substantial dilution. If we were billionaires we might be involved in the rescue of some of these banks (we can

identify sensible targets) but even then the rescue is probably best done by buying the bank from the FDIC after confiscation. Certainly, except in very rare cases, buying shares on market does not look sensible.

### A comment on banking

We know a few people who are customers for large construction loans. One of those identified the problem well:

Very small banks (up to say \$300 million in assets) work because the CEO/majority owner knows every local businessman from the local club. He knows who cheats on his golf score\* – and if he is savvy he will be able to successfully lend by backing the jockey rather than the individual project. Some of these banks have managed to avoid the vast bulk of the problems – and some very small regional banks will come out of the crisis in an extremely fine position.

However, if you wish to borrow \$100 million for a large shopping centre the best execution has always been the “Wells Fargo grind” or similar. The big banks are transaction driven – and they have a team of people who have lent on dozens of shopping centres. They know a good shopping centre from a bad one – and their books are *better than the average book of shopping centres*.

The midsized banks however are a mess. They have neither the personal skills of the better micro-banks or the management depth of the larger banks. Fundamentally they have no competitive advantage and hence have no long-term reason to exist. This does not mean that equity holders are doomed – but even if the banks survive, the best exit will be to sell to a large bank that will use the cheap deposits to make better-selected loans.

Our looking has been focused on these midsized banks, primarily because many of them have very old (and hence solid) deposit bases. But – for the reasons explained above – their loan books are unspeakably bad.

### **Cascade Bancorp – an example of the midsized bank problems**

One bank we were originally extremely interested in is Cascade Bancorp (Nasdaq:CACB) based in Oregon and Idaho. The bank has a very bad book – being laden with construction loans and the stock price has fallen from USD30 to under 70 cents. The market capitalisation is now about \$20 million.

The bank was a sterling performer for fourteen years before it blew up – which is simply a result of having the foot too close to the floorboards for fourteen go-go years. Bank management of course attributed their out-performance to genius and were doing so as recently as their last annual report. Indeed the last annual report indicated that cumulative shareholder return over 14 years was a respectable 18 percent compound.

In truth, the bank was taking (way) too much risk and continued doing so right until the music stopped. The Buffett maxim applies: any series of respectable numbers multiplied by a single zero is still zero. It is not just that past performance is not an indicator of future performance: past performance is completely irrelevant.

Anyway, Cascade swallowed a few decent banks over the past fifteen years and it has decent core deposits. Part of the business of Cascade is worth saving. Indeed this bank has over \$400 million of

non-interest bearing deposits – that is \$400 million in cash they simply do not need to pay for. \$20 million seems an (excessively) attractive market capitalisation.

Alas, Cascade is badly infected with the commercial construction loan bug. At year end it had 517 million in commercial construction loans. The provisions against these loans were only 18.7 million reflecting their (false) view that most of these loans were good. Moreover the low provisions reflected low delinquency on those loans.

Those provisions were of course woefully inadequate. About 70 million were charged off over the next nine months and 140 million remain delinquent. Moreover the current reserves also look understated.

The FDIC has given the company a cease-and-desist order insisting that they raise more capital. They looked to have a successful capital raise organised (with a billionaire playing the white-knight role). However that raise has now fallen over.

It is hard to see how the bank does not fail. Whilst the position might be survivable with unlimited FDIC forbearance, the bank has now agreed to raise more capital at pain of confiscation. Moreover they agreed to capital adequacy standards that are onerous – and they made that agreement probably to get an FDIC monkey off their back.

They failed to raise that capital. The bank's only hope is that someone comes to the party now or the FDIC chooses not to execute their threat.

Both don't look like good hopes.

That said, the bank has over 90 million in tangible common equity left. It has written off almost all goodwill and tax assets. It also has over 60 million of preferred stock which could be converted to common equity. If the preferred is compromised (as per the original recapitalisation plan) and a relatively small amount of capital is injected then it is hard to see how the bank would ever fail to have some common equity and it thus hard to see why the bank should fail.

It's just that that seems a weak basis for buying common stock to us. We are trying to find easier targets.

In all this looking we have purchased shares in only one bank – a very small regional bank in the Pacific Northwest. We are reluctant to name it because the stock is very illiquid. However the bank is small enough that the CEO can limit his lending only to people he knows don't cheat at golf. The bank has surprisingly few bad loans (they can be counted on two hands). More to the point – the bank has chosen to restructure construction loans in advance of property completion – one of our key tests as to whether the bank is in a position to be pro-active – or whether it is thumb-sucking and hoping. We think we will get a multi-bagger over the said small bank.

John  
Simon

PS. We are not joking about golf scores as a method of checking up on people. The single best example is Bernie Madoff. Here are his scores...

Florida State Golf Association **9.8**  
 Palm Beach Country Club Effective 12/01/2008  
 Name : **Bernie Madoff**

Score History				
Used	T	Mo./Yr.	Score	CR/Slope
*	H	05/00	87	72.8/135
*	H	05/99	86	72.8/135
	H	12/98	85	68.8/118
	H	11/98	83	68.8/118
*	H	08/98	85	72.8/135
*	H	08/98	83	72.8/135
*	H	08/98	85	72.8/135
*	H	08/98	84	72.8/135
	H	08/98	89	72.8/135
*	H	07/98	84	72.8/135
*	H	07/98	86	72.8/135
*	H	07/98	85	72.8/135
*	H	05/98	80	68.8/118
	H	03/98	82	68.8/118
	H	03/98	87	68.8/118
	H	03/98	84	68.8/118
	H	03/98	84	68.8/118
	H	03/98	84	68.8/118
	H	02/98	86	68.8/118
	H	01/98	84	68.8/118

Consistent returns rounds, low volatility, yada, yada yada (and thanks to the late Greg Newton for showing us these numbers)

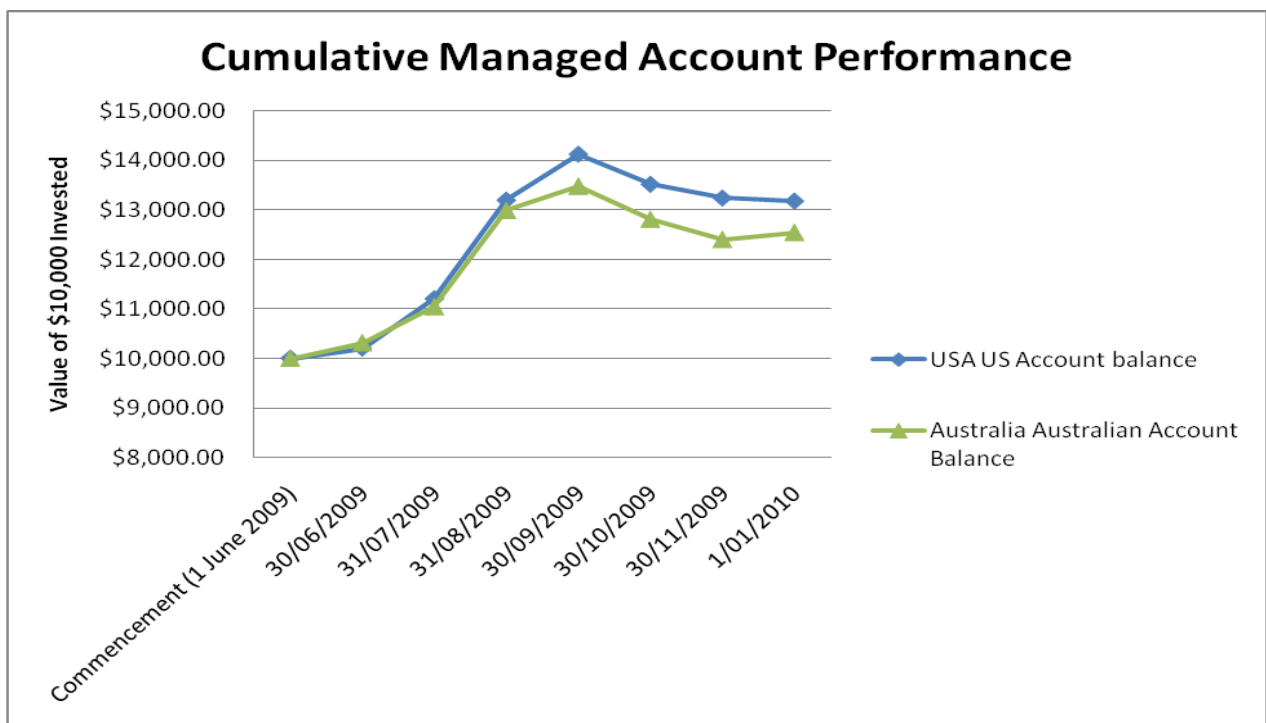
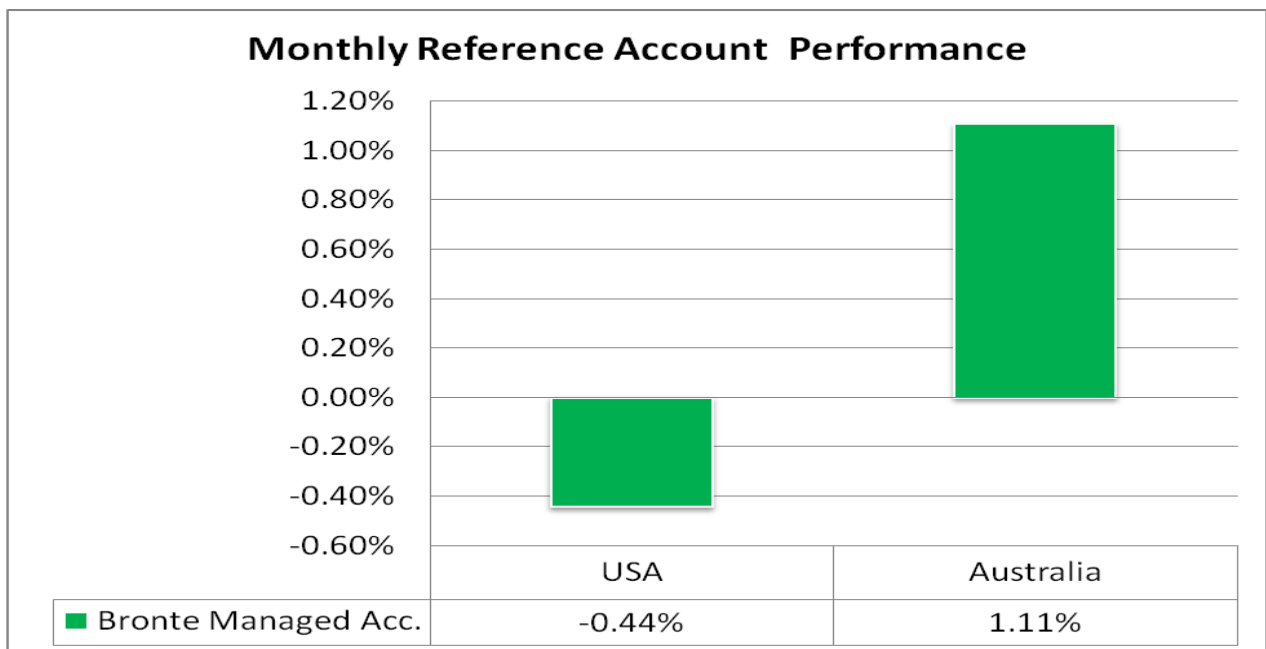
## Portfolio Management

	Long	Short	Net Long
USA Reference Account	107.7%	25.5%	82.2%
Australian Reference Account	107%	24.2%	82.8%

In addition to the small bank mentioned above we acquired long positions in a Canadian renewable energy technology firm and an Australian based global infrastructure business. This was partially offset by lessening our exposure to a small renewable energy company. We also reduced our short positions in cruise lines and USA retail.



## Performance data<sup>1</sup>



<sup>1</sup> All performance data is adjusted to allow for an accrual of the annual performance fee. The cumulative performance chart was modified this month to also detail accrual of this fee.