Comerica case study

[Business](#)

Simply putting, banks accept deposits from public; keep some of those deposits with hem and lend the rest to businesses and individuals. Businesses and individuals in turn pay interest on those loans and banks pay interest to depositors, making money from the spread.

Nowadays banks operations have become more and more complicated, and hence more important to capital markets. To get in to more detail, banks' profits come from the following several ways: Differences between Interest Rates on Loans and Deposits: As already explained Banks lend loans at the Interest rates that are higher than the ones they pay for deposits.

A large part of banks' profits come from the spread twine banks' depositing and lending rates. Service Fees: Banks provide financial services to their clients and charge certain amount of fees. By charging fees for managing customers' bank accounts and providing other financial services such as issuing letter of credits, banks create another source of income, known as interests income. Now banks' services have also expanded into investment consulting and information disseminating.

These services usually cost expensive fees.

Financial Products: Banks provide financial products to help clients manage their property and generate interests income. A good example can be that banks sell mutual funds to their clients and gain Income from both commissions and certain percentage of the funds' returns. In addition, banks sometimes also act as brokers and generate revenues from bid-ask spread. Investment: Some banks play an active role in venture capital industry.

By making investments in promising small companies, banks earn the benefits like capital investors or buy-out funds do. In addition, banks can also explore profit opportunities within currency exchange market.

Circulation Intermediary for Cash: Bank can boost the economy by reallocating idle money to investors who need money. Banks can gather the discrete money by absorbing deposit and then lend out loans, thereby increasing the liquidity of cash and thriving investment activities. Create Derivative Value: Because of banks, several times the value of original deposit is created. People save their money In banks, and banks lend the money out.

New loans throughout the banking system generate new deposits elsewhere In the system. Thus new deposits are derived by the loan and create more sources of cash for banks to lend out.

Payment Chains: Banks encourage ten Dustless Detente companies Dye managing ten s I n Toot Tunas through corporate accounts. Banks can also represent their clients to make payments and help their clients to honor cash. Commerce Incorporated (CAM), one of the 20- largest banks operating in America, has major operations in Midwest, California, Texas and Florida. Commerce operated under three business segments: the business bank, the retail bank and the wealth and institutional management.

Due to the financial crisis of 2008, banks, especially ones with high exposure in mortgage related moans, were under a lot of stress.

Commerce, being one of them, is being evaluated by the jack, as a potential investment. CHARACTERISTICS OF SCAM'S FINANCIAL HEALTH: Based on the financial statements provided and the Exhibit 5, we have outlined the main characteristics which define Scam's financial health. Increase in Credit Loss Reserves: Credit loss provisions are the estimated loan losses from the current operating period, which means that company is not expecting to receive these loans back and hence expensing them out, by increasing the allowance for credit losses on balance sheet.

There is a substantial increase in the company's credit loss provisions for Commerce. The percentage of credit loss provisions to PET plus credit losses skyrocketed, from 3.

6 percent in 2006 to 66 percent in June 2008, indicating the Corporation's tough situation in collecting the outstanding loans. Increase in Non-performing Assets: Reserve coverage ratio, despite the increase in loss reserves, is decreasing dramatically, from 213% in 2006 to 87% in June 2008, indicating an enormous increase in non-performing assets (NAP). The main reason on increase in Naps the fact that high percentage (32.) of company's total loans is Real Estate loans. This is the reason that company's interest income has decreased despite the increase in loans made in 2008. Efficiency ratio is basically an operating expense margin measure, the lower the better.

The above 60 percent efficiency ratio, 50 percent generally regarded as optimal, is an indicator of company's deteriorating performance. Use of Long Term and Short Term Debt to Finance Loans: Balance sheet show that

Commerce’s total deposits are maintaining a level since 2005, however company’s net loans have increased by almost $10 Billion.

Balance sheet Leary shows that these loans are finance from the increase in short-term and long term debt, which cast doubts on the profitability of company going forward. Unsuitability of the Dividend Pay-out Ratio: Exhibit 5 shows an increasing trend in the dividends, which Commerce has tried to maintain despite the low earnings. In the June 2008 quarter, company paid $99 Million as dividends against the net income of $56 Million during the same quarter.

These levels of dividends are not sustainable in the current recessionary environment, and when the company does cut dividends, it will send a bad signal to the market.

Downward Revision in the Federal Funds Rate: We noticed that spread, which equals to net interest expense as a % of earning assets minus net interest expense as a percentage of interest bearing liabilities, is decreasing. One of the reason of this phenomenon is that interest bearing deposits are increasing – which is bad for the company. Moreover, there has been a onwards revision AT 3 percent In ten Ethereal Tunas’ rate Trot Its Orlando level AT 5. 25% in July 2007, to 2.

0% in 2008 – limiting the banks’ ability to charge higher spreads.

Moreover, commercial loans are predominantly floating rate, so decrease in he Federal Funds rate will affect company’s interest income. We do think that decrease in the Feeds rate will increase the demand for loans but given

the credit crunch, it seems unreasonable in the short run. Decrease in Interest Income Percentage Measures: The shrinkage of interest income can be obviously seen from the Corporation's net interest income as a percentage of earning assets, from 6. 82% in 2007 to 4. 86% by the end June 2008.

This decrease is due to both factors of the ratio, one interest income is decreasing, secondly earning assets for Commerce Inc. , which is loans, investment securities available-for-sale and short-term investments are increasing. Moreover, net interest margin, which is calculated as a difference between net interest income and net interest expenses divided by earning assets, show a downward trend. VALUATION: To value Commerce, we have used both methods Jack is planning to use. We will first do the sensitivity analysis (Exhibit 7 in the case) to find the range of tangible book value, earnings and dividends.

Using that sensitivity analysis table, we will find the range of firm's value employing comparable and dividend discount models. Sensitivity Analysis: In the Exhibit 7 at the end of the case, we have already been given the existing quarterly earnings estimates and tangible book value at the end of 2009. Those estimates are based on charge-off ratio of 0. 85%. We have completed the sensitivity analysis based on the following assumptions: Percentage of charge off is annual, and dollar value of the charge off will be distributed over each quarter equally. Company's charge-off ratio taken in 2008 will continue to be the same in 2009.

We think this is a reasonable assumption because of current low reserves for credit shoes to NAP ratio of Commerce, as compared to its peers. Company will maintain a certain level of allowance of loan losses. Therefore any increase in percentage of charge off will translate to decrease in tangible book value of the company through the income statement. Dividends are taken to be 48% of earnings in case of positive net income and zero in case of negative net income.

Company is trying hard to keep the level of dividends constants, to avoid sending bad signals.

But company will not be able to sustain this level of dividends, so it will revert to the historical average of 48% dividend payout ratio (Exhibit – 1). Using these assumptions, we get the range of tangible book value, at the end of 2009, of $5, 247 Million in case of 0. 85% charge off to $4, 647 Million in case of 2% charge-off. Detailed calculations are provided in the Exhibit – 2. Comparable Method: We have chosen two multiples to value Commerce I.

Price to tangible book value and price to earnings ratio. Since, due to the current financial crisis, earnings of the companies are very volatile, we think price to tangible book value is a better multiple. Therefore, we will use price to earnings ratio Just as a check multiple. Now that we have decided which multiples to use, we need to assign weights to the comparable companies to find out the weighted average multiples. To assign weights, we considered the following factors in terms of similarity between Commerce and comparable companies.

Geological location AT ten operations Percentage of loans from different business segments Financial – Including total revenue break up, return on equity and assets, reserves for loan losses to total loan and total Naps etc. Based on these weights signed we calculated the comparable weighted average of the price to tangible book value ratio and price to earnings ratio. Following table summarizes values calculated by both the methods and their sensitivity to the charge-off percentage. Detailed calculations are given in Exhibit – 2 and 3.

As we mentioned before, earnings are very volatile right now and are suppressed because of the financial crisis.

So we think price to tangible book value is a better measure of company's intrinsic value. Therefore we think, company is undervalued right now and hence Jack should propose to long its stock. Dividend Discount Model (EDM): We have also used EDM to find the intrinsic value of the company. We think that company will not be able to sustain its dividends of $0. 66 per share per quarter in the short run.

However, by year 2010 company will have enough earnings to come back to its previous level.

Keeping in mind the fact that company has been growing its dividend payout ratio, and earning are also expected to increase in the long run; we have assumed that company's dividends will grow at the rate of 2% in perpetuity. Using these assumption, and cost of equity 8. %, dividend discount model gives us the share price of $40. 39 per share, which also indicates that

company is undervalued right now. Detailed calculations are provided in Exhibit – 4.

The collapse of mortgage market has taught financial industry an expensive lesson, making a lot of financial institutions unable to fully recover even till now.

One of the major factors that cause a lot of banks' failure and bankruptcy during financial crisis is the banks' overconfidence in real estate market and issuing huge amount of new debt without the checking credit quality of borrowers. After the financial crisis, banks have become very cautious when dealing with mortgage related loans.

Requirements regarding borrowers' personal incomes and documentation have been considered necessary and valuation process about mortgages has gone very conservative. Facing the liquidity during the financial crisis, banks are required to improve their capital bases to improve their insolvency. One regulation from Base Ill incorporates a significant expansion in risk coverage and introduces modified ways to calculate risk- based capital.

Moreover, complex hybrid capital instruments, which used to be insider as a part of banks' equity, has been exclude from banks' equity calculation.

Base Ill also puts increasing focus and emphasis on banks to acquire common equity that can be quickly cashed out when facing unexpected situation. The enactment of Base Ill and the self-improvement happening in the banking industry or, even broader, financial industry have made bank valuation focus more on bank's traditional originate-to-hold business, and

associated bank’s serialization activities with higher risk. Increasing focus has also been put on a bank’s capital ease, which has everything to do with a bank’s solvency and liquidity.

Banks, whose equities have complex hybrid equity capital instruments, tend to be less liquid and have higher business risk. Funding source is another factor considered.

Banks with less rate II Tuning on tenet Dalliance sneers are more vulnerable when unexpected situations happen. Loan quality, which had been largely neglected when everyone had big overconfidence to housing market before the burst of the financial crisis, has been brought back to the ‘ valuation table’ and greatly reemphasized.