

Commerce Bank NYSE: CBH
Analysis by Sheryl Sostarich
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Eye on Operations

Commerce Bank has earned its way to Wal-Mart fame. The bank has been able to generate the highest deposit growth rates in America with one of the lowest cost of funds. Its empire has grown from one small branch in southern New Jersey to more than 290 branches in four states. One of the few ways a bank has of distinguishing itself from its competitors is by offering superior customer service. Commerce was one of the first banks in New England to stay open 7 days a week. Deposit growth has come both from growth in the existing base and from new stores.

In 2003, Commerce opened 46 new stores including 34 in metropolitan New York and 12 in metropolitan Philadelphia. Two years ago, Commerce had no stores in New York State. Today there are 27 stores in New York City and 15 stores in Long Island. New York has been a lucrative market for Commerce Bank where metropolitan New York deposits now exceed metropolitan Philadelphia deposits. The next East Coast target market for Commerce is Washington-Baltimore where the plans are to build 200 stores. Deposit growth in 2003 averaged \$30 million per store. Comparable store deposit growth in 2003 for stores open two years or more was 27.4%.

The risk model is simple. The bank seeks to attract long-lived deposits, make quality loans, and reinvest in triple A-rated or U.S. Government bonds. Commerce rarely goes to the wholesale market to borrow funds. The bank does not make sub-prime, indirect, or third party consumer loans. Nor does it buy nationally shared credits for companies outside its local market. Commerce has had no trouble raising capital in the public markets. Its sale of common stock raised an aggregate of \$209 million in 2003.

Past Performance

The financial results for the latest fiscal year ending December 31, 2003 are the envy of most competitor banks:

1. Total stores increased from 224 to 270 including the first stores in Westchester County, New York.
2. Total assets increased 38% to a record \$22.7 billion.
3. Total deposits increased 42% to \$20.7 billion, which translates to a five year compounded growth rate of 39%.
4. Total revenues increased 31% to \$1.088 billion.
5. Net income increased 34% to a record \$194 million.

The Commerce online site gives customers the convenience of the following services:

1. Online bill pay without transaction fees
2. The opportunity to apply for a loan
3. The opportunity to buy and sell stocks
4. The opportunity to get free insurance quotes
5. Access to account information

It would not be typical for credit quality not to suffer as the number of loans processed increases. Yet, Commerce Bank's loan portfolio suffered very little as the bank has grown its portfolio. The latest fiscal year wrought significant gains. The number of loans processed increased by 25%. Commerce originated \$6.6 million in new loans in fiscal 2003. There were relatively few defaults – non-performing loans were a mere one-tenth of one percent of total assets.

Commerce Bank is a major player in the Small Business Administration loan program. Again the statistics bear this out:

1. First in dollar volume for SBA loans made in the Mid-Atlantic States
2. First in dollar volume and the number of SBA loans made in New Jersey
3. First in New Jersey in loans to businesses owned by women, veterans, African Americans, Asians and Hispanics
4. Seventh nationwide in dollar volume for SBA loans provided by all banks involved with the SBA program

A Tarnished Image

Although the banking industry has always been scrutinized, the degree of scrutiny going on now is unprecedented. And, the regulators aren't just looking at loan portfolios and asset classification. They're looking at compliance, operating losses and frauds. Commerce Bancorp isn't in the same class as the money center banks with exposures to corporations that are on the verge of collapse. Commerce Bank has always had strict policies of corporate governance. In fact, there hasn't been much of anything to criticize until June of 2004.

The major concern is a lawsuit that was filed against the corporation. Two of the bank's branch officers have been accused of a payoff scheme. All of the negative publicity has hurt the image of Commerce's municipal finance operations, which represent 18% of total deposits and a big part of the growth story. Commerce is trying to downplay the incident, which has been traced to a Philadelphia branch bank only. None of the Company's chief executives have been accused of any wrongdoing. A second cause for concern is Commerce's \$15 billion mortgage-backed securities portfolio. In a period of rising interest rates, these assets will have to be marked down. A third cause for concern is the rumor circulating on Wall Street. Commerce is said to be artificially inflating its reported earnings by classifying some of its operating expenses as capital expenses.

In an industry where growth is downplayed, that all changed with the birth of Commerce Bank. No one has ever tried to grow a bank at the torrid pace that Commerce Bank is growing its empire. In the next five years, the goal is to more than double the number of branches to 700 and grow deposits fourfold to \$100 billion. Rising interest rates are bad news for mortgage-backed securities. Commerce is especially vulnerable because 60% of the bank's assets are mortgage-backed securities. The hit these instruments took in the second quarter of 2004 reduced shareholders' equity by \$200 million or 14%. We know that investors can be very unforgiving as a corporation comes under increasing regulatory and law-enforcement scrutiny. It would be wise to wait and see how the recent events play out before taking a position in Commerce Bank.

Key Statistics

The average rating of the seventeen analysts who follow the Company is a hold. Six analysts rate the company a buy, five analysts rate the company a hold, and six analysts rate the company a sell. Earnings growth for the next five years is projected at 19%. The PEG ratio is 1.02. The lower the PEG ratio, the more reasonably priced a stock is relative to its future growth prospects. The number used for the annual growth rate can vary. It can be a forward indicator, predicting growth or a trailing indicator, covering a one to five year time span. A price/earnings ratio only looks at the past. Commerce is currently trading at a price/earnings ratio of 20. Pretax profit and return on equity have been steady at 38% and 15% respectively. An investment in Commerce Bank has rewarded shareholders with a 20% average annual return.

Judgments On the SSG

Commerce Bancorp has been a favored stock in its industry group for many years. Of lately, the sentiment has turned negative. The consensus believes that the company will grow its earnings at a 19% rate over the next five years. I've chosen judgments that are more conservative than analysts' consensus.

In valuing a bank stock it is important to plot the trends in book value and dividend payouts. Clearly, Commerce Bank shows an upward trend in both metrics. On December 21, 2004 Commerce Bank declared that it was raising its annual dividend by 16 percent. This is the thirteenth consecutive year that Commerce has increased its dividend.

The five-year average high and low P/Es are 24.4 and 15.6. I've chosen to use the ten-year median high and low P/Es of 22.8 and 13.1. The relative value is 102%.

The Bottom Line

At 25/50/25 zoning and a current price of \$63, CBH has an upside potential of 2 to 1 with a buy below price of \$57.70. That puts the stock outside of our buy range. The projected return (PAR) is 8.2% and the total return is 13%.

I believe it's prudent to be cautious while the legal issues are being resolved. I recommend that we pass for now and review this stock again in six months.