| This 3DAdvisors Report Covers: |
|---|
| ✓ **Insider Trading**: Insider Trading Behavior |
| ✓ **Accounting**: Quality of Earnings Issues |
| **Governance:** Corporate Governance Issues |
| ✓ **Fundamentals:** Analysis of fundamentals |
| **Deception:** Deception detection analysis |

# Asset Quality Falls Further, Charge-Offs Don't Budge
# People's United Financial Inc. (NASDAQ:PBCT) Update

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

## Business Description

People's United Financial Inc. (PBCT) operates as the savings and loan holding company of People's United Bank that provides various financial services to individual, corporate, and municipal customers principally in Connecticut, Massachusetts, Vermont, New Hampshire, Maine, and New York. On January 1, 2008, People's United Financial completed its acquisition of Chittenden Corporation, a multi-bank holding company headquartered in Burlington, Vermont. As of 09/30/08, PBCT had total deposits of $14.2 billion. Its services include extending secured and unsecured commercial and consumer loans, and originating mortgage loans secured by residential and commercial properties, as well as accepting consumer, commercial, and municipal deposits. The Company was founded in 1842 and is headquartered in Bridgeport, Connecticut.

## Summary of 3DAdvisors Findings for PBCT

- **Fundamentals:** Asset quality continued to deteriorate in 2Q09
- **Accounting:** Non-performing assets double in 1H09, charge-offs barely budge
- **Insider Trading:** CEO: "we believe PBCT remains a very attractive investment"

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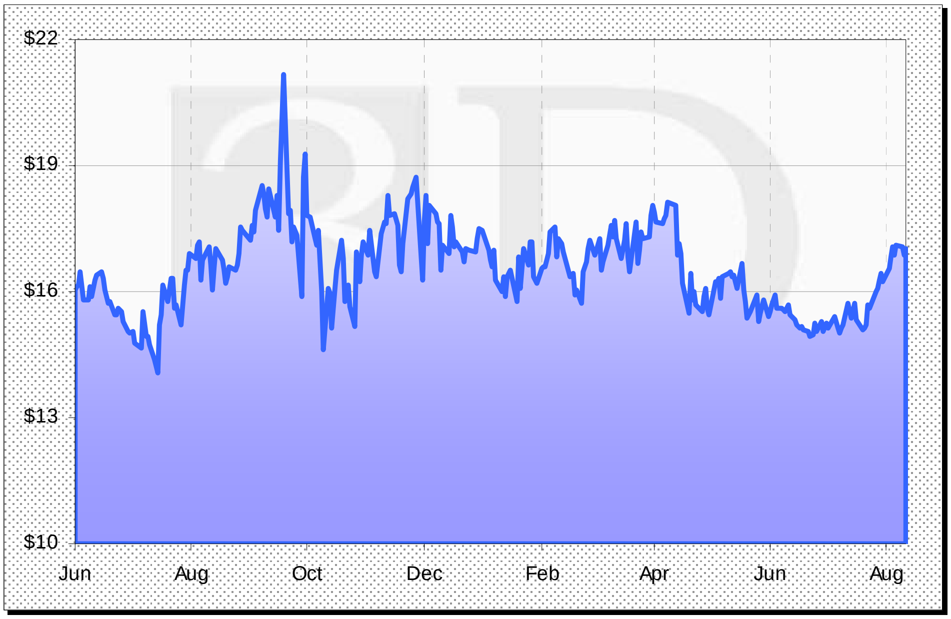
## Discussion of 3DAdvisors Findings for PBCT

In our most recent report on People's United Financial Inc. (PBCT) on 06/19/09, we readily acknowledged that the regional bank was indeed in very good shape relative to its peers. It had over $2.5 billion in excess capital, virtually no exposure to sub-prime or Alt-A residential mortgages and extraordinarily low net charge-offs in each of its various loan portfolios. We also mentioned that the 2008 acquisition of Chittenden Corp. of Burlington, VT provided a natural and geographically adjacent extension of its footprint into Northern New England, while increasing its assets significantly, expanding most notably its commercial real estate portfolio. Some analysts and shareholders have complained about management's slowness in putting the excess capital to work and its conservative practices and low net interest margin have led to little top and bottom line growth, but all of the above attributes still hold true. Even so, the stock has remained in a fairly tight trading range over the past year.

We remain drawn to PBCT because of multiple behavioral and fundamental inconsistencies with this otherwise happy picture. As is almost always the case given our methodology, PBCT initially got on our radar by way of an aggressive and unusual insider trading profile. It started with our coverage late last year (11/18/08) that featured a group of insiders who bought shares at $20 in an offering associated with the Company's second-stage thrift conversation who then, en masse, turned around and sold many of those acquired shares at a loss shortly after the lock-up expired. This type of sentiment reversal by a group of senior executives is exceptionally rare.

**Figure 1.** PBCT Daily Closing Price, 06/02/08 through 08/12/09. Source: Reuters.




We noted in our update on 06/19/09 that the 1Q09 results showed some of the first signs that PBCT was not completely immune to the decelerating regional economy as total non-performing assets jumped 50% from the end of 2008 to $142 million. Though it is certainly true non-performing assets are still very low relative to total assets even after this healthy increase, several things stood out to us. First, management sought to downplay the obvious deterioration in asset quality by repeatedly citing comparative statistics showing that PBCT was still far better off than its peers. Second, even with the big increase in non-performing loans, its allowance for loan losses and net charge-offs barely budged at all, arguing that its "conservative underwriting standards coupled with strong monitoring resolution and loss control practices" are what have allowed management to keep the loss content of non-performing loans low. But third, while management somewhat smugly was suggesting that they were just better bankers than anyone else, the long-time head of commercial banking and named executive officer, **Brian Dreyer**, sold off the majority of his actionable position following the release of 1Q09 results at 15% lower prices than when he last sold in the 4Q08. His behavior stood out to us given that commercial real estate is likely an under appreciated exposure for the bank and that non-performing commercial real estate loans, though still low relative to the total CRE portfolio, still increased by 80% in the 1Q09. A behavioral sidebar was that his wife, a former PBCT executive who worked for her husband but whose relationship was never disclosed, also sold most of her remaining stake.

Since our last update, the financial media and some analysts have continued to express concerns that commercial real estate loans are the next financial catastrophe on the horizon, and in particular, small and medium sized banks have failed to make adequate allowances for loan loses and charge-offs against their CRE portfolios and that a day of reckoning is not far off. In a recent article in *The Wall Street Journal* [1], the newspaper said it analyzed financial reports from some 8,000 banks and concluded that CRE loan losses and charge-offs were growing at a rate not seen in at least 20 years and that by the end of 2009 could reach $30 billion. More to the point, the WSJ analysis also suggested that CRE charge-offs at small and medium sized banks increased last year at a pace one quarter that of larger banks, implying smaller institutions may just be putting off the pain longer, which could make for a worse outcome later.

Whether one believes draconian outlooks for CRE such as this and others like it or one believes the story told by the PBCT management that their better banking practices will help them avoid a doomsday scenario is not really relevant. What we can say for sure is that the same fundamental and behavioral trends we discussed in our last update have continued. In the 2Q09 results (released 07/17/09), non-performing assets again increased substantially, by 28% to $182 million, led by an increase of 39% in non-performing CRE assets to $75 million. But again, the allowance for loan losses and net charge-offs barely moved at all. On the ensuing conference call, management again attempted to downplay the increases in non-performing assets by citing numerous statistics showing how much healthier PBCT is compared to its peers despite the fact that non-performing assets have doubled since the end of 2008. And then finally, we once more have several key insiders taking more chips off the table, including CEO **Philip Sherringham**, who despite saying on the last conference call “we believe People’s United remains a very attractive investment”, just sold 60,000 shares representing a fairly healthy chunk of his actionable position.

We begin this brief update with a review of the elements of the 2Q09 results and conference call that we feel are most relevant.

## Fundamentals: Asset quality continued to deteriorate in 2Q09

In a way, there was a telling admission by Philip Sherringham in his response to the very first question in the Q&A portion of the 2Q09 conference call:

> **Analyst:** Two questions. First of all if you can take a longer term view of credit quality in the economy -- obviously things are still very, very challenging for the industry -- where do you think if you look six months, twelve months down the road, where do you think you're going to see the biggest stresses in your own portfolio?
>
> **Philip Sherringham, CEO:** I would say that possibly two portfolios we're watching carefully obviously would be the Equipment Leasing portfolio and Commercial Real Estate.

[1] Wei, Lingling and Tamann, Maurice, “Commercial Loans Failing at a Rapid Pace”, *The Wall Street Journal*, July 21, 2009, page M11.

Looking at the actual data from 2Q09, you might conclude that Sherringham was stating the obvious. Total non-performing assets increased 28.2% or $40 million to $182.0 million, as shown in Table 1 below. The biggest percentage increases were in the commercial real estate (39.4%) and commercial equipment leasing (83.3%) portfolios (highlighted below), just as one might expect given Sherringham's comment.

**Table 1.** Non-Performing Assets by Loan Category (Top) and Sequential % Change in Non-Performing Assets by Loan Category (Bottom). Source: PBCT SEC Filings.

| Non-Performing Assets (Millions of $) | 3Q08 | 4Q08 | 1Q09 | 2Q09 |
|---|---|---|---|---|
| Commercial RE | 29.9 | 29.8 | 53.8 | 75.0 |
| Residential Mortgage | 21.1 | 24.2 | 42.3 | 51.4 |
| Commercial | 23.9 | 21.1 | 16.3 | 21.3 |
| PCLC | 6.9 | 5.8 | 9.0 | 16.5 |
| Consumer | 3.2 | 3.3 | 4.6 | 3.8 |
| Indirect Auto | 0.1 | 0.1 | 0.1 | 0.0 |
| REO and Repossessed | 6.3 | 9.4 | 15.9 | 14.0 |
| Total | 91.4 | 93.7 | 142.0 | 182.0 |
| **% Chg in Non-Performing Assets (Sequential)** | | | | |
| Commercial RE | -6.3% | -0.3% | 80.5% | 39.4% |
| Residential Mortgage | 15.3% | 14.7% | 74.8% | 21.5% |
| Commercial | 2.1% | -11.7% | -22.7% | 30.7% |
| PCLC | 7.8% | -15.9% | 55.2% | 83.3% |
| Consumer | 3.2% | 3.1% | 39.4% | -17.4% |
| Indirect Auto | -- | -- | -- | -- |
| REO and Repossessed | 90.9% | 49.2% | 69.1% | -11.9% |
| Total | 5.8% | 2.5% | 51.5% | 28.2% |

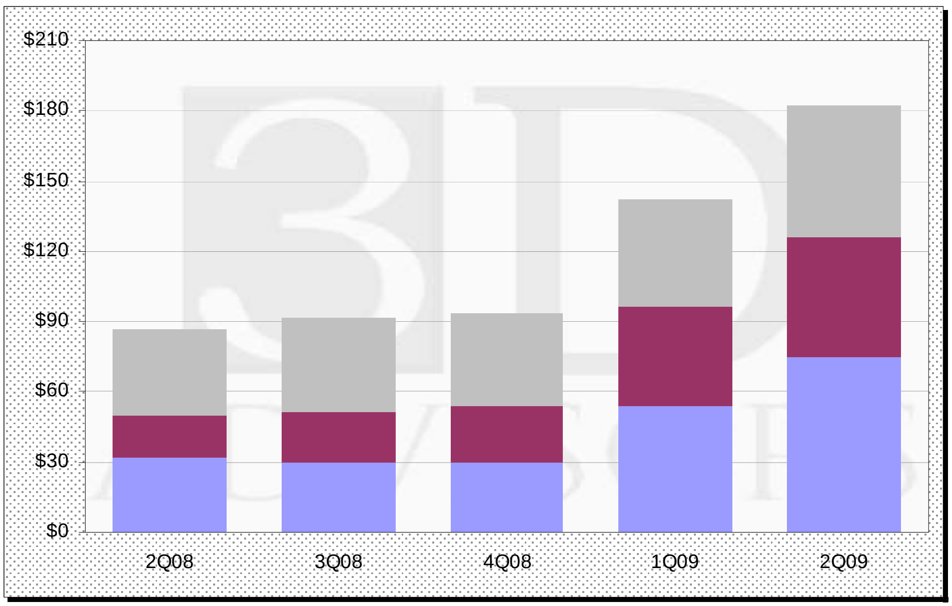
And while there was a big jump in percentage terms in the commercial leasing portfolio, the absolute number is small at $16.5 million. The biggest contributor to the overall increase in non-performing assets was by far the commercial real estate portfolio (53% of the total increase in non-performing assets), followed by the residential mortgage portfolio (23%), then the C&I portfolio (12.5%). Non-performing assets in both CRE and residential mortgages have more than doubled since the end of 2008. Still, with this significant growth in non-performing assets, they are still just 125 basis points of total assets, up from 97 basis points at the 1Q09.

Management is quick to point out, and perhaps rightly so, that these ratios are still well below the top 50 banks and its peer group banks. It also provides additional statistics as to why it is comfortable with the asset quality of the various portfolios, despite the large percentage increases in loans moving to non-accrual. But there is no denying the fact that level of non-performing assets has now for two quarters in a row trended in the direction of its peers rather quickly, and the Company acknowledges the trend is likely to continue as it stated in the 2Q09 SEC Form 10-Q[2]:

[2] People's United Financial Inc. 2Q09 SEC Form 10-Q, filed 08/10/09, page 62.

The level of non-performing assets is expected to fluctuate in response to changing economic and market conditions, and the relative sizes of the respective loan portfolios, along with management's degree of success in resolving problem assets. Management takes a proactive approach with respect to the identification and resolution of problem loans. However, given the current state of the U.S. economy and, more specifically, the real estate market, it is anticipated that the level of non-performing assets will continue to increase in 2009.

**Figure 2.** PBCT Total Non-Performing Assets, 2Q08 through 2Q09, Millions of $. Blue is commercial real estate, red is residential mortgage, grey is all other portfolios. Source: PBCT 2Q09 SEC Form 10-Q.




Accounting: Non-performing assets double in 1H09, charge-offs barely budge

The fact that PBCT non-performing assets have been increasing rapidly in the current economic environment is not really much of a surprise. What we find remarkable is that while NPAs have more than doubled since the end of 2008, the allowance for loan losses and net charge-offs have barely budged. Figure 3 below demonstrates this by showing the sequential percentage change in non-performing assets as compared to the percentage change in the allowance for loan losses. We pointed out this gap between these two metrics in our last update, and that situation clearly continued in 2Q09. Net charge-offs in the 2Q09 where just .16% of total average loans (annualized), and in fact were *down* from .18% in the 1Q09. In effect, management is saying that while they have always been good at keeping loan losses low, they have *actually gotten much, much better than they used to be* and can still keep loan losses at the same level despite the fact that the number of loans that have moved to non-accrual has doubled in the last two quarters. The question is how much longer the gap can continue.

**Figure 3.** Sequential Percentage Change in Non-Performing Assets (Blue) and Allowance for Loan Losses (Red). Source: PBCT SEC Filings.


Management has all along said that the "secret sauce" that allows it to keep loss content extraordinary low is that its underwriting practices are very conservative and it proactively manages and works to remediate any problem loans as soon as it suspects problems are developing. An analyst asked CEO Sherrington for more details on what they are doing that allows them to keep loan losses so low, but he got few specifics:

**Analyst:** Okay. And then just in terms of the credit side and why you've seen such low loss migration and you talk about your credit administration practices, can you just give a little bit more color as to what's driving that? Is it a timing issue or are you finding yourselves working more with your borrowers and maybe restructuring some loans? I mean, what is it specifically that's helping you control the losses?

**Philip Sherringham, CEO:** Well, as I've said many times before, I think the secret is patented of course; I can't actually give it to you. It's a combination of fact. It's not a silver bullet. It's I think the stability of our credit philosophy over time, the stability of our Management team in the field and the fact we know our customers very well. Yes, of course, we work with them very closely but we are on top of things. We don't let things deteriorate to where it becomes unmanageable or the loss content just can't be controlled. Not to say that it wouldn't happen once in a while but in general we try to avoid this. We're very proactive managing this portfolio and I have to emphasize that again, the underwriting initially is good. It makes a huge difference over time as to what your underwriting was initially. We made sure that our borrowers have equity in the project in terms of CRE. We make sure the companies have good solid cash flow in the case of C & I, and over time, that kind of approach clearly pays off. I mean, it's the basics if you will of the banking business.

But when another analyst asks if the low level of charge-offs is likely to continue and can be used for forecasting purposes, Sherringham says ‘no’, essentially telegraphing that charge-offs are bound to increase at some point:

> **Analyst:** Okay, thanks, and then just in terms of credit quality could you give us a sense of how to think about the loss reserve relative to charge-offs and expected charge-offs? You're indicating that you don't expect a big increase in charge-offs and the coverage seems very, very conservative. I wonder if the regulators have changed their policies and allow you and others to build reserves in a very conservative manner these days as opposed to the past?
>
> **Philip Sherrington, CEO:** Well, yes, we don't, I don't think the regulators as far as I know have changed their policy or their approach. Certainly the accountants haven't, and the build up you've seen this quarter was just something prudent and frankly warranted again by the methodology and the approach that we're using traditionally and that hasn't changed so we built up our provision because we thought it was the right thing to do given the increase we've seen in the non-performing assets regardless of the loss content of those assets actually.
>
> **Analyst:** So it's not appropriate to think that that's a forecast of 12 or 18 months for those charge-offs?
>
> **Sherringham:** No, it's not. It's not.

In fact, the Company has been routinely making the following disclosure in SEC filings for at least the last couple of quarters: “The relatively low level of net loan charge-offs in terms of absolute dollars and as a percentage of average loans is unlikely to be sustainable in the future.” The question then becomes whether there will be an abrupt increase in net charge-offs, and if so will it surprise the Street and be dramatic enough to force a big increase in the allowance going forward and damage management’s credibility and reputation.

<u>Insider Trading: CEO: “…we believe PBCT remains a very attractive investment”</u>

There has been a noticeable decline in selling activity by PBCT insiders in 2009 with the issue having traded sideways for the better part of the year. After selling 1.1 million shares in 2008 at an average price of $17.22, insiders took profits on 222,640 shares this year at prices ranging from $15.66 to $16.90. As we discussed in our last update, the most interesting trades in the second quarter came from Executive V.P. Brian Dreyer, head of the Commercial Banking Group, who sold 90% of the actionable equity owned by him and his wife, a former bank executive who worked in her husband’s division. There were a number of independent board members who took profits on small percentages of their holdings in the quarter as well. The third quarter marks the return of familiar names who had previously executed some of the largest dispositions we had seen from PBCT insiders. Now, with the issue having worked its way higher in the wake of the 2Q09 earnings release, three insiders resumed their diversification efforts at nearly identical prices to those that inspired their last trades.

The most notable seller was President and CEO Philip Sherringham (55), who remarked on the 2Q09 conference call that the bank has “excellent growth opportunities ahead" and "remains a very attractive investment". It is not exactly clear to us who Sherringham thinks PBCT shares are an attractive investment for considering the Company refuses to repurchase its own shares and Sherringham himself sold, not bought, 60,000 of his directly-held common for a pre-tax profit of $1 million on August 11th, one day after the Company filed its SEC Form 10-Q. This was only his third sale (or round of sales) since the Company's April 2007 subscription offering, which he bought into at $20. His last action, the sale of 89,000 shares in October 2008 at equivalent prices ($16), came just one quarter before the Company first reported deteriorating earnings and a surge in non-performing assets. Sherringham's latest sale covered just 22% of his actionable ownership, but more important to us is that he keeps up his bullish posturing for the investment community whilst selling stock out the back door.

Another interesting sale came from Executive V.P. of Organization Effectiveness **Henry Mandel** (64), who sold 70,000 shares (all common) on August 6th for $1.1 million. Mandel, who has been with the bank for more than ten years, paid $20 for 30,000 shares in April 2007 only to sell them seven months later at a 16% loss. He would then resurface in June 2008 to sell 126,000 shares in the mid $16s, getting out of the shares before they would touch a new low of $14.92 the following month. Now, more than a year later, Mandel executed the second largest disposition by a current officer since his June sale, unloading 45% of his actionable position (common plus vested options).

The last seller so far this quarter was the aforementioned EVP Dreyer, who vested in 3,937 shares from a July 2006 restricted stock award on July 28th. Dreyer immediately monetized the stock at $16.04 per share, prices marginally above those at which he sold in the second quarter. He continues to hold just 2,000 shares in his 401(k) or ESOP plan as well as 22,000 options with strike prices of $12.02 and $14.91.

As we reported in our initial report on the Company on 01/16/09, PBCT executives and directors were compensated handsomely with stock and options following the completion of the second-step conversion. Insiders stand to gain access to a large number of shares in the next few years; however, many of their currently vested options and even those scheduled to vest in the next 52 weeks are under water at the current market price. Certain options carry strike prices of $17.08 and therefore would be in the money with even a slight uptick over yesterday's closing price ($17.00). There are other options, however, that will require a 27% increase from current market prices before insiders will be able to monetize them for a profit. We will be very interested to see if any insiders act on the $17.08 options if the issue breaks above that level in the near-term.