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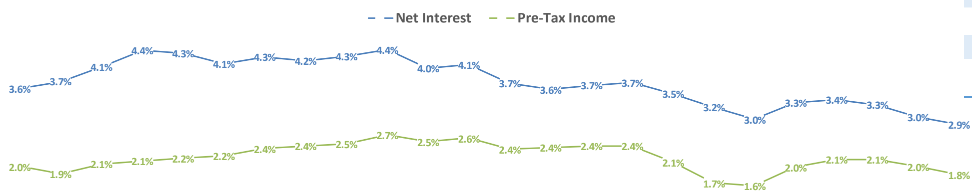
Commerce Bancshares

NASDAQ: CBSH

Commerce Bancshares (NASDAQ: CBSH)

Stock Price: $48.50

	EV/Earning Assets	EV/Deposit	EV/EBT	EV/Owner Earnings
UMB Financial	0.15	0.18	13.01	6.64
BOK Financial	0.17	0.22	10.29	6.17
Enterprise Financial	0.18	0.20	12.91	11.59
Great Southern Bancorp	0.20	0.23	9.83	8.93
U.S. Bancorp	0.22	0.28	10.95	8.20
Minimum	0.15	0.18	9.83	6.17
Maximum	0.22	0.28	13.01	11.59
Median	0.18	0.22	10.95	8.20
Mean	0.18	0.22	11.40	8.31
Standard Deviation	0.02	0.04	1.48	2.15
Variation	14%	16%	13%	26%
Commerce Bancshares	0.21	0.24	11.74	7.00



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Net Interest Income	206	231	276	312	346	346	370	395	434	448	435	468	465	469	477	495	504	495	494	566	618	638	626	619	206	638	466	447	121	27%
Net Non-interest Expense	92	117	136	161	172	159	164	165	183	178	163	172	170	156	162	173	203	240	225	226	224	219	211	222	92	240	172	179	37	21%
Pre-tax Income	115	114	140	151	174	187	206	230	252	271	272	295	294	313	315	322	301	255	268	340	394	419	414	397	114	419	271	268	91	34%
Short-term Investments	490	423	283	133	206	467	246	293	287	228	542	84	63	84	117	300	527	472	370	329	974	1,045	1,355	1,238	63	1,355	329	445	354	79%
Securities	1,985	2,269	2,695	2,804	2,645	2,626	2,651	2,583	2,680	2,170	2,476	3,595	4,440	4,892	4,322	3,559	3,369	3,610	5,254	6,723	8,085	9,077	9,088	9,096	1,486	9,096	3,369	4,167	2,381	57%
Loans	3,259	3,474	3,836	4,180	5,162	5,322	5,815	6,597	7,217	7,802	7,810	7,762	8,009	8,130	8,561	9,421	10,511	11,283	11,027	10,057	9,270	9,389	10,316	11,260	3,240	11,283	7,810	7,548	2,642	35%
Total Earning Assets	5,734	6,166	6,814	7,117	8,012	8,415	8,712	9,473	10,185	10,199	10,828	11,441	12,513	13,106	13,000	13,280	14,408	15,365	16,651	17,109	18,328	19,511	20,759	21,594	5,306	21,594	11,441	12,161	4,816	40%
Non-interest bearing Deposits	968	1,121	1,303	1,342	1,497	1,559	1,750	1,622	1,372	1,331	1,101	975	1,083	1,288	656	643	648	670	920	994	4,742	5,523	5,961	6,339	643	6,339	1,288	1,854	1,731	93%
Interest-bearing Deposits	4,566	4,899	5,301	5,503	6,062	6,375	6,448	7,146	7,887	7,610	8,367	8,814	8,934	9,041	9,869	10,477	11,230	11,580	12,901	13,369	10,929	11,304	12,100	12,456	4,168	13,369	8,814	8,694	2,828	33%
Total Deposits	5,535	6,020	6,604	6,845	7,559	7,934	8,198	8,768	9,260	8,941	9,468	9,789	10,017	10,329	10,525	11,120	11,878	12,250	13,821	14,363	15,671	16,827	18,061	18,796	5,117	18,796	9,789	10,548	3,849	36%
Equity	481	556	669	736	846	892	942	1,029	1,079	1,101	1,223	1,356	1,447	1,450	1,379	1,378	1,476	1,595	1,732	1,989	2,110	2,245	2,177	2,289	442	2,289	1,356	1,305	558	43%
Return on Earning Assets																														
Net Interest Income	3.59%	3.75%	4.05%	4.38%	4.32%	4.11%	4.25%	4.17%	4.27%	4.40%	4.01%	4.09%	3.71%	3.58%	3.67%	3.73%	3.50%	3.22%	2.96%	3.31%	3.37%	3.27%	3.01%	2.87%	2.87%	4.40%	3.72%	3.73%	0.47%	0.13
Net Non-interest Expense	1.60%	1.90%	1.99%	2.26%	2.15%	1.89%	1.89%	1.75%	1.79%	1.74%	1.51%	1.51%	1.36%	1.19%	1.24%	1.30%	1.41%	1.56%	1.35%	1.32%	1.22%	1.12%	1.02%	1.03%	1.02%	2.26%	1.51%	1.55%	0.35%	0.23
Pre-tax Income	2.00%	1.85%	2.06%	2.12%	2.17%	2.22%	2.37%	2.42%	2.47%	2.65%	2.51%	2.58%	2.35%	2.39%	2.42%	2.42%	2.09%	1.66%	1.61%	1.99%	2.15%	2.15%	2.00%	1.84%	1.61%	2.65%	2.16%	2.19%	0.28%	0.13
Leverage																														
Earning Assets/Equity	11.92	11.08	10.18	9.67	9.47	9.43	9.25	9.20	9.44	9.27	8.85	8.44	8.65	9.04	9.43	9.64	9.76	9.63	9.61	8.60	8.69	8.69	9.54	9.43	8.44	12.00	9.43	9.56	0.91	10%
RETURNS																														
Return on Equity	24%	21%	21%	20%	21%	21%	22%	22%	23%	25%	22%	22%	20%	22%	23%	23%	20%	16%	15%	17%	19%	19%	19%	17%	15%	25%	21%	21%	2%	0.12
GROWTH																														
Net Interest Income		12%	19%	13%	11%	0%	7%	7%	10%	3%	-3%	8%	-1%	1%	2%	4%	2%	-2%	0%	15%	9%	3%	-2%	-1%	-3%	19%	3%	5%	6%	1.22
Net Non-interest Expense		28%	16%	19%	7%	-8%	4%	1%	11%	-3%	-8%	6%	-1%	-9%	4%	7%	18%	18%	-6%	0%	-1%	-2%	-3%	5%	-9%	28%	4%	4%	10%	2.27
Pre-tax Income		0%	23%	8%	15%	8%	10%	11%	10%	8%	0%	9%	0%	7%	1%	2%	-6%	-15%	5%	27%	16%	6%	-1%	-4%	-15%	27%	7%	6%	9%	1.56
Federal Funds and Other Deposits	-16%	-14%	-33%	-53%	55%	127%	-47%	19%	-2%	-21%	138%	-84%	-25%	33%	39%	157%	76%	-10%	-22%	-11%	196%	7%	30%	-9%	-84%	196%	-5%	22%	71%	3.20
Securities	34%	14%	19%	4%	-6%	-1%	1%	-3%	4%	-19%	14%	45%	24%	10%	-12%	-18%	-5%	7%	46%	28%	20%	12%	0%	0%	-19%	46%	6%	9%	17%	1.90
Loans	1%	7%	10%	9%	23%	3%	9%	13%	9%	8%	0%	-1%	3%	2%	5%	10%	12%	7%	-2%	-9%	-8%	1%	10%	9%	-9%	23%	7%	6%	7%	1.26
Total Earning Assets	8%	8%	11%	4%	13%	5%	4%	9%	8%	0%	6%	6%	9%	5%	-1%	2%	8%	7%	8%	3%	7%	6%	6%	4%	-1%	13%	6%	6%	3%	0.52
Non-interest bearing Deposits	2%	16%	16%	3%	12%	4%	12%	-7%	-15%	-3%	-17%	-11%	11%	19%	-49%	-2%	1%	3%	37%	8%	377%	16%	8%	6%	-49%	377%	5%	19%	78%	4.19
Interest-bearing Deposits	10%	7%	8%	4%	10%	5%	1%	11%	10%	-4%	10%	5%	1%	1%	9%	6%	7%	3%	11%	4%	-18%	3%	7%	3%	-18%	11%	6%	5%	6%	1.28
Total Deposits	8%	9%	10%	4%	10%	5%	3%	7%	6%	-3%	6%	3%	2%	3%	2%	6%	7%	3%	13%	4%	9%	7%	7%	4%	-3%	13%	6%	6%	3%	0.61
Equity	9%	16%	20%	10%	15%	5%	6%	9%	5%	2%	11%	11%	7%	0%	-5%	0%	7%	8%	9%	15%	6%	6%	-3%	5%	-5%	20%	7%	7%	6%	0.82

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Geoff Gannon, Writer | Quan Hoang, Analyst |
Tobias Carlisle, Publisher

Commerce (NASDAQ: CBSH) is a Giant Local Bank Spread Across Three Neighboring States

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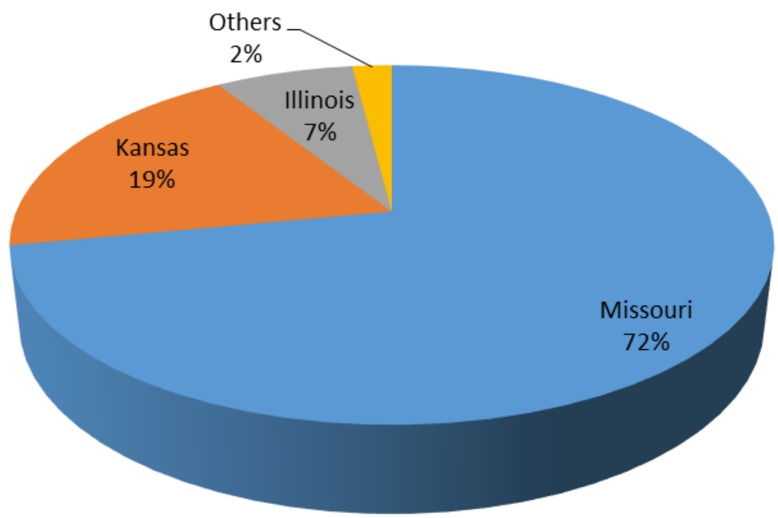
OVERVIEW

Commerce is a regional bank based in Kansas City. The Kansas City market straddles the states of Missouri and Kansas. So, Commerce not surprisingly gets almost all of its deposits from these two states. About 72% of the bank's deposits are in Missouri. Another 19% of deposits are in Kansas. So, 91% of the bank's deposits are in those two states. Illinois accounts for just 7% of deposits. So, we will limit our discussion to the Kansas City market specifically and Missouri generally.

Commerce can trace its roots to the Kansas City Savings Association founded in 1865 (the year the American Civil War ended). By 1903, the bank was named Commerce and it was headed by William Thornton Kemper. So, it was already in the Kemper family about 113 years ago. Commerce was placed in receivership during the Panic of 1907. It survived a bank run in 1933 (during The Great Depression). The bank's history since 1933 has been pretty boring. Missouri's economy doesn't have exposure to energy. It didn't experience any boom and bust like Texas. So, the only 1980s and 1990s crisis in the state was the nationwide savings and loan crisis. Net charge-offs at Commerce peaked at 0.48% in 1991. So, this wasn't a crisis for the bank. In the 2008 financial crisis, Commerce refused TARP money. This isn't surprising considering how little housing prices in the Kansas City market increased. From 2002 through 2007, house prices nationwide rose a total of 47%. House prices in Kansas City rose just 27% total. Incomes rose about the same amount. So, housing did not become less affordable. Commerce's net charge-offs of residential mortgage loans peaked at just 0.18%. Again, that's nowhere near a crisis. So, for Commerce, there really wasn't any savings and loan crisis in the early 1990s or housing bubble in the early 2000s.



Commerce gets the vast majority (72%) of its deposits from its home state of Missouri and virtually all (98%) of its deposits from the three neighboring states of Missouri, Kansas, and Illinois combined.

Commerce is still run by the Kemper family. William Thornton Kemper was the first family member to run the bank. He became President in 1903. His son – James Kemper Senior – succeeded him in 1925. James Kemper Senior was succeeded in turn by his son – James Kemper Junior – in 1955. James Kemper Junior was then succeeded by his son – David Kemper – in 1986. And then in 2013, David Kemper was succeeded by his son. That son is John Kemper. He is the current President and Chief Operating Officer. So, we have a direct line of descent from William Thornton Kemper in 1903 through David Kemper in 2013. It's an unbroken line of Kemper sons running about 110 years and five generations. So, this is a family run bank.

Commerce is now in the states of Missouri, Kansas, Illinois, Oklahoma, and Colorado. It's a big bank. It has $19 billion of deposits. This puts it close in size to some banks – like Frost and Prosperity – we've discussed recently. Commerce has 195 branches. So, a little under $100 million in deposits per branch. This is higher than Prosperity but a lot lower than Frost. It's best to think of the bank as a Kansas City and Saint Louis bank. It gets over 90% of deposits from the states of Missouri and Kansas. About 33% of total deposits are from Kansas City. Another 32% of deposits are from St. Louis. So, the two cities combined contribute 65% of total deposits. No other single market is bigger than about 5%. That would be Wichita. This is largely a result of geography. Kansas has very few medium sized cities in it. In fact, if you look at the region Commerce operates in – the two metropolitan markets of Kansas City and St. Louis are a very big part of the economy of the region. So, it makes sense that these two cities are a big part of total deposits. Commerce is quite big in relative terms within these communities. It has the third largest deposit share in Missouri behind only nationwide giants U.S. Bancorp and Bank of America. And it has the second largest deposit share in Kansas behind only Bank of America.

Commerce gets 41% of revenue from fee based businesses. Management sees its payment processing business as its best franchise. Bank card transaction fees are 17% of total revenue.

The deposit base is good. Deposits account for 90% of total liabilities. About 34% of deposits are non-interest bearing. Another 54% of deposits are savings, interest checking, and money market accounts that – when taken as a group – pay about half the Fed Funds Rate. So, about a third of deposits pay nothing. And then another half of deposits pay only half the Fed Funds Rate. Overall, it's a low cost deposit base.

It grows slowly though. Over the last 25 years, total deposits grew just 5.6% a year. This is much lower than other banks we've discussed like Frost and Prosperity. Commerce returns its excess capital. And since it grows so slow, it has a lot of excess capital each year. Generally, the bank uses about half of each year's earnings to buy back stock. It uses a third of EPS to pay dividends. It retains just 18% of earnings on average. This means that if you buy Commerce at say a P/E of 16 or 17 – you are getting a roughly 2% dividend yield, a 3% buyback rate, and a 5% deposit growth rate. That's about a 10% annual return even when the stock is priced as high as 16 or 17 times earnings. This is possible because the company's growth rate may be low at about 5% a year – but it returns earnings to shareholders at a rate of 80% or more. When the combination of earnings yield times 0.8 plus deposit growth rate is good, the stock's total return is good. So, say you buy at an earnings yield of 5%. That means 5% times 0.8 equals 4%. Deposit growth is 5%. Add four percent plus five percent and you get nine percent. That's a good long-term return. And it's possible even when the bank doesn't grow very fast and when the P/E is as high as 20. We don't advise buying the bank at a P/E of 20. But, it can theoretically outperform the S&P 500 even when it's priced at a P/E that high, because unlike most stocks – Commerce returns most of its earnings to shareholders by the end of each year. Commerce is not a growth stock. But, it's a good value stock. The combined level of growth in deposits per share – this number is boosted by the annual stock buybacks – and the dividend yield is high enough to outperform the S&P 500. Commerce is a safe and boring bank. So, when it's priced to outperform the S&P 500, it should be bought.

DURABILITY

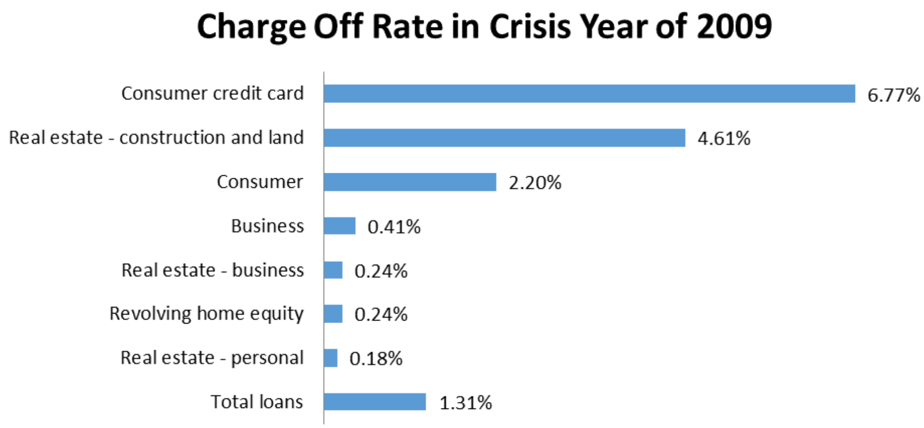
Commerce Has Been Run by the Kemper Family for Over a Century

Commerce has been controlled by the same family – the Kemper family – for over 100 years. In the 113 years since the Panic of 1903, Commerce has survived several financial crises. In 2008, it did not accept TARP money from the U.S. government. Commerce's net charge off rate peaked at just 1.31% in 2009. Even in that crisis year, loan losses at Commerce were quite low (well less than half a percentage point) in all areas except credit cards, real estate construction, and consumer credit. These 3 areas are high risk loan categories. Right now, about 13% of Commerce's total loans are in areas Quan and I consider high risk. Credit cards are 7% of total loans, real estate construction (and land) is 4% of total loans, and boat and recreational vehicle loans are 2% of total loans. So, 13% of Commerce's loans are in areas that would be severely stressed by a financial crisis like the one seen in 2008. The next financial crisis probably won't look like the last one though. They never do. So, it doesn't make sense to focus too much on loans that go bad with the housing market and household finances. Just know that about 87% of Commerce's total loan portfolio is in fairly safe and traditional types of lending. None of these types of loans had charge-off rates above 0.41% in 2009. Those are very low charge-off rates. So, any risk to the durability of Commerce comes from the other 13% of loans that are in credit cards, real estate construction, and marine and RV lending.

Overall, Commerce makes all types of loans. Consumer and mortgage loans are 41% of total loans. Real estate is 47% of total loans. Real estate is diversified among: business real estate (20% of total loans), personal real estate (16%), home equity (7%), and construction (4%). There are many ways to break down a bank's loan portfolio. In Commerce's case we can look at some big and fairly traditional forms of lending and see what they add up to. Business loans (non-real estate – so commercial loans) are 35% of all loans. Business mortgages are 20%. Personal mortgages are 16%. So, right there, you have 71% of loans from those 3 categories. These loans are very typical of what banks we've talked about before make. Then, we get down to some categories of loans that Commerce makes which are less important at other banks – or even non-existent. We have 8.5% car and motorcycle loans, plus 1.3% RV loans, plus 0.4% boat loans equals 10.2% vehicle loans of some kind. We have 7% credit card loans. And we have 6.6% home equity loans. Home equity loans are fairly common at other banks. Auto loans and credit card loans are often a lot smaller at the banks we've talked about then at Commerce though.

Commerce's charge-off rate tends to be much lower than the industry. This isn't just overall. It's also within each category. Commerce did have higher charge-offs in 2009 than Frost. A lot higher, in fact. But, this was due to Commerce making types of loans that Frost does not. So, in 2009, Commerce peaked at a 1.31% charge off rate. Frost peaked at 0.58%. As you know from reading our bank issues – Frost and BOK Financial and Prosperity all had very low charge-offs right through the crisis. Commerce did not have an extraordinarily low charge-off rate. But, the crisis was a much tougher test of the types of loans Commerce makes than it was at Frost. Frost makes a lot of business loans in Texas. Businesses in Texas just weren't very stressed by the crisis. Real estate in parts of the country was stressed. Households around the country were stressed. But, businesses in Texas were stressed much less by the 2008 financial crisis than by the early 1990s recession or the early 1980s oil bust. So, 2008 was not the toughest moment for Frost's borrowers. It was certainly the toughest moment in 30 or more years for some of the consumer type loans that Commerce makes.

For example, Commerce made construction loans. These are very risky in a housing bubble. In 2008, 2009, 2010, and 2011 Commerce charged off 0.89%, 4.61%, 2.69% and 1.66% of its construction loans. That sounds high. But, now, let's do a comparison of Commerce versus the industry in that loan category. In 2008, Commerce charged off 0.89% of its construction loans versus 2.63% for the industry. In 2009, it was 4.61% vs. 5.40%. In 2010, it was 2.69% versus 5.45%. And in 2011, it was 1.66% versus 3.33%. In 2012, 2013, and 2014 – Commerce then had a negative charge-off rate (it actually recovered on some written off loans) while the industry as a whole never did. For the entire period of 2008 through 2014, Commerce wrote off far less of its construction loans than the industry did.



Commerce's charge off rate peaked at 1.31% of total loans in 2009

Over the last 24 years, Commerce has only charged off an average of 0.63% a year of its consumer loans (these are passenger vehicles, boats, and recreational vehicles – probably they are mostly cars). In each year from 2008 through 2014, Commerce charged off less than the industry did within the category. It's also worth mentioning that the composition of this category is now different. In 2009, boat and recreational vehicle loans were 50% of all consumer loans at Commerce. Today, boat and RV combined are just 12% of all consumer loans at Commerce. So, Commerce is making far more car loans in this category relative to boat and RV loans.

Charge-offs in credit card lending are always high. Over the last 24 years, Commerce has averaged a charge-off rate of 3.5% a year in this category. Commerce's charge-offs peaked in 2009 at 6.77% of all its credit card loans. The industry peaked in 2010 at 10.08% of all of its credit card loans. Again, Commerce's charge-off rate in this category was lower than the industry's charge-off rate in every single year from 2008 through 2012.

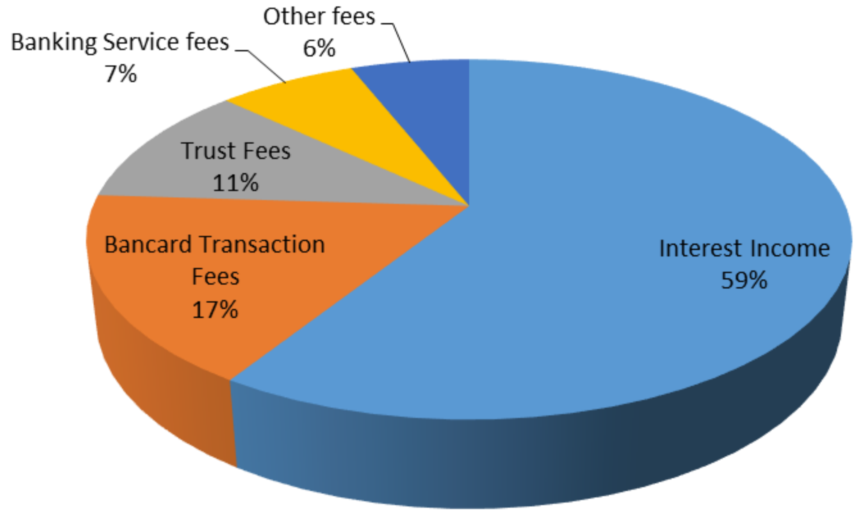
I focused on these riskier categories even though they are not Commerce's biggest categories – because they are the only categories where charge-offs have ever been high enough to cause any concern. Commerce's biggest loan categories are actually real estate loans. Missouri and Kansas didn't have a housing bubble. So, Commerce's record in these areas is pristine. Net charge-offs in business loans averaged 0.07% a year. They peaked at 0.70% in 1991. Charge-offs were a lot lower in the 2008 crisis than in the early 1990s recession. The same pattern is true for residential real estate loans. The very worst charge-off rate for residential real estate was just 0.19%. The industry average was 9 times higher at 1.72% in 2009. Commerce probably had low losses because Missouri and Kansas didn't have a real estate bubble, Commerce generally originated the loans on its books (it didn't acquire them), it never made subprime loans, and it generally required at least a 20% down payment. To illustrate, in the year 2006 (a bubble year in the U.S.), 87% of all Commerce's residential real estate loans had a loan-to-value ratio of 80% or less. And 98% of loans required principal payments be made – not just interest payments.

Commerce's commercial and industrial loans actually have even lower charge-off rates than Frost's C&I loans. So, by category, Commerce is a more conservative lender than Frost. To be fair to Frost, that bank specializes in commercial lending and avoids things like credit card and home mortgage loans entirely.

Commerce – like Frost – also has a lot of cultural continuity. If the bank didn't make risky loans in a category in the past – it's very unlikely to start making risky loans in that category, because the same people are making the loans. Commerce has been run by the same family for over 110 years. It is the slowest growing bank among those we've profiled. It is in the slowest growing region. And it isn't a serial acquirer. BOK Financial, Frost, and Prosperity all grow faster and either make acquisitions or have to hire new employees more frequently than Commerce. In 2013, the company's CFO said: "Somebody that's been with us for 10 years is a short-timer. We still look at them kind of as a newbie and that's just sort of the culture at Commerce." Commerce made it safely through the 2008 financial crisis without accepting TARP money. There is no reason to believe another 2008 type crisis is imminent. When another crisis like 2008 does happen though, Commerce should be in the same position to survive it. Commerce's durability should be equal to or greater than the durability at BOK Financial, Frost, and Prosperity. Cultural continuity is probably even higher at Commerce than at those banks. And the bank doesn't grow as quickly as those banks do. So, the pace of change in risk taking is probably slower at Commerce than at those banks. It's a durable bank.

MOAT

Commerce Generates its Profit from Lending Sticky Customer Deposits and Charging Those Customers Fees on a Range of Traditional Banking Products



Commerce gets 41% of its revenue from fees.

Like other banks, Commerce's moat comes primarily from its deposit base. American households and businesses rarely move their bank accounts. Once they are customers of one bank, they are unlikely to move their deposits to another bank just because it offers a higher interest rate. This high customer retention rate even when a bank offers interest rates on its deposits that are much lower than the Federal Funds Rate is what creates a moat around the low cost funds a bank controls. We won't go into much detail discussing this part of Commerce. It is mostly the same as at Frost, BOK Financial, and Prosperity. Once a bank has deposits, it tends to keep those deposits. And the depositors don't demand high rates of interest. So, a bank has a "moat" around its existing customer base.

What we will discuss is the other sources of revenue that Commerce gets. Sources other than interest. So, interest income is now 59% of total revenue at Commerce. This is interest on loans and securities that Commerce funds with customer deposits. That leaves 41% of revenue from non-interest sources. These are fees like bank card transaction fees, trust fees, etc. In 2014, Commerce got $436 million in revenue from fees. A full $176 million of the bank's revenue (this is 17% of total revenue) came from bank card fees alone. Trust fees generated $112 million (11% of total revenue). Another $148 million (13% of revenue) comes from all other fees.

Lots of banks have fees. Big, national banks generate the most fee income. Regional banks and community banks tend to generate a lot less fee income. Commerce has very high fee income for a bank its size. Let's compare bank card transaction fees at 3 banks – Frost, BOK Financial, and Commerce. Frost has $28 billion in assets versus $24 billion at Commerce. Frost is the bigger bank. Yet, Frost doesn't make any money off bank card transaction fees. BOK Financial is a $31 billion bank. Commerce is a $24 billion bank. Again, Commerce is by far the smaller bank. Yet, BOK Financial makes $124 million from bank card transaction while Commerce makes $176 million. Commerce is 23% smaller than BOK Financial. And yet Commerce's bank card business is 42% bigger than BOK Financial's bank card business. Commerce also has a wealth management business that is almost the exact same size ($112 million in revenue) as BOK Financial ($116 million) and Frost ($106 million) – despite Commerce being the smallest of the 3 banks by assets. The relative importance of bank card transactions and wealth management is higher at Commerce than at banks like BOK Financial and Frost.

Commerce's wealth management business definitely has a wide moat. We know that before the financial crisis, Commerce had an even higher retention rate in its wealth management business than most banks have among their depositors. Commerce included this statement in its 2008 annual report: "In 2008, account retention also improved for the fourth consecutive year to 95%." As we mentioned in the Frost issue we did, Frost advertises that it has a 92% customer retention rate overall and considers this "industry leading". Commerce's wealth management business has at least as high a retention rate as you see in banking generally. And banking has a very high customer retention rate. So, Commerce's wealth management business has a wide moat.

Commerce's bank card transaction business is also wide moat. At the 2008 shareholder meeting, Commerce's then CEO said: "As we said in the annual report over probably the last five years, our most valuable franchise is the payment system business. It's a very high risk-adjusted return business and something that we think is an essential product for our customer and ties into a lot of other products…It is a very impressive operation; I think one of the best in the country." In 2010, Commerce's then CEO said: "…we are talking about building core relationships, and it's very much about relationships, not transaction(s), which starts with payment system(s)."

Commerce thinks of itself as a super community bank. It is bigger than all but the national banks. Yet it is essentially local. Commerce gets probably two-thirds of its business from just two cities: Kansas City and St. Louis. It's smaller and less spread out than even banks like Frost, Prosperity, and BOK Financial. In 2010, the company's CEO said: "We think we have an advantage over the very large national banks, (Bank of America) and U.S. Bank would be our two major competitors in our large markets. At the same time… we have scale, so especially in (businesses) like the payment system and money management, we are large enough and compete very effectively against any of the large providers throughout the country." Community banks are usually weakest in services like wealth management and payment processing.

Commerce's traditional banking business is good too. It's a better than average bank – even without the wealth management and payment processing businesses. Non-interest bearing deposits are 34% of total deposits versus less than 20% for the industry. CDs are just 12% of deposits. Overall, Commerce's use of what Quan and I consider "good" sources of funding – basically, customer deposits that are not CDs – funds about 81% of the bank's entire balance sheet. The U.S. banking industry as a whole only uses customer deposits – excluding all CDs – to fund about half of its balance sheet. So, while Commerce's funding isn't quite as cheap as someplace like Frost (almost no bank's funding is as good as Frost's) it is still about 80% funded by sticky customer deposits in an industry that is only about 50% funded by sticky customer deposits. Commerce comes out better than the banking industry overall on all funding cost comparisons. Frost, UMB Financial, and First Financial have all had lower funding costs than Commerce from 1991 through today. We estimate that Frost has a 25 basis point funding advantage over Commerce. So, Commerce isn't industry leading in terms of its deposit base. But, to put this in perspective, Commerce is a bank with over $10 billion in assets. We estimate that Commerce has a 40 basis point funding advantage over the average "big" (that is, over $10 billion in assets) bank. The advantage over smaller banks is even bigger. Having low costs is really a quality issue. Moat is a customer retention issue. Banks with lower costs don't actually take customers from banks with higher costs. Both high and low cost banks tend to keep their customers.

We know Commerce had a 95% customer retention rate in wealth management in 2008, we know Commerce is consistently ranked at or near the top of Midwestern banks in customer service surveys, we know American households and businesses rarely change their primary banking relationship, and we know switching costs are high and inconvenient in payment processing. Banking is a wide moat industry generally. And all signs point to Commerce being a wide moat business within that wide moat industry.

QUALITY

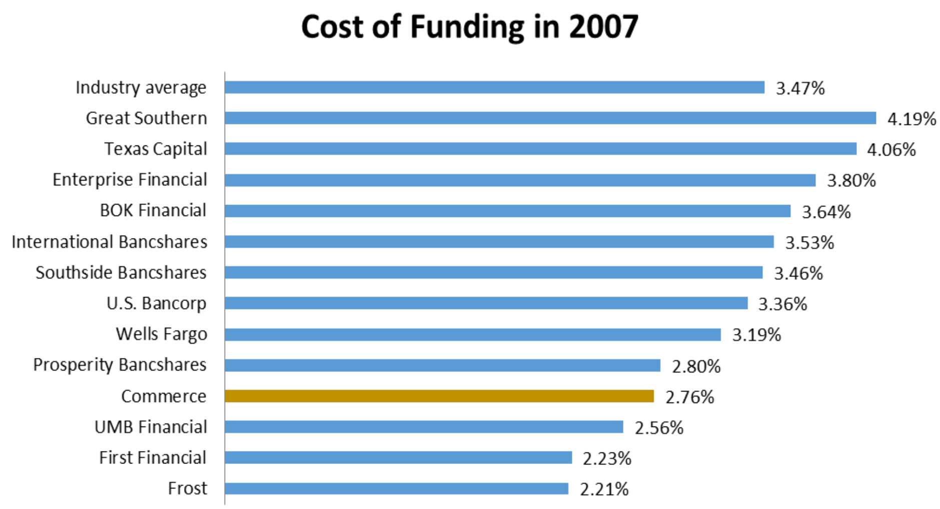
Commerce's Cost of Funding is as Low or Lower Than High Quality Banks Like Wells Fargo and Prosperity

The quality of a bank is mainly determined by the cost of its deposit base. There are two kinds of costs. There are interest costs. And there are non-interest costs. Non-interest fees can offset some non-interest costs. So, the number that matters is interest expense plus non-interest expense less non-interest income divided by total deposits. We use total earning assets as a stand in for deposits. Quan and I don't especially like the traditional measure of profitability in banking – the efficiency ratio. That's because the efficiency ratio measures costs relative to revenue. A lot of a bank's revenue is interest income. Banks have little control over how much interest they earn on loans and securities. And the interest earned is cyclical. So, we much prefer using total costs relative to earning assets. You can use a long-term average or look at a normal year. We often use 2007 as a "normal" year for interest costs in the sense that 2007 was the last year where the Fed Funds Rate was consistently far above zero throughout the year. In 2007, Commerce's total cost of funding (2.76%) was lower than Wells Fargo's (3.19%) but higher than Frost's (2.21%).

Commerce has a low net yield. Net yield is our estimate of interest income minus charge-offs divided by average earning assets. It may sound important that a bank's net yield be good. Don't banks make money by making loans? In reality, most banks make money by having a lower cost of funds than other institutions. They aren't better at earning interest than insurance companies, hedge funds, etc. They are just better at getting nearly free money. Many banks can achieve a cost of funds that is 1% higher than the Fed Funds Rate. From 1954 through 2014, the median level of the 10-year U.S. Treasury Bond's Yield over the Fed Funds Rate has been 1.06%. So, if a bank can have a spread of just 1.06% or less over the Fed Funds Rate, it can borrow at a similar rate to the U.S. government. This is how good banks make money. Great banks make money by having a cost of funds that is even lower than the Fed Funds Rate. In fact, Commerce's cost of funds in a normal year should be about 40% of the Fed Funds Rate. The industry is unlikely to manage a cost of funds lower than about 70% of the Fed Funds Rate in a normal year.

So, Commerce doesn't have to be a great lender to be a great bank. That's good, because Commerce isn't a great lender. It is a safe lender. But, the net yield on its loans is not especially good. Commerce's net yield is about 0.25% to 0.50% lower than many other regional banks. Probably the bank with the best net yield is Wells Fargo. Commerce's net yield is 0.75% lower than Wells Fargo. This means that after loan charge offs – Wells Fargo earns 75 cents more per one hundred dollars of loans than Commerce does. So, the same deposit is worth more at Wells Fargo than it is at Commerce. Regional banks have better net yield than the industry as a whole. Commerce doesn't. Commerce has about the same net yield as the banking industry overall.

All of Commerce's quality advantages are on the deposit side. Like we said



In 2007, Commerce's cost of funding was 0.71% lower than the industry average.

earlier, Commerce's cost of funding is about 40% of the Fed Funds Rate. The industry average is more like 70%. So, imagine a 3% Fed Funds Rate. An average bank would have a cost of funds of 2.1% (that's 3% times 0.7). Meanwhile, Commerce would have a cost of funds of 1.2% (that's 3% times 0.4). That would mean Commerce has a 0.9% edge over an average bank when the Fed Funds Rate is 3%. Banks often leverage their earning assets by 10 times or more. So, a 0.90% advantage in terms of return on earning assets translates into a 9% advantage in terms of return on equity.

To illustrate this point, we'll use 2005 as a typical year. The average Fed Funds Rate for 2005 was 3.21%. The average bank with more than $10 billion in assets had a 2.3% cost of funding. Commerce's cost of funding was 1.51%. The bank's advantage should be even bigger today because it uses lower cost sources of funds. But, let's set that aside. Commerce had a 0.79% advantage in terms of return on earning assets in 2005. If leveraged 10 times, this generates just under 8 more percentage points of ROE. Those additional eight percentage points of ROE make Commerce an above average bank. Although many banks have a leverage ratio (earning assets divided by tangible equity) of more than 10 – Commerce doesn't right now. The bank's worst return on earning assets was 1.61% in 2009. Its median return on earning assets in the past was 2.16%. Using the median return on earning assets and today's low leverage, the after-tax return on equity would be more than 13% (2.16 percent times 10 equal 21.6% times 0.65 for after-tax income equals 13.65%). Commerce can comfortably make a 13% after-tax return on equity in all normal environments. The bank even made a 10% after-tax return on equity during the crisis. Quan estimates that – going forward – Commerce should be able to average closer to a 19% after-tax ROE. This is because Commerce's cost of funds should be a lot lower in the future than it was in the past. Commerce uses much cheaper funding sources now than it used to. If you assume a 3% Fed Funds Rate is normal, Commerce could generate a 2.9% return on average earning assets. Leveraged 10 times this gives you a 29% pre-tax ROE and a 19% after-tax ROE. Is this possible? Maybe. I don't think it matters much to a long-term investor whether Commerce makes a 13% ROE or a 19% ROE. Anything in that range is better than an investor could earn on their own money. Commerce can get a good return on whatever earnings it retains. It won't retain much – because it grows slow. So, a lot of the return in Commerce will depend on the price you buy the stock at, the return you get on your dividends, and the return the company gets on the stock it buys back. A company's ROE becomes more important the more earnings it retains. It is less important the less earnings the company retains. Commerce will retain very little earnings. Its ROE will always be better than adequate. Retained earnings will create value for shareholders. But, Commerce won't retain most of what it earns. So, an investor in Commerce shares won't earn anywhere near 13% to 19% a year in the stock even though Commerce can earn that on the money it puts back into its own business.

CAPITAL ALLOCATION

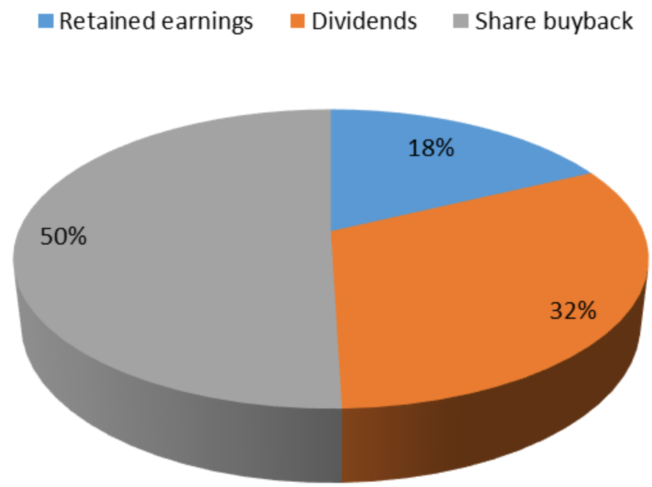
Commerce Buys Back Stock Every Year and Has Increased its Dividend Payments for 47 Straight Years

The only problem with Commerce's capital allocation is that the bank can't reinvest much of its earnings. As we talked about in the quality section, Commerce can achieve a teens (13% to 19%) type after-tax return on equity in a normal interest rate environment. That doesn't mean Commerce stock can return anywhere near 13% a year. That's because Commerce can't reinvest much of its earnings at that high rate of return. Instead, it must either pay earnings out in dividends or buy back its own stock. Neither the return on the dividends you receive nor the return on the stock buybacks Commerce makes while you own the stock will return anywhere near 13% a year forever. Over the last 22 years, Commerce has retained just 18% of its earnings. The other 82% of earnings have gone to share buybacks and dividends. About 50% of total EPS has gone to share buybacks. And about 32% has gone to dividends. That means you can expect Commerce's long-term return on its earnings – the buy and hold type return you can expect as an investor – to be half determined by the rate of return on share buybacks, a third determined by the return on dividends, and less than one-fifth determined by Commerce's own return on its reinvestment in the business. This means a long-term shareholder will benefit the most from Commerce's stock price staying relatively low. A high stock price while you own Commerce stock is not good for the long-term return in the stock. The good news about that is you can get a better long-term return in CBSH shares if they trade for a low price, because Commerce will get a better return on share buybacks and half of EPS is used in buybacks and you can obviously get a good short-term return in the stock if the share price rises too high. Long-term, a low stock price is good. Short-term, a high stock price is good. This is different from a company that reinvests mostly in its own business and does not buy back stock. In that case, a low stock price does you no good as an investor. In this case, there are benefits to you both if Commerce stock is especially cheap or especially expensive over the next few years. If it's cheap, half of EPS will be used in a high return way to buy back stock. If it's expensive, you can sell the stock yourself and get a good return over a period of just a few years.

Commerce is controlled by the Kemper family. Another branch of the Kemper family controls UMB Financial. That bank is a peer of Commerce. It is in the same region of the country. Commerce does have share based compensation. This is about a 0.75% annual drag on the stock. However, Commerce devotes about half of EPS to buying back stock. So, the actual share count falls over time. This means share based compensation really works a lot like giving employees cash bonuses. As a shareholder, the share based compensation is a real expense for you. But what it costs you isn't additional shares being issued over time. Instead, what it costs you is the cash Commerce uses to buy back this 0.75% a year dilution before it can even start reducing its share count. So, it's a very real expense. But, it doesn't actually lead to a higher and higher share count – because Commerce buys back all the shares it issues in options and restricted stock plus even more shares held by the public. Most of the bank is owned by the public. These are institutions like mutual funds that are widely diversified among banks and other stocks and not necessarily long-term shareholders. They usually aren't concentrated holders of the stock. The Kemper family controls the bank – but the family is not actually a big shareholder. The Kempers own about 3% of the company. Commerce bank itself owns about 10% of its own shares in a variety of different ways. A good example is the 401K plan for employees. This plan owns about 4% of the company on behalf of employees of the company. Even taking everything Commerce owns of itself plus everything the Kemper family owns – we are talking about well under 15% of the bank's shares. So, control of the bank does not come from having a large ownership in the bank. It comes from the Kemper family being the traditional path of succession. This is different from a bank like BOK Financial. As you might remember from that issue, BOK is actually controlled by George Kaiser through a huge stock ownership position. That's very rare. Big banks almost never have big shareholders who own a majority of the stock. The biggest shareholder of a bank is rarely an insider. The Kemper family has cultural control of Commerce. It doesn't control the stock. It doesn't have a lot of voting power.

From 1995 through 2007, the number of Commerce shares declined by 2.6% a year. To put this another way, Commerce shares tended to trade around 15 times earnings. Annual share dilution for compensation was about 0.75%. And the bank devoted about half of EPS to share buybacks. So, EPS was 1/15 equals 6.7% of the stock price. One half of 6.7% was devoted to share buybacks. That's about 3.35% devoted to share buybacks. But, about 0.75% share dilution was happening because of employee incentive compensation. So, that means 3.35% of the market cap was spent on share buybacks – on average from 1995 through 2007 – and yet that only reduced share count by about 2.6% a year (3.35% minus 0.75% equals 2.6%). So, the "buyback yield" was 2.6% of the stock. Organic growth in deposits was around let's say 5% a year (it was only 3.4% a year during Commerce's worst 10-year growth period from 1996 through 2006). So, we can illustrate the math of what a long-term return in Commerce would look like in the 1990s and 2000s. The earnings yield was often about 6.7% (this is a P/E of 15). Half of that 6.7% was used on buybacks. But, this was lowered to only a 2.6% net buyback yield after employee compensation. Dividends were about one-third of EPS. So, an earnings yield of 6.7% often translated into a dividend yield of 2.2%. The rest of EPS was retained to grow the bank. Deposits at the bank overall tended to grow around 5%. So, a shareholder's return in the stock had three components. The deposit growth rate of 5%, the buyback yield of 2.6%, and the dividend yield of 2.2%. Add these 3 figures together and you get a sum total return of 9.8% a year. That's a pretty accurate guess of what Commerce stock returns if you buy it around a P/E of 15 and it tends to trade around a P/E of 15 forever. You get 5% growth in deposits, a 2.6% decline in shares outstanding, and a 2.2% dividend yield each year. If Commerce can keep this up – keep growing deposits by 5% a year forever and keep trading at a P/E of 15 forever – a buy and hold shareholder can earn just under a 10% annual return forever. That's a good, safe investment. It's a perfect buy and hold stock.

I'm not sure if the bank will grow as much in the future as in the past. We think the bank can shrink shares by 2.5% a year forever. And we think the bank can pay a dividend yield – on a P/E of 15 – of 2% to 2.5% a year forever. Commerce has increased its dividend for 47 straight years. There were a couple crises in there. And it's been controlled by the same family for all of those 47 years. So, we're confident in that assessment. We're also confident in the share buyback assessment based on the record over the last 20 to 25 years. Growth could be lower if the states of Missouri and Kansas have low population growth – this depends a lot on internal migration trends in the U.S. – and if nominal GDP (so especially inflation) in the U.S. is lower than it has been in the past. The markets Commerce is in – Saint Louis, Kansas City, etc. – will grow slower than the markets Frost is in (San Antonio, Austin, Dallas, etc.) simply because of population trends. Commerce is a very low growth stock. But, it can definitely return 7% to 10% a year forever even if Missouri and Kansas specifically and the U.S. generally have much lower nominal GDP growth in the future than they did in the past. That's because we know Commerce can – at a normal P/E of 15 – buyback 2.5% of its shares and pay out at least 2% of its stock price in dividends. So, that's 2.5% plus 2%. That gets you – pretty conservatively – to a 4.5% annual rate of return before any deposit growth. To figure out your total return in the stock you just have to take 4.5% plus x where x is the deposit growth rate at Commerce. Say, you demand an 8% annual return from now until the end of time to buy a safe, durable stock like Commerce. That's a reasonable hurdle rate. You just look at 8 minus 4.5 and you get 3.5 and then ask yourself whether 3.5% is higher or lower than what Commerce will grow deposits at in the future. Commerce's worst 10-year growth period ever was still a 3.4% growth rate and it was during the super competitive banking period of 1996 through 2006. Today, banks are not opening more and more branches to compete with Commerce. New banks and new branches are uncommon since the financial crisis. No one expects the nominal GDP growth rate of the U.S. or of Missouri or Kansas to be lower than 3.5% a year long-term. No one is predicting that. So, it's hard to come up with a long-term prediction for Commerce if you buy the stock today and hold it forever where you end up making less than 8% a year. Commerce may not have as much upside as some stocks. Earning 8% a year forever might not sound that exciting compared to some other banks – for example, I think Frost could return 20% a year over the next 5 years if the Fed Funds Rate goes from today's 0.5% or less to 3% or more. Commerce does not have Frost's upside over the next 5 years. I don't like the bank's long-term return prospects as much as Frost or Prosperity. But, Commerce isn't riskier than those banks. And while it may have less chance of earning you 10% to 20% a year, it doesn't have less of a chance of earning you 8% a year forever. Quan and I don't think the S&P 500 is going to get you an 8% annual return right now. You can check bond yield on even the longest dated corporate bonds and see they aren't going to get you anywhere near 8% a year. So, Commerce has limited upside. It's not the best bank you could buy. But, it's a solid buy and hold forever stock. You can make more than 8% a year but less than 10% a year indefinitely. That's a good deal. And the only reason you are being offered that deal is because Commerce devotes half its EPS to buybacks and a third of its EPS to dividends. If that changes, the long-term return here will change too. So, Commerce is only as good as its capital allocation.



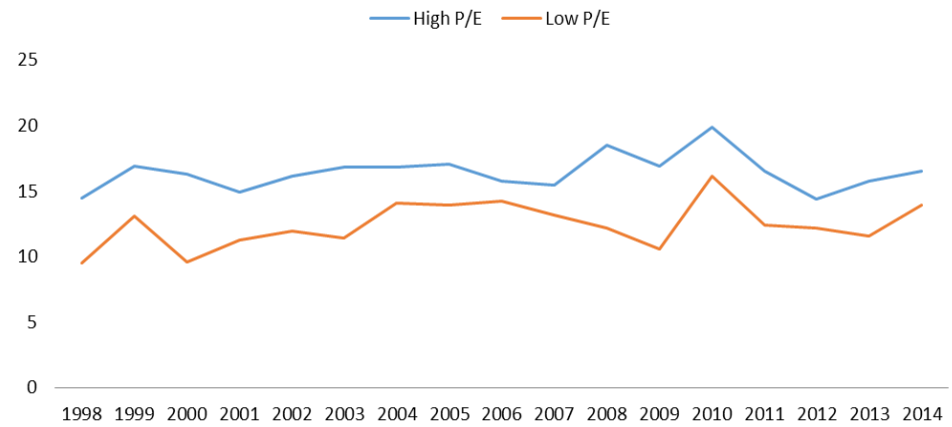
Over the last 22 years, Commerce paid out 82% of its earnings in stock buybacks (50%) and dividends (32%).

VALUE

Investors Only Look at Commerce's Current Earnings – They Don't Price the Stock on Normal Future Earnings

Commerce stock is cheap today because interest rates are low and the market only pays attention to Commerce's current earnings. In the future – when interest rates are higher – Commerce will make more money. The market will put the same multiple on those earnings as it does on today's earnings. In other words, the market cares only about what Commerce reports in earnings per share right now. But, what matters to a long-term investor is not what Commerce reports in earnings per share today but what it will report in earnings per share in 2021. From 1998 through 2014, Commerce tended to trade in a range of between 10 and 15 times its earnings. The stock's P/E was 10 to 15 regardless of whether interest rates were especially high, at a normal level, or very close to zero. In fact, Commerce's P/E ratio today is about the same as its P/E ratio was in 2006. The Fed Funds Rate was quite high in 2006 (that was the peak of the housing bubble). It is incredibly low today. Logically, a Fed Funds Rate near zero is much more likely to rise in the future than a Fed Funds Rate near three percent or higher. Yet, the market never prices this into Commerce stock. It is as if the market ignores Commerce's sensitivity to future interest rate changes.

Commerce is a better bank today than it was the last time – in 2003 through 2007 – that interest rates were "normal". In the 2003 to 2007 period – which is roughly equivalent to the "housing bubble" in the U.S. – Commerce funded about 40% of its earning assets using CDs and other borrowings. Today, Commerce funds just 17% of earning assets using these high cost sources. The key figure to focus on is savings, interest checking, and money market accounts. These sources of funds – which are all sticky deposits from households and businesses that bank with Commerce – cost much less than the Fed Funds Rate. We can look at the 2002 through 2007 period as an illustration. In 2002, these – what I'll call traditional customer deposits – cost 45% of the Fed Funds Rate. In 2003, it was 40%. In 2004, 32%. In 2005, 24%. In 2006, 28%. And in 2007, these traditional customer deposits cost just 32% of the Fed Funds Rate. Compare this to CDs and other borrowings. In the same time period, these two funding sources together generally cost exactly the same amount as the Fed Funds Rate. So, CDs and other borrowings can cost three times more than interest checking, savings, and money market accounts. That means there is a huge difference in Commerce's quality today versus its quality on the cusp of the financial crisis. Commerce is a much better bank today than it was in 2007.



From 1998 through 2014, Commerce stock tended to trade at a P/E of 12 to 17 regardless of interest rates.

So, we are understating Commerce's future earning power when we use figures from its past. But, we will be conservative and use past averages anyway. From 1990 through 2014, Commerce had a very stable net interest margin around 3.72%. This figure tends to be constant over time. It is the yield on earning assets less the cost of interest bearing liabilities. Then we have the net operating cost of running the bank. This number is 1.03% of earning assets right now at Commerce. Unlike the net interest margin, good banks – like Commerce – tend to reduce this figure over time. They don't become more efficient in terms of interest income and interest expense. But they do become more efficient in terms of non-interest income and non-interest expense.

Quan estimates that Commerce's pre-tax return on earning assets should be 2.95% in a normal interest rate environment. We can break this down into each source of funds. What I mean by this is we can take a dollar provided by a customer's non-interest bearing account and say what if you loaned that out – how much profit would you make on that dollar. Then we can take a dollar from an interest bearing account and so on.

Commerce's gross yield on its loans should be about 6% in a normal interest rate environment. It was 6.3% to 6.6% during the peak period of 2006-2007. In the future – at a 3% Fed Funds Rate – a 3% gross yield on loans is a good estimate. From 1991 through 2014, Commerce charged off an average of 0.29% of its loans each year. So, we take 6% and we subtract 0.3%. That gives us a 5.7% net yield in a normal interest rate environment.

That is what will generate Commerce's revenue on each dollar. Let's look at what the cost of each dollar will be. Commerce gets 18% of funds from shareholder equity and non-interest bearing customer accounts. These forms of financing pay no interest. So, the spread on them is 5.7%. We estimate – and this may be too conservative – that commercial demand deposits will cost 1.6% in a normal interest rate environment. So, the spread on these is 4.1%. We estimate that the spread on interest bearing liabilities will be 3.42%. The mix of funding sources is 64% interest bearing, 18% commercial demand deposits, and 18% free funding. When you do a weighted average interest margin you get 3.98%. This is higher than Commerce's net interest margin in the past – because that margin calculates only the spread on interest bearing liabilities. Commerce gets about a third of its funds from shareholders, non-interest bearing accounts, and commercial demand deposits which all pay much, much less (or nothing) in interest compared to other types of customer accounts. So, Commerce's interest margin should be 3.98%. Then you must subtract the 1.03% net operating expense ratio. The result is a 2.95 cent pre-tax profit on every dollar of earning assets on Commerce's balance sheet. The tax rate in the U.S. is 35% (at the federal level). Apply this 35% rate and you get 1.92 cents per dollar of assets. Commerce has $22.59 billion in earning assets. So, $22.59 billion times 1.92% equals $434 million in after-tax earnings. The bank has 93.34 million shares outstanding. So, in a normal interest rate environment, Commerce should produce $4.65 of earnings per share. Like we said at the start of this "Value" section, Commerce tends to trade at a low P/E of 10 for the year and a high P/E of 15 for the year. So, if the bank should earn $4.65 per share when the Fed Funds Rate is at a normal level, it should trade at a stock price of between $47 a share and $70 a share. In other words, If the Fed Funds Rate was already at a normal level today – Commerce stock would already be somewhere between $47 and $70 a share. We should also say that Commerce has tended to outperform the stock market. In other words, it's tended – in the past – to be priced too cheaply. In fact, it should always trade at 15 times earnings and never trade at 10 times earnings. We explained why this was before. The bank reduces its share count by 2.5% a year and pays a dividend yield of 2% a year even when it trades at 15 times earnings. That means even if the bank grows at just 4% a year, it would return 8% to 9% a year. The stock market won't do better than that. And – in all likelihood – Commerce will grow no slower than 4% a year. Those figures assume a P/E of 15. At a P/E of 10, Commerce could shrink its share count by 3.8% a year and pay a dividend yield of 3% a yield. You can see why a P/E of 10 is always inappropriate for Commerce. You'd be getting a 6.8% a year return in the stock before growth. Growth of even just 2% a year would get you to a 9% annual return. So, a P/E of 10 is way too low for Commerce. A P/E of 15 is not too high. It might be a little too low. Or, it might be just right. In our valuation, we'll assume a P/E of 15 is just right.

What will Commerce look like in 5 years? This is a question we'll take up in more detail in the "Future" section later in this issue. But, it's the best way to value the stock. So, let's talk a little about it here. The Fed Funds Rate is expected to be between 3% and 4% by 2021. We'll take the low end and assume a 3% Fed Funds Rate. The local economy where Commerce is located might grow around 5% a year over the next 5 years. Commerce says it may lose as much as 7% of its deposits if the Fed Funds Rate went from near zero (when management made that statement) to 3% in 2020. This drag on deposits could mean Commerce grows slower than the Missouri and Kansas economies. Let's say a 3% annual growth in deposits is possible. Take a 3% annual growth in deposits from 2016 through 2021 and you get a 2021 EPS estimate of $5.39 a share. Apply the 15 times P/E we suggested Commerce should never trade below. You get $5.39 times 15 equals $81 a share. That is the stock price Commerce should trade for in 2021. However, that is incorrect. It's too conservative. If Commerce trades at no more than 15 times earnings between now and 2021, it can also buy back 2.5% of its shares each year. That means the stock price in 2021 should be $92 a share – not $81 a share. This is because there will be 12% fewer shares outstanding in 2021 than there are today. You will also collect a 2% dividend yield. So, say you buy the stock today at $50 a share. It is worth $92 a share in 2021. Your capital gain is 13% a year. Your dividend yield is 2% a year. You make 15% a year over the next 5 years. It's a good deal. And it's a great diversifier. Non-bank stocks are likely to have contracting P/E multiples as interest rates rise. An interest rate sensitive bank like Commerce benefits from interest rate increases. As we showed, Commerce's P/E doesn't expand or contract much at all with interest rate cycles. It earns more when rates are higher. So, this is a stock that may rise when other stocks in your portfolio are falling. Commerce could return 10% to 15% a year over the next 5 years. And it could do that while other non-bank stocks in your portfolio are falling far short of a 10% annual return.

GROWTH

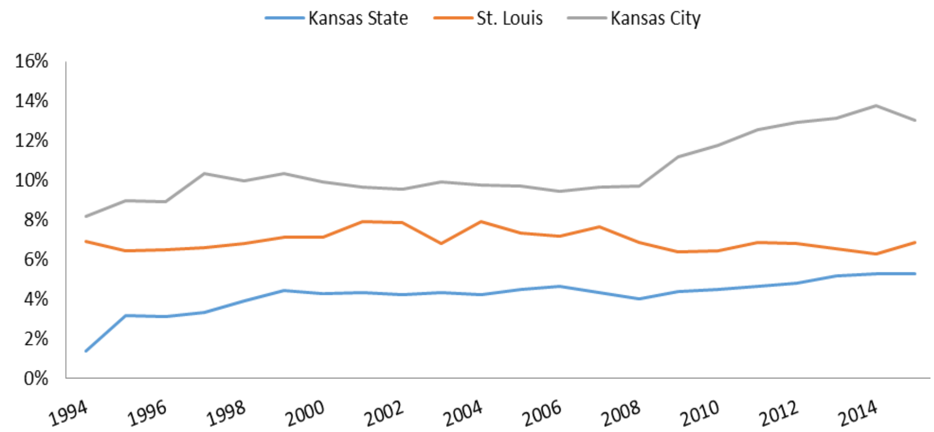
Commerce Could Grow as Slowly as 4% a Year

Commerce gets 91% of its deposits from two states: Missouri (72%) and Kansas (19%). So, we'll limit our discussion to just these two states. Missouri's population grows at just 0.7% a year. It grew 0.6% a year over the last 15 years. It is projected to grow a little faster in the future. However, this is a slow growth state. There is no decade from the 1950s through today during which Missouri reached even a 1% annual population growth rate. Compare this to Texas which routinely had population growth of 2% a year. There is a big difference. Missouri is a laggard when it comes to GDP growth. We can see this by looking at Missouri's share of U.S. GDP. In 1997, Missouri accounted for 1.86% of the nation's GDP. In 2014, Missouri accounted for 1.61% of the nation's GDP. That means Missouri grew slower than the rest of the country. This is not a fast growth state. It doesn't grow much slower than the country as a whole. But, it grows significantly slower than some states we have looked at recently. Two of the banks we like best – Frost and Prosperity – operate almost entirely in Texas. Texas grows a lot faster than

Missouri. So, Frost and Prosperity can grow a lot faster than Commerce. Overall, we estimate that Missouri's GDP has been about one full percentage point behind the nation's GDP. For example, the U.S. grew GDP by about 4.2% a year from 1997 to 2014. Meanwhile, Missouri grew GDP by 3.3% a year from 1997 through 2014. The deposit data supports this. From 2001 through 2014, Missouri's bank deposits compounded at a rate of 5.2% a year. Over the same time period, U.S. bank deposits compounded at a rate of 6.5% a year. So, Missouri's deposit growth rate was 1.3% a year lower than the nation's deposit growth rate. We also have 22-year data for Missouri deposit growth. It was 4.2% a year over 22 years. It's difficult to estimate long-term average deposit growth precisely. As you can see, deposits have grown faster than GDP in recent years. This can happen when an economy is especially slow growing and deleveraging. The reverse can happen when an economy accelerates. We know Missouri's GDP grew 3.3% a year from 1997 through 2014. And we know Missouri's deposits grew 4.2% a year from 1993 through 2014. I think a good guess is for 3% to 4% annual deposit growth in the future. A bank that neither gains nor loses market share in Missouri shouldn't grow much slower than 3% a year nor much faster than 4% a year.

Kansas might grow a little faster. Kansas's GDP as a percent of U.S. GDP has been extremely stable. The state rarely grows much faster or slower than the nation. Nationwide deposit growth could be between 4% and 5% a year. So, Kansas's deposit growth could also be between 4% and 5% a year.

Commerce has not lost deposit share over time. St. Louis accounts for one third of the bank's deposits. Commerce's market share has been stable at about 6.88% of the city's total bank deposits. From 1994 through 2015, the bank's lowest deposit share was 6.3%. The highest was 7.9%. That's not much fluctuation.



Over the last 20 years, Commerce gained market share in both Kansas City and Kansas State.

Commerce had increased its market share in Kansas City. Kansas City is also one third of total deposits. The bank had 8.2% of all deposits in Kansas City back in 1994. About two decades later – in 2015 – Commerce had 13% of all deposits in Kansas City. So, Commerce grew its deposits faster than the overall Kansas City market.

Commerce also gained market share in Kansas as a state. Commerce does not have high market share in the overall state of Kansas. But, it has grown its share of deposits in that state over time. In 1995, Commerce has 3.17% of all deposits in Kansas. By 2004, that number had reached 4.51%. And then in 2015, it was 5.29%.

Commerce competes with two really big banks: U.S. Bancorp and Bank of America. These banks have lost market share over time. In fact, they are probably the biggest source of market share gains for Commerce and any other banks that have gained depositors in these markets.

In 1994, U.S. Bancorp had 27.75% of all deposits in the St. Louis market. By 2015, that had plunged to 15.44%. Bank of America went from a 19.78% market share in St. Louis in 1994 all the way down to an 11.86% share today. Bank of America also lost a lot of market share in Kansas City. It went from 16.07% in 1994 to 9.71% today. U.S. Bancorp lost a little market share. It went from 7.55% in 1994 to 6.14% of the Kansas City market in 2015. U.S. Bancorp gained some share in Kansas state. But, it's a tiny player with just 3.44% market share today. The big player is Bank of America. And its market share in Kansas collapsed. It went from 11.77% market share in Kansas State back in 1994 down to just 5.29% deposit share today.

It's difficult to get much insight into why banks gain or lose market share in a region. Commerce would say that it is a "Goldilocks" bank in the sense that it is a super community bank. It's small enough to be focused on the Kansas City and St. Louis markets – unlike Bank of America and U.S. Bancorp who aren't local at all. But, it's also big enough to have wealth management, payment services, etc. businesses that smaller banks in the region don't have. There might be truth in this explanation. Bank of America and U.S. Bancorp definitely lost market share in Kansas City and St. Louis over the last 20 years. So, that part about big, national banks not being local enough to provide personal touch could be an explanation for why the biggest players would lose share. It's hard to know that. It's much easier to know that the "super" part of Commerce's "super community bank" description is true. Commerce gets a lot of fee based income. This is non-interest income. Other banks in the region don't generate much of this at all.

Here are some examples. Enterprise Financial – a bank in Kanas City, St. Louis, and Phoenix – gets just 13% of revenue from fees. Great Southern – which is focused on the Springfield, Missouri market where it has 14.5% deposit share versus Commerce's 14.8% deposit share – gets just 16% of revenue from fees. National Bank Holding – a Missouri and Colorado bank that is the number six bank in Kansas City – gets 18% of revenue from fees. Commerce gets 41% of revenue from fees. So, we have three possible smaller peers. They get anywhere from 13% to 18% of revenue from fees. Commerce gets two to three times more income from fees than those banks do. This is the benefit of being big. You can offer some services that require scale to make economic sense. National banks can do that. And Commerce can do that. The local banks can't do that.

The market is very fragmented in the places where Commerce competes. The top 5 banks have 52% of all deposits in Kansas City, 42% of all deposits in St. Louis, and just 22% of all deposits in the state of Kansas. After the top 5 banks, almost everyone else has 3% or less of total deposits in a local market. So, the rest of the market – after the top 5 – is often divided among 20 or more banks.

Commerce should be able to grow 4% to 5% a year long-term. Missouri can grow 3% to 4% a year. Kansas can grow 4% to 5% a year. And Commerce can gain a little market share. However, Commerce's growth may be very slow in the near term. Commerce's management has said it expects to lose 7% of total deposits if the Fed Funds Rate goes to 3% or higher. If Commerce grew at 4% a year over the next 5 years before this headwind and then it had this one time outflow of about $1.25 billion in deposits – Commerce would grow about 2.5% a year over the next 5 years. So, it's possible Commerce grows as slow as 2% to 3% a year over the next 5 years and then – after 2021 – it grows as fast as 4% to 5% a year. Overall, a long-term growth assumption from today into the far future of 4% a year sounds reasonable. I think you should expect 4% annual growth at Commerce. This is below average for a stock. But, Commerce can pay out between 80% and 85% of its earnings. The total return in the stock can be decent. If you pay 15 times earnings for the stock, it can grow deposits by 4% a year forever while buying back 2.5% of its shares and paying a 2% dividend yield. In that case, your total return in the stock would be 4% plus 2.5% plus 2%. That's an 8.5% annual return. And that's a very conservative estimate. It assumes you pay 15 times normal earnings. Today's interest rates aren't normal. So, earnings aren't normal. So, you're paying a lower price than a P/E of 15. On top of that, Commerce might succeed in growing its business faster than we expect. It might gain more market share. And it might grow its fee business faster than its deposits. We didn't discuss that possibility. Even if Commerce grows as slowly as Quan and I expect, the stock could still deliver a return of 8% to 9% a year for a buy and hold investor. That's impressive for a business that grows slower than the overall economy.

MISJUDGMENT

Will Commerce Still Be Run the Same Way When the Kempers Own So Few Shares in the Company?

Commerce isn't focused on a particular type of loan category. For example, Frost is a commercial bank in Texas. Frost makes 53% of its loans for commercial and industrial (these are non-real estate business loans) purposes, 36% for commercial real estate, and then only 11% for consumer loans. So, Frost is 89% a business bank.

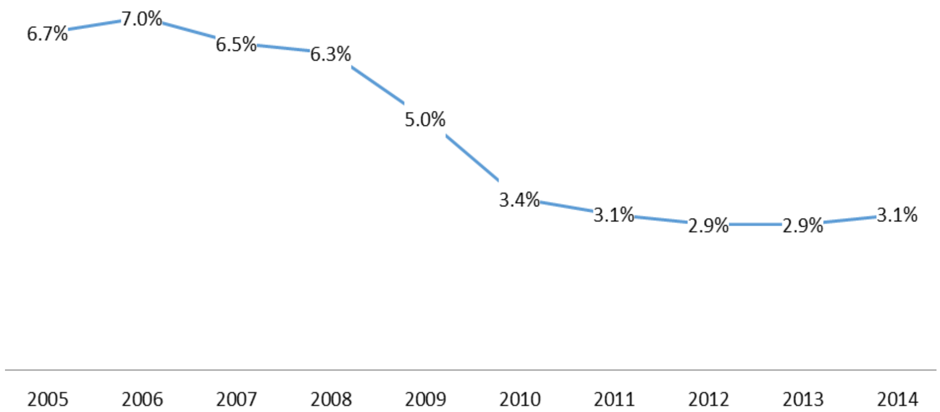
Commerce isn't just a business bank. Commercial and Industrial lending is 35% of the portfolio. Personal real estate – these are residential mortgages which are a type of loan Frost doesn't even make – is 16% of Commerce's loan portfolio, then consumer loans are 14%, home equity is 4%, and credit card is 7%. If you total these categories up – personal real estate of some sort is like 20% of all loans. Consumer loans – including credit cards – are 21% of all loans. At best, Commerce is only about 59% a business bank. It's pretty close to an even split between lending to businesses and lending to households. The bank has credit card loans, auto loans, RV loans, and boat loans in its portfolio. These aren't big loan categories for Commerce. But they are a bigger proportion of loans than at many other banks. And Commerce is not a business bank like Frost. Frost is focused. Commerce is not.

Some of the types of loans can go bad in large numbers in certain years. It's important that Commerce keep to good lending practices. Historically, the bank has done that. As we showed earlier in the issue, Commerce is a more conservative lender than the industry in every loan category. It may have higher loan losses than some banks. But, it doesn't tend to have higher loan losses in a certain category than other banks have in that same loan category. In a year where Commerce has higher loan losses than Frost, that's usually because consumer loans had higher losses than C&I loans in that year.

Commerce has been run by the Kemper family for 113 years. A different branch of the Kemper family runs UMB Financial. We may do an issue on that bank in the future. It's another good bank. So, the Kemper family has been running both Commerce and UMB Financial for 4 generations. Right now, 3 members of the Kemper family are part of top management at Commerce. David Kemper is the Chairman & CEO. Jonathan Kemper is the Vice Chairman (and the CEO's brother) and John (note the difference in spelling) W. Kemper is the President and Chief Operating Officer (and the CEO's son). The current CEO became President in 1982 at the age of 32. He has been CEO for almost 30 years. So, the bank's Chief

Operating Officer is now about the age when his father became CEO of the bank. For several generations, there has been a relatively young – less than 40 year old – member of the Kemper family who has already been made President of the bank. So, there has usually been a family member CEO and a family member heir apparent (the CEO's son) already in the President role. That is true today. In theory, a 37 year old Chief Operating Officer could be elevated to CEO and then serve for 25 years (that would make him 62 years old when he retired). In fact, it's easy to imagine John Kemper succeeds David Kemper and runs the bank for the next 25 to 30 years. That would pretty much keep with tradition.

But, it's unclear how the Kemper family keeps control of the bank long-term. The Kempers owned 6.7% of the bank in 2005. Today, they own just 3.1% of the bank. This is all the more surprising when you consider that a stake of 6.7% should have increased to maybe something like 8.5% of the company over 10 years if the family wasn't selling its shares at all. So, they didn't just sell shares to offset share buybacks. They sold shares much faster than the company bought back stock. They cut their stake by more than half in just 10 years. Obviously, 3% of the voting stock of the company doesn't do much good at all in maintaining control of the bank. So, the family controls the bank by having the Chairman and Vice Chairman roles, having the current CEO slot, and then presumably naming members of the family as replacement CEOs and replacements COOs when needed through the normal process that would take at a public company. If the current CEO, the Chairman, and the Vice Chairman are family members – you have control of the succession. That's not the same thing as having control of the company in the way George Kaiser controls BOK Financial through his huge stock ownership. He can block any deal he doesn't like to take over that bank. And he can sell the company to another buyer whenever he wants. He doesn't really need any support from other shareholders to do a deal. Nor can a deal get done to sell the company without his approval. George Kaiser truly controls BOK Financial. The Kemper family doesn't control Commerce that way.



David Kemper's stake in Commerce declined from 7% of total shares in 2006 to just 3% today.

Does it matter? Probably not. American banks don't take each other over in hostile deals. Investors don't usually build up meaningful stakes in one bank and try to exert control over that bank. Banks are rarely the targets of activist investors. So, they are basically run by the top people on the board and the top people in management. The top two board roles at Commerce are held by Kemper family members. The top two executive positions are held by Kemper family members. At a normally functioning public company whoever those people want to succeed them is who will succeed them. So, no non-Kemper family members will be in top positions unless the family wants them there. However, the Kemper family couldn't block an attractive offer to acquire the bank if proxy advisory firms said mutual funds should vote in favor of it.

What matters to us is whether lending will get riskier at Commerce over time. There's no reason to believe anyone outside the Kemper family will run the bank during the next 25 to 30 years. The family has run the bank for the last 113 years. And the bank has never needed bailout funds or a rescue of any sort during that time. Loan losses during crisis periods look good. The bank doesn't grow or change quickly. So, there is no reason to believe the culture around lending will change unless there is a transformative acquisition, a non-Kemper family member takes over as CEO, etc. And there are no signs of any of that at Commerce. In fact, Commerce will probably change slower than either Prosperity or Frost. So, despite the Kemper family's very small stock ownership – the bank should make loans in the future the way it has made loans in the past.

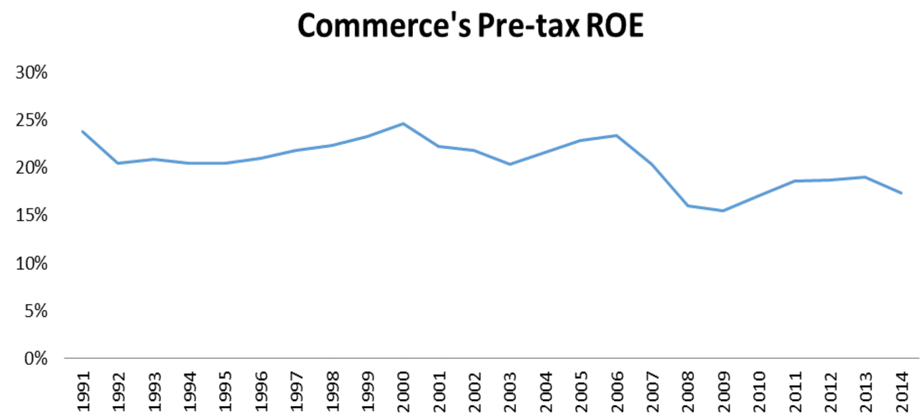
CONCLUSION

Commerce is a High Quality, Slow Growing Bank Stock that is Cheap Relative to Normal Future Earnings

After reading this issue, you may think Commerce is a solid business and a safe bank but still not want to buy it. The most likely reason for this is that there is no real urgency in why you should buy it. Commerce is a boring stock. It's family controlled. And it seems to trade at a P/E of about 12 to 17 all the time. When the stock is priced in that range, it doesn't seem like much of a bargain. But, history shows it has been. The stock has – despite being priced at a normal P/E of 12 to 17 most of the time – actually outperformed the S&P 500 over long periods of time. So, it can be a good purchase even when it doesn't seem especially cheap relative to its own past.

Commerce isn't an obvious value stock. It doesn't have a single digit P/E ratio. It doesn't have a super low price-to-book ratio. It doesn't have a very high dividend yield. These are the figures a traditional value investor would look at first. But, they aren't necessarily the best indicators of whether a stock is actually cheap or not. For example, let's say Commerce is priced to have about a 3% dividend yield and to buy back about 3% of its shares over the next year. A dividend yield of 3% seems normal. But, a dividend yield of 6% would seem really high. In reality, it is the combination of stock buyback rate and dividend yield that matters. A stock can pay a 6% dividend yield, it can buyback 6% of its shares during the year, or it can pay a 3% dividend yield and buy back 3% of its shares. These all really amount to the same thing. But, they don't show up in a value screen that looks just for a high dividend yield.

The same is true in a way of price-to-book. Many value investors like to use price-to-book when buying a bank. If a bank trades below book value – or even very, very close to book value – they consider it cheap. The problem with this approach is that it matters what a stock's normal return on equity will be. In fact, the number that really matters is often the lowest ROE the bank has because this will drag down the long-term return on equity. Book value is equity. So, the lower a bank's return on equity – the lower its return on book value. The higher a bank's return on equity is – the greater the price-to-book ratio you should pay. From 1991 through 2015, Commerce has never had a pre-tax return on equity below 15%. This means the bank has never had a normal after-tax return on equity below 10%. The average stock does not return 10% a year. So, Commerce should never trade below book value. A bank that sometimes earns a 5% return on equity could easily be worth less than book value. Commerce should always trade at a higher price-to-book ratio. That means the stock can be cheaper when it is priced at 1.5 times book value than a value investment in a lower quality bank that trades at 0.9 times book value. Value investors will tend to prefer the bank trading at 0.9 times book value over the bank trading at 1.5 times book value. But, this may be a mistake. Banks have rather persistent profitability trends. It's very easy to predict what a bank's normal profitability should be given its deposit base and a certain interest rate level.



Over the last 25 years, Commerce's pre-tax ROE has always been higher than 15% which translates into an after-tax return on equity of greater than 10% in even the worst years.

Commerce's quality is disguised by low interest rates. Low interest rates tend to make worse banks look better relative to the best banks. Consider that a bank funded completely with customer deposits would have a cost of funds around 50% of the Fed Funds Rate or lower. Meanwhile, a bank funded completely with CDs would have a cost of funds around 100% of the Fed Funds Rate. Now, assume that – like today – the Fed Funds Rate is around 0.5%. The difference between a really good bank and a really bad bank in this environment is only 0.25% in terms of funding. But, we know a 0.5% Fed Funds Rate is abnormal. What's normal? Historically, a rate around 3% or higher has been normal. Members of the Fed expect the rate to be between 3% and 4% within 5 years from now. So, let's use 3%. Now, a bank funded entirely with CDs would have a cost of funds in terms of interest that was about 3%. The bank funded entirely with customer deposits – not CDs – would almost certainly be paying less than 1.5% interest. The advantage would now be at least 1.5%. Banks use leverage. A 1.5% advantage like that becomes a 15% advantage on equity. Using this example, a bank funded almost entirely with CDs could be worth a little less than book value while a bank funded almost entirely with customer accounts could be worth a little more than double its book value – and you still couldn't be sure which stock was better. This is why normalizing earnings is so important. Commerce is a quality stock. Value investors may overlook it. But, quality investors need to consider that the bank has earned between a 15% and 25% pre-tax return on equity – which is equivalent to a 10% to 16% after-tax return on equity – every single year for the last 25 years. A lot of other banks have dipped below a 10% ROE. As long as a bank is always earning more than 10% on its equity, there is no reason for retained earnings to bring your return in the stock itself below 10%. It's only a matter of how much you pay for the stock that determines your return. This isn't true for a low quality bank. If you buy a bank at less than book value but it earns less than 10% a year on its equity – the longer you hold the bank, the more likely a return below 10% a year in the stock itself becomes.

Growth investors definitely aren't excited by Commerce. Missouri has below average GDP growth. Kansas has average GDP growth. Commerce rarely makes acquisitions of any kind. It pays out 80% to 85% of all its earnings. Growth in EPS comes from fewer shares outstanding. That's not something that excites growth investors.

So, it's possible for value investors, quality investors, and growth investors to all overlook Commerce right now. But, you don't have to pick an investing ideology. You can be a true pragmatist. Commerce stock should return between 8% and 10% a year pretty much forever as long as it follows the same capital allocation it has in the past. So, you can buy and hold the stock forever and get a better than 8% return and worse than 10% return. If your choice is between buying and holding Commerce forever and buying and holding the S&P 500 forever – there's no reason to believe Commerce will lag the index. You can afford to hold it forever. But, you don't have to. You can look at just the next 5 years. It's possible that buying and holding Commerce from 2016 through 2021, can give you a return close to 15% a year. The bank is priced at about two-thirds of what it would be worth in normal times. Interest rates should be normal within 5 years. Therefore, the stock price should rise 50% to reach normal within 5 years. This adjustment alone can provide about an 8% annual return over 5 years. That's the increase in the stock price you should see regardless of the increase in the intrinsic value of the business in normal times. You can make close to 8% a year over 5 years just from the normalization process. The buy and hold process can provide another 8% a year because Commerce can grow a tiny bit as a company over the next 5 years, it can buy back more than 2% of its shares, and it can pay a dividend of more than 2% a year. Add those underlying increases in the business to the return from normalization – and you can actually make 15% a year in this stock. So, the downside in Commerce is holding it forever and making something like 7% or 8% a year. The upside in Commerce is the Federal Reserve raising rates to 3% over the next 5 years, and then you sell Commerce stock in 2021 after making more like 14% to 15% a year over 5 years. So, the range of reasonable outcomes here for holding the stock somewhere between 5 years and forever is an annual return somewhere between 7% and 15% a year. That's actually a really, really good range for a long-term investment. Commerce doesn't fit nicely into a style box: value, quality, or growth. But, it does offer a very certain chance of an acceptable – 7% to 15% a year – return over a long (5 plus year) holding period. Any stock that has high odds of providing an adequate return over a long holding period is worthy of your investment. Commerce is a good stock to add to your bank portfolio. It can take its place next to Frost, Prosperity, and BOK Financial.

Commerce Bancshares (NASDAQ: CBSH)

Appraisal Value: $69.91

Price-to-Appraisal Value: 70%

Commerce Owner Earnings	(in millions)
Earning Assets	
Short-term Investments	$1,261
+ Securities	$9,591
+ Loans	$11,734
= Earning Assets	$22,587
Deposit	
Free Funding	$4,138
+ Commercial Demand Deposits	$4,100
+ Interest-bearing liabilities	$14,349
= Total Funding	$22,587
Assumptions	
Fed Funds	3.00%
Cost of commercial demand deposit	1.50%
Cost of Interest-bearing liabilities	2.28%
Margin on Interest-bearing Liabilities	
Net Interest Spread	3.72%
- Charge-offs	0.29%
= Margin on Interest-bearing Deposits	3.42%
Margin on Free Funding	
Margin on Interest-bearing Liabilities	3.42%
+ Cost of Interest-bearing Liabilities	2.28%
= Margin on Free Funding	5.70%
Margin on Commercial Demand Deposits	
Margin on Free Funding	5.70%
- Cost of Commercial Demand Deposits	1.50%
= Margin on Commercial Demand Deposits	4.20%
Weight of Funding	
Free Funding	18%
Commercial Demand Deposits	18%
Interest-bearing Deposits	64%
Weighted Average Margin	
Free Funding	1.04%
+ Commercial Demand Deposits	0.76%
+ Interest-bearing Deposits	2.17%
= Weighted Average Margin	3.98%
Return on Earning Assets	
Weighted Average Margin	3.98%
- Operating Costs	1.03%
= Return on Earning Assets	2.95%
Pre-tax Owner Earnings	
Earning Assets	$22,587
* Return on Earning Assets	2.95%
= Pretax Owner Earnings	$667

Business Value

Commerce's business value is $6,670 million.

- Pre-tax owner earnings are $667 million
- Fair multiple = 10x pre-tax owner earnings
- $667 million * 10 = $6,670 million

Fair Multiple

Commerce's business is worth 10x pre-tax owner earnings

- Commerce has above average quality
- But it doesn't have the capacity to reinvest

Share Value

Commerce's stock is worth $69.91 a share

- Business value is $6,670 million
- Preferred stock: $145 million
- Equity Value is $6,525 million
- $6,670 million - $145 million = $6,525 million
- Equity Value = $69.91/share
- 93.34 million outstanding shares
- $6,525 million / 93.34 million = $69.91

Price to Appraisal Value

Commerce is trading at 70% of its value.

- Business Value = $6,670 million
- Enterprise Value = $4,672 million
- $4,672 million / $6,670 million = 70%

	EV/Earning Assets	EV/Deposit	EV/EBT	EV/Owner Earnings
UMB Financial	0.15	0.18	13.01	6.64
BOK Financial	0.17	0.22	10.29	6.17
Enterprise Financial	0.18	0.20	12.91	11.59
Great Southern Bancorp	0.20	0.23	9.83	8.93
U.S. Bancorp	0.22	0.28	10.95	8.20
Minimum	0.15	0.18	9.83	6.17
Maximum	0.22	0.28	13.01	11.59
Median	0.18	0.22	10.95	8.20
Mean	0.18	0.22	11.40	8.31
Standard Deviation	0.02	0.04	1.48	2.15
Variation	14%	16%	13%	26%
Commerce Bancshares (Market Price)	0.21	0.24	11.74	7.00
Commerce Bancshares (Appraisal Value)	0.30	0.34	16.79	10.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

SINGULAR DILIGENCE

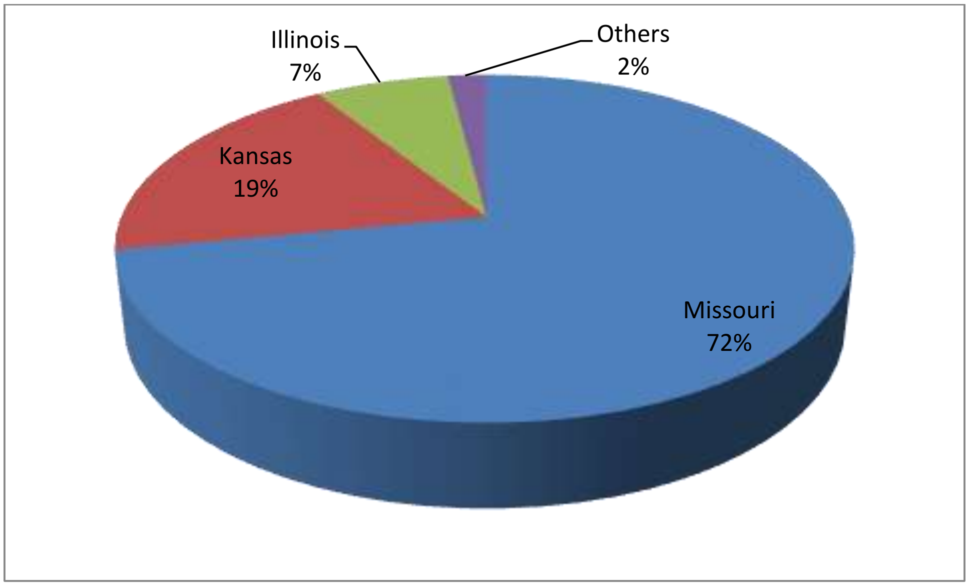
NOTES

Commerce Bancshares

NASDAQ: CBSH

Overview

Commerce Is a Super Community Bank in the Midwest



Commerce gets 98% of its deposits from Missouri, Kansas and Illinois

- Commerce was founded by Francis Reid Long
    - In 1865
    - As Kansas City Savings Association
    - With $10,000 in capital
- It became Commerce Bank
    - In 1903
    - William Thornton Kemper, Sr. was its first President
- Commerce was briefly placed into receivership by the Comptroller of Currency
    - In 1907
    - Following the Panic of 1907
    - Commerce paid its depositors
    - And ownership was returned to its owners
- Commerce has been much less "eventful" than most banks ever since
    - It survived a bank run during the Great Depression[1]
        - In 1933
    - Missouri doesn't have exposure to energy like Texas
        - Commerce didn't have any problem like Frost in 1980s
    - Commerce survived the savings and loan crises in 1989-1990
        - Its net charge-offs was just 0.48% in 1991

    - It was among 8 of the top 50 banks that refused TARP in 2008
        - The housing bubble wasn't big in its markets
        - From 2002 to 2007
            - Average housing price in its markets increased 27%[2]
                - National average: 47%
            - Personal income was similar
            - => housing is more affordable in the Midwest
        - Net charge-offs/average residential mortgage loans peaked at only **0.18%**
- Commerce's management is very stable
    - It's now in the 5th generation of the Kemper family
    - William Thornton Kemper became President in **1903**
    - James Kemper Sr. became President in **1925**
        - He's William Thornton Kemper's son
        - Became chairman in 1938
    - James Kemper Jr. became President in **1955**
        - He joined Commerce in 1946 as an assistant cashier
    - David Kemper became President and COO in **1982**
        - He's James Kemper Jr.'s son
        - He has been CEO since 1986
    - John Kemper became President and COO in 2013
        - He's David Kemper's son
- Commerce today has banking operations in 5 states
    - Missouri
    - Kansas
    - Central Illinois
    - Oklahoma
        - Tulsa
        - Colorado
    - Colorado
        - Denver
- It has

    195 full-service branches
    - 392 ATMs
    - Over $19 billion deposits
- 91% of deposits are from Missouri and Kansas
    - Missouri: 72%

- Kansas: 19%
    - Illinois: 7%
    - Others: 2%
- 2/3 of deposits are from Kansas City and St. Louis
    - Kansas City, Missouri: 33%
    - St. Louis, Missouri: 32%
    - Wichita, Kansas: 5%
    - Bloomington, Illinois: 3%
    - Peoria, Illinois: 2%
    - Others: 25%
- It has the third largest by deposit market share in Missouri
    - U.S. Bancorp: 11.21% market share
    - Bank of America: 9.02%
    - Commerce's market share: **8.85%**
    - UMB Financial: 6.57%
    - Central Bancompany: 4.83%
- It has the second largest deposit market share in Kansas
    - Bank of America's market share: 8.13%
    - Commerce's market share: **5.29%**
    - Intrust Financial: 4.67%
    - U.S. Bancorp: 3.44%
- It offers a wide range of products and services
    - For consumers
        - Debit and credit cards
        - Personal mortgage banking
        - Consumer installment lending
        - Wealth management
            - Trust and estate tax planning services
            - Brokerage services
            - Advisory and discretionary investment portfolio management services
    - For business
        - Business lending and leasing
        - Merchant and commercial bank card products
        - Cash management services
        - Wealth management
- Commerce makes about **41%** of revenue from fee-based businesses

- Bank card transaction fees: **17%** of total revenue
  - Sells services like
    - Merchant services
    - Commercial cards
    - Purchasing card
      - Payable payments processing
  - Commerce is
    - The 7th largest purchasing card issuer
    - The 17th largest commercial card issuer
    - The 11th largest acquiring bank
- Trust fees: **11%**
- Traditional banking service fees: **7%**
- Other: **6%**

- Commerce see the payment systems business as its most valuable franchise
  - Help build relationship with customers
  - Secure low-cost deposits
    - Deposits/total liabilities: 90%
    - Core deposits/total liabilities: 81%
    - Deposit mix
      - Noninterest-bearing deposits: 34%
      - Savings, interest checking, and money market: 54%
        - These deposits cost less than 50% of Federal fund rates
      - Time deposit: 12%
- Low funding cost and low operating costs allows Commerce make
  - 10% after-tax ROE in bad years
  - 15-20% after-tax ROE in normal years
- It doesn’t have high growth
  - Deposit grew only 5.6% annually over the last 25 years
- => Commerce has a lot of excess cash
  - It returned 82% of total earnings over the last 22 years
    - Dividends: 1/3 of earnings
    - Share buyback: ½ of earnings
- Its earnings is currently depressed by low interest rates
  - At $46 per share, it’s trading at 2/3 of its intrinsic value
  - It’s a solid value stock

[1] "UMB and Commerce have survived tough times in the past: Bank runs were common in the 1890s in the Midwest, as crop failures hit wide swaths of the population and squeezed entire communities financially.

Commerce, opened in Wild West Kansas City in 1865 by W.T. Kemper, made it through those runs on skill and goodwill. It backed some smaller banks in trouble and saw the favors returned when it faced hard times.

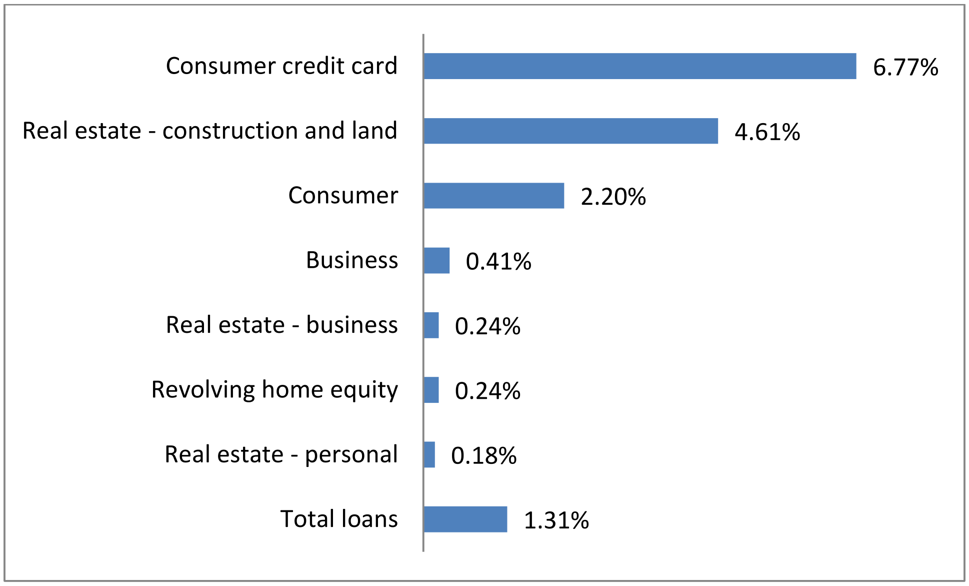
During the Depression, UMB CEO R. Crosby Kemper Sr. reached out to customers after business hours, unheard of then, to quell their fear.

In March 1933, Commerce Bank CEO W.T. Kemper dealt with a run on his bank with apples: He bought them at the farmer's market and cheerily handed them out to panicked customers in line." – All in the Family: Missouri Cousins Run 2 Top-Ranked Banks, Sharon Silke Carty, USA Today, 27 May 2010

[2] "Residential development and home values have become a significant challenge for the national economy. **The average housing price in our markets appreciated 27% in the last five years compared to a national average of 47%. Since personal income in our markets is similar to national averages, housing is more affordable in the Midwest**, and we expect less relative pressure on prices in our markets." – Commerce's 2007 Annual Report

Durability

Commerce Has Never Needed Bailout Money during Its 150-year History



Commerce's net charge-offs was 1.31% of total loans in 2009

- **Biggest Negative**:
  - 12.7% of loans are risky loans
  - Marine and RV: 1.7%
  - Credit card: 7%
  - Real Estate – Construction and land: 4%
- Commerce has been in the business for 150 years
  - Currently in the 5th generation of the Kemper family
  - It has never needed bailout money
  - It was among the only 8 of the largest 50 banks to decline TARP
    - In 2008
- Commerce has a strong culture
  - Employees who stay at Commerce for 10 years are newbies[1]
  - Commerce focuses on 4 metrics[2]
    - Topline growth
    - Pretax profit growth
    - Employee engagement
      - **94%** of employees are satisfied or better
        - The industry's average ratings: 70-75%
      - Commerce's employees know

        - What they do in their departments
        - What they do in their daily jobs
        - How that contributes to CBSH's success
        - => They're motivated
    - Customer satisfaction
      - It's consistently ranked highest for customer satisfaction
        - In the Midwest
  - Commerce remains a community bank despite its size[3]
    - Flat organization
    - 300 community directors
      - They're the eyes and ears of the organization
      - They understand the local markets
    - Commerce can hook up the top 10 markets every Monday mornings[4]
      - 100 people on the phone
      - Talk about what Commerce is going to do that week
      - Large banks can't do that
- Commerce has conservative lending
  - Loans mix
    - Business loans: 35%
    - Real estate – Construction and land: 4%
    - Real estate – Business: 20%
    - Real estate – Personal: 16%
    - Consumer: 14%
      - Passenger vehicle: 8.5%
      - Marine: 0.4%
      - RV: 1.3%
      - Fixed-rate home equity loans: 2.6%
      - Others: 1.2%
    - Revolving home equity: 4%
    - Consumer credit card: 7%
  - It doesn't avoid risks by avoiding some types of loans like Frost
    - It makes a lot of real estate and consumer loans
    - Consumer and mortgage loans: 41% of total loans
    - Real estate: 40% of total loans
  - Its net charge-offs/average loans is low in each type of loans
    - The average charge-offs was 0.46% over the last 24 years

        - The highest was 1.31% in 2009
    - Commerce's charge-offs is about one half of the industry
        - Industry's average net charge-offs is 0.93% since 1996
            - Was 2.5% in 2009-2010
- Commerce has higher charge-offs than Frost and BOKF in 2009
    - Commerce: 1.31%
    - Frost: 0.58%
- This is because Commerce is active in some riskier types of loans
    - Real estate – construction and land: **4%** of total loans
        - Average net charge-offs was **0.34%** over 24 years
        - Net charge-offs was
            - 2008: 0.89%
                - Industry: 2.63%
            - 2009: **4.61%**
                - Industry: 5.4%
            - 2010: 2.69%
                - Industry: 5.45%
            - 2011: 1.66%
                - Industry: 3.33%
            - (Commerce recovered some of these loans after)
            - 2012: **-**0.08%
                - Industry: 1.77%
            - 2013: **-**1.24%
                - Industry: 0.52%
            - 2014: **-**0.37%
                - Industry: 0.03%
    - Consumer loans: **14%**
        - These are mostly loans secured by
            - Passenger vehicles
            - Marine and recreational vehicles
        - Average net charge-offs was **0.63%** over 24 years
        - Net charge-offs was
            - 2008: 1.28%
                - Industry: 2.13%
            - 2009: **2.20%**
                - Industry: 2.97%
            - 2010: 1.64%

        - Industry: 2.05%
    - 2011: 1.09%
        - Industry: 1.25%
    - 2012: 0.69%
        - Industry: 1.02%
    - 2013: 0.52%
        - Industry: 0.85%
    - 2014: 0.54%
        - Industry: 0.77%
- The main problem was Marine and RV loans[5]
    - These loans were **50%** of consumer loans in 2009
    - Consumers don't use their boats and RV in recessions
    - => prices of those assets go down
    - => higher credit losses
    - Net charge-offs on these loans were[6] [7] [8]
        - 2007: 0.6%
        - 2008: 1.7%
        - 2009: 3.0%
        - 2010: 2.5%
    - => these loans account for 1.5% net charge-offs on consumer loans in 2009
        - Total loans charge-offs on consumer loans were 2.2% in 2009
        - => charge-offs on automobile and other consumer loans were **1.4%** in 2009
- These loans declined to **12%** of consumer loans in 2014

- Consumer Credit card: **7%** of loans
    - Average net charge-offs was **3.5%** over 24 years
    - Net charge-offs was
        - 2008: 4.06%
            - Industry: 5.44%
        - 2009: **6.77%**
            - Industry: 9.10%
        - 2010: 6.28%
            - Industry: **10.08%**
        - 2011: 4.23%

        - Industry: 5.45%
    - 2012: 3.35%
        - Industry: 3.95%
    - 2013: 3.34%
        - Industry: 3.35%
    - 2014: 3.28%
        - Industry: 3.12%
- Commerce's real estate loans performed very well
    - Business real estate loans: **20%** of total loans
        - (excluding commercial construction and land)
        - About 50% of these loans are owner-occupied
        - Average net charge-offs was **0.07%** over 24 years
        - Max net charge-offs was 0.70% in 1991
        - Net charge-offs was only 0.24% in 2009
- Residential real estate: **16%** of total loans
    - Average net charge-offs was **0.05%** over 24 years
    - Max net charge-offs was 0.19% in 2011
    - Net charge-offs was only 0.18% in 2009
        - Industry: 1.72%
    - Commerce has never made subprime loans
        - Never made reduced-document loans
        - Never acquired mortgage loans from brokers
    - Commerce stayed below 80% loan-to-collateral value
        - (LTV)
        - The breakdown of its mortgage loans in 2006
            - Loans with interest only payments: 2.3%
            - Loans with less than 80% LTV: **86.6%**
            - Loans with 80-90% LTV: 5.9%
            - Loans with 90-100% LTV: 4.7%
            - Loans with more than 100% LTV: 0.5%
    - Commerce retains most of its loans
        - Retains all adjustable rate mortgage loans
            - (ARM)
            - About 63% of the portfolio in 2006
            - About 32% of the portfolio in 2014
        - Retains certain 15-year fixed rate loans
            - About 37% of the portfolio in 2006

            - About 68% of the portfolio in 2014
        - Midwest doesn't have big boom and burst[9]
            - From 2002 to 2007
                - Average housing price in Commerce's markets increased 27%[10]
                    - National average: 47%
                - Personal income was similar
                - => housing is more affordable in the Midwest
    - Revolving home equity loans are very safe
        - **4%** of total loans
        - Average charge-offs was **0.17%** over 24 years
        - Max net charge-offs was 0.41% in 2010
    - Commerce's C&I loans performed better than Frost
        - 35% of Commerce's total loans
        - Average net charge-offs was **0.09%** over 24 years
            - Frost's 24-year average: 0.29%
        - Max net charge-offs was **0.41%** in 2009
            - Industry in 2009: 2.36%
            - Frost in 2009: 0.85%
- => **75%** of Commerce's loans are very safe
    - **25%** of Commerce's loans are riskier
        - Including
            - Consumer loans: 14%
            - Credit card: 7%
            - Real estate – Construction and land: 4%
        - **12.7%** of Commerce's loans are truly risky
            - Marine and RV: 1.7%
            - Credit card: 7%
            - Real Estate – Construction and land: 4%
        - Even if net charge-offs is 10% for its risky loans
            - => only **1.3%** negative impact on the loan portfolio
- Commerce's securities portfolio is very safe
    - Never had exposure to subprime mortgage
    - The portfolio is currently $9.1 billion, including[11]
        - Agency mortgage-backed securities: **28%**
            - $2.5 billion
            - Issued by agencies including

                - FNMA
                - GNMA
                - FHLMC
                - FHLB
                - Federal Farm Credit Banks
                - FDIC
        - Non-agency MBS: 7.5%
            - $682 million
        - Asset-backed securities: **27%**
            - $2.5 billion
            - Very high quality asset-backed securities in
                - Credit cards
                - Automobile
                - Student lending
            - Offset the duration in MBS and the municipal portfolio
                - Weighted average maturities: 2.4 years
                    - Duration is shorter
                - Weighted average yield: 1.1%
        - State and municipal obligations: **20%**
            - $1.8 billion
        - U.S. Government: **14%**
            - $1.3 billion
    - The portfolio's duration is 2.9 years
- Commerce's liquidity is great
    - Deposits/total liabilities: 90%
        - Deposits: $19.3 billion
        - Total liabilities: $21.4 billion
    - Core deposits/total liabilities: 81%
        - Core deposits don't include time deposits
            - $2 billion
    - Commerce has **$1.8 billion** in short-term investments
    - The securities portfolio's duration is 2.9 years
        - 12-month maturities: **$1.6 billion**
    - More than **$3 billion** of loans mature within 12 months
    - 79% of loans mature within 5 years
        - $9 billion

[1] "**We have a very engaged team of long tenure. Somebody that's been with us for 10 years is a short-timer. We still look at them kind of as a newbie and that's just sort of the culture at Commerce and it's been very successful for us**. We have consistent execution, we hold people accountable and we give them good opportunities to develop themselves.

And all of that relates to really strong engagements scores, something we've been measuring for a long time. **Our employee engagement at 94% is better than financial services companies**, it's better than the US high-performance companies in general. It has gotten better every year. The key thing to that is our **people know what they do in their departments and what they do in their daily jobs, how that contributes to our company's success. They know that and they're very motivated**. They're personally motivated and they say that and they follow up with their actions and they do whatever they can to make Commerce Bank successful. People are proud to work at Commerce. We've got a good model; we've done well in the crisis and really, this has gotten nothing but stronger for us over time." – Charles Kim, Commerce's CFO, KBW Regional Bank Conference, 27 February 2013

[2] "**We try to measure our organization on four basic metrics, so we talk about topline growth, about pretax profit growth, and then the other two cornerstones are employee engagement and customer satisfaction**. We take that very seriously and this just gives you an indication about -- we talk about Commerce Bank engagement, something we do every year. And you can get a proxy for the industry but you can see on that bottom line, we are significantly ahead of the market and also you can only go so high but we have continued to have improvement in people's attitudes, banker's attitudes, and how they feel about the Company.

We try to talk a lot about being owner managers. **We have a bank incentive stock program and a lot of people have that, but we really take that very seriously and try to get long-term ownership of the bank**. **We think that's the best model where the employees really feel like they are owners of the organization** because we emphasized all the time that you have got to make long-term decisions to increase the value of the franchise." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[3] "We talk a lot about being a super community bank and the idea is that we are a community bank, a flat organization that we are very close to the market. **We**

have 300 community directors, a lot of banks have gone away from that, but we feel they are a very helpful group in being the eyes and ears of the organization. **And we understand what the market is, so we operate like a community bank**. We've got a very strong culture. I will talk about that in a minute.

We think we have an advantage over the very large national banks, B of A and U.S. Bank would be our two major competitors in our large markets. **At the same time, at $18 billion, we have scale, so especially in businesses like the payment system and money management**, we are large enough and compete very effectively against any of the large providers throughout the country." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[4] "And I think we've got the right kind of super community model to provide the service level and there's no question because I see it every day that we can outcompete the very large banks. I think one lesson that's been learned the last couple of years is **very large organizations are very difficult to manage. We've got the kind of culture that we think we can get everybody in one room**.

Just for an example, **every Monday morning we hook up our top 10 markets and we've got about 100 people on the phone. We talk about what we're going to do that week. We can do that in our organization. Large banks can't do that and small banks just don't have the product line**. So we think it's an excellent model in the market that should improve and even though it's going to be difficult operating environment the next year, we are very optimistic in the long run." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[5] "**The consumer is not using his boat and is driving less in his RV and the prices of those assets have gone down. And so we, like everybody else, are taking higher losses**. I guess the good news is that portfolio is going down.

We have basically done it had out lot more (inaudible) than everybody else has. That's something which is going to have to work through. I think the biggest challenge is to change with the consumer is that they are going to have -- **they're not going to have a lot of discretionary items like boats and RVs and so the used prices of those have already come down. So everybody is taking more losses if you have to repossess one of those assets.**

And people are just -- they're very concerned about unemployment and they are just being more conservative. So as I mentioned, we have had higher losses in that area. We think that is going to continue as unemployment is weak and well, I just have to work through it." – Unidentified Company Representative, Commerce's 2009 Shareholder Meeting

[6] "**Approximately 29% of the consumer portfolio consists of automobile loans, 51% in marine and RV loans and 9% in fixed rate home equity lending**. As mentioned above, total consumer loans declined $2.3 million in 2008 as a result of a decline in auto lending, which decreased $15.6 million, or 3.2%, but was offset by a $27.6 million increase in marine and RV lending. Since July 2008 and in conjunction with the Company's decision to reduce marine and RV originations, these loans have declined $38.7 million. Net charge-offs on consumer loans were $21.4 million in 2008 compared to $9.5 million in 2007. Net charge-offs increased to 1.3% of average consumer loans in 2008 compared to .6% in 2007. **The increase in net charge-offs in 2008 compared to 2007 was mainly due to higher marine and RV charge-offs. Net charge-offs on marine and RV loans were $9.9 million higher in 2008 compared to 2007, and were 1.7% of average marine and RV loans in 2008 compared to .6% in 2007**." – Commerce's 2008 10-K

[7] "**Approximately 28% of the consumer portfolio consists of automobile loans, 50% in marine and RV loans and 10% in fixed rate home equity lending**. As mentioned above, total consumer loans declined $281.7 million in 2009 as a result of a decrease of $156.0 million in marine and RV loans, due to the Company's decision in 2008 to cease most marine and RV lending. In addition, auto lending declined $97.0 million, or 20.8%. Net charge-offs on consumer loans were $32.2 million in 2009 compared to $21.4 million in 2008. Net charge-offs increased to 2.2% of average consumer loans in 2009 compared to 1.3% in 2008. **The increase in net charge-offs in 2009 compared to 2008 was mainly due to higher marine and RV charge-offs. Net charge-offs on marine and RV loans were $8.3 million higher in 2009 compared to 2008, and were 3.0% of average marine and RV loans in 2009 compared to 1.7% in 2008.**" – Commerce's 2009 10-K

[8] "Approximately 66% of consumer loans outstanding were originated indirectly from auto and other dealers, while the remaining 34% were direct loans made to consumers. **Approximately 28% of the consumer portfolio consists of automobile loans, 46% in marine and RV loans and 11% in fixed rate home equity lending**. As mentioned above, total consumer loans declined $169.4 million in 2010 as a result of a decrease of $135.8 million in marine and RV loans, due to the Company's decision in 2008 to cease most marine and RV lending. In addition, auto lending declined $40.8 million, or 11.0%. Net charge-

offs on consumer loans were $20.5 million in 2010 compared to $32.2 million in 2009. Net charge-offs decreased to 1.6% of average consumer loans in 2010 compared to 2.2% in 2009. **Consumer loan net charge-offs included marine and RV loan net charge-offs of $14.8 million, which were 2.5% of average marine and RV loans in 2010, compared to 3.0% in 2009**." – Commerce's 2010 10-K

[9] "**This is our markets. You've got St. Louis and Kansas City, which is sort of the biggest part. We are actually dually headquartered**. I'm in St. Louis. Jeff, my chief accounting officer, is in Kansas City. We have a fair amount of rivalry between the Cardinals and the Royals. The Royals happened to be good this year, which is sort of exceptional. But we are -- there's some advantages to us being dually headquartered. We are kind of a hometown bank in both of those places and that serves as pretty well in the trust business and sort of the middle-market/commercial. There's a fair amount of travel between Kansas City and St. Louis, but the inefficiency we think we have sort of worked out on that.

Our community markets tend to be the surrounding Missouri/Kansas markets and then you get into what I would call kind of our commercial expansion markets, Tulsa and Oklahoma City in Oklahoma; Denver; Nashville; Cincinnati; and Dallas. The reason we are there, the population dynamics are a little bit better, a little bit better population growth. Tends to be pretty good household income across all those markets. **We are in the Midwest. The bad news is we don't boom. The good news is we don't bust. And that's served us pretty well.**" – Chuck Kim, Commerce's CFO, Raymond James U.S. Bank Conference, 09 September 2015

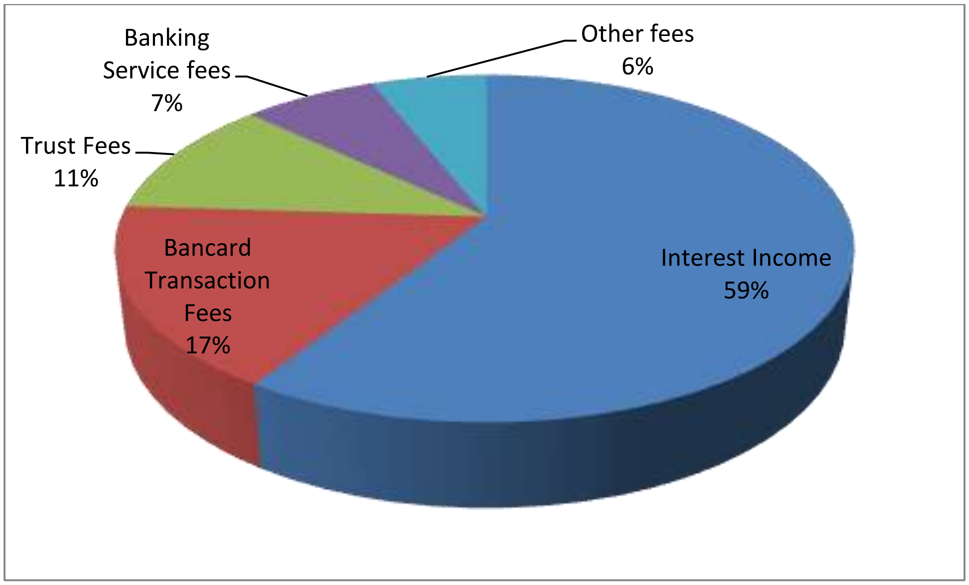
[10] "Residential development and home values have become a significant challenge for the national economy. **The average housing price in our markets appreciated 27% in the last five years compared to a national average of 47%. Since personal income in our markets is similar to national averages, housing is more affordable in the Midwest**, and we expect less relative pressure on prices in our markets." – Commerce's 2007 Annual Report

[11] "Here's the investment portfolio, which is big, about $9.2 billion, I think, as of June 30. It's pretty short. **You can see the duration about 2.9 years. We've got a lot of cash, 12-month maturities $1.6 billion, so there's a fair amount of cash coming at us**. So how do we do that? Again we sort of stay different from most peers. **The mortgage-backed securities are only about 36% of what we have.**

We have a pretty big municipal portfolio, at 20% there I think. And then other asset-backed which are critics side, automobile pretty short the other asset back weighted average rate 1.1%, the average life 2.4 years, so that's kind of the character of our bond portfolio. Yields have been kind of getting flat on us which is good that they have not been going down quite as much. But a very short high-quality bond portfolio. And really the story going forward is we would like to swap bonds for loans and we've been doing some of that over the last couple of years. I think the bond portfolio probably reached a peak of about $10 billion." – Chuck Kim, Commerce's CFO, Raymond James U.S. Bank Conference, 09 September 2015

Moat

A Broad Range of Products and Services Helps Commerce Secure Its Sticky Customer Base



Fees are 41% of Commerce's total revenue

- **Biggest Negative**:
  - Consumer loans are usually commoditized
    - Car loans
    - Mortgage loans
    - Credit card
- **Michael Porter questions for the banking industry**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Is the threat of new entrants high or low?
      - **(-)** About 1-2% new FDIC charters in 2002-2008
      - Almost no new FDIC charters after 2009
    - Is the bargaining power of buyers high or low?
      - **(+)** Borrowers care about rates and terms
    - Is the threat of substitutes high or low?
      - **(-)** No threat of substitutes
      - Online banking isn't a threat

            - People need physical branches for services
        - Is the bargaining power of suppliers high or low?
            - **(=)** Suppliers of money
                - Low for checking accounts
                - High for CDs
            - **(-)** Staff costs are 50-60% of noninterest expenses
                - Bankers are generally not unionized
        - Is the rivalry within the industry high or low?
            - **(+)** banks compete aggressively for loans
    - **For the company**
        - Is the threat of new entrant different for this company specifically?
            - **(-)** similar to the industry
        - Is the bargaining power of buyers different for this company specifically?
            - **(-)** 45% of loans are relationship-based
                - C&I loans are 35% of total loans
                - Business real estate loans: 20% of total loans
                    - About ½ are owner-occupied
        - Is the threat of substitutes different for this company specifically?
            - **(-)** no threat of substitutes
        - Is the bargaining power of suppliers different for this company specifically?
            - **(-)** time deposit is just 12% of total deposits
                - Noninterest bearing deposit are 34% of total deposits
            - Total deposits are 90% of total liabilities
        - Is the rivalry within the industry different for this company specifically?
            - **(+)** similar to the industry
- **Michael Porter Questions for fee-based businesses**
    - Commerce has a significant fee-based business
        - **41%** of total revenue
        - 2014 revenue: $436 million, including
            - Bankcard transaction fees: $176 million
                - **40%** of total fees
                - **17%** of total revenue
            - Trust fees: $112 million
                - **26%** of total fees

                - **11%** of total revenue
            - Traditional banking service fees: $79 million
                - **18%** of total fees
                - **7%** of total revenue
            - Other fees: $69 million
                - **16%** of total fees
                - **6%** of total revenue
        - Bankcard is a very big business for a bank of its size
            - Sells services like
                - Merchant services
                - Commercial cards
                - Purchasing card
                    - Payable payments processing
            - Commerce is
                - The 7th largest purchasing card issuer
                - The 17th largest commercial card issuer
                - The 11th largest acquiring bank
            - For comparison
                - Commerce is smaller than BOK Financial and Frost
                    - Commerce's assets: $24 billion
                    - Frost: $28 billion
                    - BOK Financial: $31 billion
                - Commerce's bankcard transaction revenue: $176 million
                    - BOK Financial: $124 million
                    - Frost: doesn't exist
        - Commerce's wealth management business is comparable to BOK and Frost
            - Trust fees
                - Commerce: $112 million
                - BOK: $116 million
                - Frost: $106 million
    - **Questions for the industry**
        - Is the threat of new entrants high or low?
            - **(-)** barrier to entry is high for payment systems
            - (**+)** barrier to entry is low for wealth management
        - Is the bargaining power of buyers high or low?

            - **(-)** Payment systems customers are sticky
            - (**-)** Wealth management customers accept standard fees
        - Is the threat of substitutes high or low?
            - **(-)**
        - Is the bargaining power of suppliers high or low?
            - **(-)** low for payment systems
                - Employees may have power in wealth management
        - Is the rivalry within the industry high or low?
            - **(-)** competitors don't compete on price
    - **Questions for the company**
        - Is the threat of new entrant different for this company specifically?
            - **(-)** similar to the industry
        - Is the bargaining power of buyers different for this company specifically?
            - **(-)** similar to the industry
        - Is the threat of substitutes different for this company specifically?
            - **(-)** similar to the industry
        - Is the bargaining power of suppliers different for this company specifically?
            - **(-)** similar to the industry
        - Is the rivalry within the industry different for this company specifically?
            - **(-)** similar to the industry
- Deposit geographical mix
    - (Based on FDIC data on June 30, 2015)
    - By state
        - Missouri: 72%
        - Kansas: 19%
        - Illinois: 7%
        - Others: 2%
    - By Metropolitan Statistical Area (MSA)
        - Kansas City, Missouri: 33%
        - St. Louis, Missouri: 32%
        - Wichita, Kansas: 5%
        - Bloomington, Illinois: 3%
        - Peoria, Illinois: 2%
        - Others: 25%

- Market share
    - (Based on FDIC data on June 30, 2015)
    - Commerce's total deposits: $19,291,998
    - Market share by states
        - Missouri: **72%** of Commerce's deposits
            - Commerce's deposits: **$13,913,232**
            - Commerce's market share: **8.85%**
            - #3 market share
                - U.S. Bancorp: 11.21%
                    - #1
                - Bank of America: 9.02%
                    - #2
                - UMB Financial: 6.57%
                    - #4
                - Central Bancompany: 4.83%
                    - #5
        - Kansas: **19%** of Commerce's deposits
            - Commerce's deposits: **$3,607,092**
            - Commerce's market share: **5.29%**
            - #2 market share
                - Bank of America: 8.13%
                    - #1
                - Intrust Financial: 4.67%
                    - #3
                - U.S. Bancorp: 3.44%
                    - #4
        - Illinois: **7%** of Commerce's deposits
            - Commerce's deposits: $1,288,817
            - Commerce's market share: 0.28%
    - Market share by MSA
        - Kansas City, Missouri: **33%** of Commerce's total deposit
            - Commerce's deposits: **$6,386,850**
            - Commerce's Market share**: 13.04%**
            - #2 market share
                - UMB Financial: 18.70%
                    - #1
                - Bank of America: 9.71%

        - #3
    - U.S. Bancorp: 6.14%
        - #4
    - Valley View Bancshares: 4.78%
        - #5
- St. Louis, Missouri: **32%** of Commerce's total deposit
    - Commerce's deposits: **$6,179,994**
    - Commerce's market share: **6.88%**
    - #3 market share
        - U.S. Bancorp: 15.44%
            - #1
        - Bank of America: 11.86%
            - #2
        - Stifel Financial: 4.81%
            - #4
        - Regional Financial Corporation: 3.14%
            - #5
- Wichita, Kansas: **5%** of Commerce's total deposits
    - Commerce's deposits: **$879,936**
    - Commerce's market share: **6.10%**
    - #4 market share
- Bloomington, Illinois: **3%** of Commerce's deposits
    - Commerce's deposits: **$562,297**
    - Commerce's market share: **4.10%**
    - #2 market share
        - Behind Heartland Bancorp
            - 4.25% market share
- Peoria, Illinois: **2%** of Commerce's deposits
    - Commerce's deposits: **$439,825**
    - Commerce's market share: **6.29%**
    - #5

- Commerce's moat is its **high retention rate**
- High retention rate is durable as a result of
    - Nature of the product
        - Banking customers don't change their primary bank account often
        - Payment systems and cash management services are integrated into daily operations of commercial customers

        - Wealth management:
            - For some reasons, trust clients aren't as fickle as investors of mutual funds or hedge funds
            - Retention rate is 95%[1]
    - Services
        - Commerce call itself "super community bank" [2]
            - Flat organization
            - Operates like a community bank
                - 300 community directors
            - Large enough for (23)
                - Payment system
                - Money management
        - For consumer:
            - Good service leads to customer satisfaction
            - Commerce is consistently ranked highest for customer satisfaction
                - In the Midwest
        - For commercial and private banking customers
            - Additional services reinforce customer relationship
                - Wealth management
                - Commercial cards
                - Merchant services
                - Treasury services
                - Etc.
        - Payment systems is the key for Commerce to gain market share[3]
            - Commerce is
                - The 7th largest purchasing card issuer
                - The 17th largest commercial card issuer
                - The 11th largest acquiring bank
            - Commerce has sales force to sell its payment systems service in 48 states
            - Core relationship starts with payment systems[4]
                - Then cross-sell
                    - Traditional banking products
                    - Wealth management
- Commerce's moat is reinforced by its low-cost advantage
    - Low cost of funding

        - Getting a lot of core deposits from customers
            - It takes a new branch at least 3 years to get $30 million deposits
        - Noninterest-bearing deposits are **34%** of total deposits
    - Low operating cost
        - Leveraging of operating expenses at each branch
        - Leveraging of customer relationship
            - A lot of fee-based revenue
        - Net operating cost is just **1.03%** of earning assets
- Low cost of funding
    - Deposit mix
        - Noninterest-bearing: 34%
            - Industry average: **18.7%**[5]
        - Savings, interest checking, and money market: 54%
        - Time deposits: 12%
    - Commerce's liabilities base cost much less than the industry
        - Commerce
            - Deposits: **81%**
                - Noninterest-bearing: **28%**
                - Interest-bearing: **53%**
            - Other interest-bearing liabilities: **8%**
                - Mostly consist of fed funds
            - Equity and other noninterest-bearing liabilities: **11%**
        - The industry
            - Based on McKinsey report in 2013
            - Deposit: **49%**
                - Ranged between 40-49% from 2002 to 2012
                - Noninterest bearing is about 20% of total deposits
                    - **10%** of total funding
            - Senior debt: **15%**
            - Repo: **6%**
            - Other liabilities: **18%**
            - Equity: **10%**
        - Commerce pays interests on 61% of its assets
            - The interest rate is about 75% of fed funds
        - The industry pays interests on 78% of its assets
            - The interest rate should be more than **75%** of fed funds

        - 3% federal fund rates can give Commerce more than **0.4%** cost of funding advantage
            - Commerce cost: 61% * 75% * 3% = 1.3725%
            - Industry cost: more than 78% * 75% * 3% = 1.755%
            - 1.755% - 1.3725% = 0.38%
    - Of the banks we looked at, only Frost, UMB Financial, and First Financial have lower cost of funding
        - Commerce's funding cost advantage over peers is
            - = median (each peer's funding cost – Frost' funding cost)
                - Since 1991
            - Frost: -0.25%
            - UMB Financial: -0.15%
            - First Financial: -0.08%
            - Bank of Hawaii: 0.15%
            - Prosperity Bancshares: 0.16%
            - Wells Fargo: 0.29%
            - U.S. Bancorp: 0.42%
            - BOK Financial: 0.67%
            - International Bancshares: 0.67%
            - Texas Capital: 0.67%
            - Southside: 0.84%
            - Banks with more than $10 billion assets: **0.40%**
            - Banks with $1 billion to $10 billion assets: **0.65%**
- Low operating cost
    - Operating expense declined overtime
        - Noninterest expense/average total earning assets:
            - Was flat around 4% from 1992 to 2008
            - Declined steadily to 3.05% in 2014
                - Consolidated its network of branches
                - The number of branches declined
                    - 2008: 217
                    - 2014: 195
    - Noninterest income grew faster than earning assets
        - => increase as a % of earning assets
    - => net operating cost/average earning assets declined overtime
        - 1991-1995: averaged 1.90%

        - 1996-2000: averaged 1.81%
        - 2001-2005: averaged 1.36%
        - 2006-2010: averaged 1.39%
        - 2011-2014: averaged 1.10%
        - 2014: 1.03%
    - Banks with over $10 billion assets has on average **1.12%** net operating cost
        - Based on all FDIC-insured institutions over $10 billion
        - Institutions over $10 billion has lower cost than institutions of smaller size
    - Most regional banks have between **1.6%** and **3.3%** in net operating cost
        - Based on a sample of about 50 publicly trade local banks
        - Example
            - Great Southern Bancorp
                - A competitor in Missouri
                    - Kansas City
                    - St. Louis
                - Average earning assets: $3.5 billion
                - Net operating cost: **3.06%**
            - Enterprise Financial
                - A competitor in Kansas City and St. Louis
                - Average earning assets: $2.9 billion
                - Net operating cost: **2.42%**
            - National Bank Holding
                - A competitor in Kansas City
                - Average earning assets: $4.4 billion
                - Net operating cost: **2.59%**
- Commerce's low-cost advantage is durable
    - High retention rate helps secure low-cost deposits
    - Fee-based revenue helps reduce net operating cost overtime

[1] "As a result of this initiative, new asset management business sourced from commercial referrals increased by 86% in 2008 to $1.2 million in annual fees. **A new data mining-driven initiative to identify wealth management prospects in Commerce's retail customer base is expected to fuel additional sales growth in 2009**.

In 2008, account retention also improved for the fourth consecutive year to 95%. These results suggest that the value proposition we offer in wealth management – which centers on objective financial advice, a conservative, long-term approach to investing and attentive personal service – is satisfying the needs of our clients and helping them achieve their goals." – Commerce's 2008 Annual Report

[2] "We talk a lot about being a super community bank and the idea is that we are a community bank, a flat organization that we are very close to the market. **We have 300 community directors, a lot of banks have gone away from that, but we feel they are a very helpful group in being the eyes and ears of the organization**. **And we understand what the market is, so we operate like a community bank**. We've got a very strong culture. I will talk about that in a minute.

We think we have an advantage over the very large national banks, B of A and U.S. Bank would be our two major competitors in our large markets. **At the same time, at $18 billion, we have scale, so especially in businesses like the payment system and money management**, we are large enough and compete very effectively against any of the large providers throughout the country." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[3] "As we said in the annual report over probably the last five years, **our most valuable franchise is the payment system business. It's a very high risk-adjusted return business and something that we think is an essential product for our customer and ties into a lot of other products**.

We have significantly expanded and consolidated our operations businesses, really our item processing as well as some of our card operation in Kansas City. It is right next to our headquarter -- about a block from our headquarters building, but really **it's state-of-the-art internal system for item processing, other payment system products. It is a very impressive operation, I think one of the best in the country**, and is really attracting business for us." – David Kemper, Commerce's CEO, 2008 Shareholder Meeting

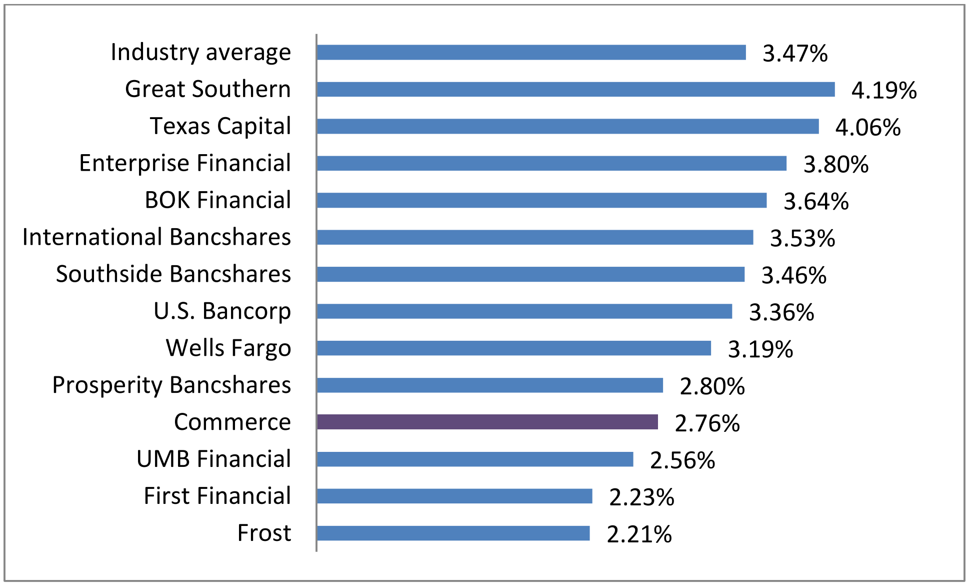
[4] "**So just to summarize, we are talking about building core relationships and it's very much about relationships, not transaction, which starts with payment system**." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financial Conference, 02 February 2010

[5] "Low cost of funding, talked about that briefly, 44.6% of our deposit base is non-interest bearing **against the industry at 18.7%**, two times the industry with our

cost of fund sitting at 0.14." – John Marine Kemper, UMB Financial's CEO, UMB 2013 Investor Day

Quality

Commerce's Quality Comes from Its Low Cost of Funding



In 2007, Commerce's cost of funding was 0.71% lower than the industry

- **Biggest Negative**:
  - Banks have no pricing power
    - That's why yield declines when interest rates declines
  - Commerce's yield on earning assets is just average
- **Michael Porter Questions**
  - (-) means low
  - (=) means medium
  - (+) means high
  - **For the industry**
    - Can the industry charge a high price?
      - **(=)** The industry charge a stable "Net Interest Margin" over cost of money
    - Does the industry have low costs?
      - **(-)** Banks have the lowest cost of money
        - lower cost of money than pension funds or bond funds
    - Does the industry have low need for assets?
      - **(+)**The industry is capital-intensive
        - Rely on high leverage

            - Leverage depends on regulatory capital ratios
    - **For the company**
        - Can the company charge a higher or lower price than the industry?
            - **(=)** similar to the industry
                - Commerce has lower yield
                    - But fully offset by lower net charge-offs
        - Does the company have higher or lower cost than the industry?
            - **(-)** Commerce has lower cost than the industry
                - Lower cost of funding
                - Lower operating cost
        - Does the company have more or less need for NTA than the industry?
            - **(=)** the same
- The industry's net interest margin is very stable
    - Net interest margin = yield on earning assets – cost of funding earning assets
    - Based on data of all FDIC-insured institutions
    - Net interest margin was about 3.6% in the 1996-2014 period
        - Min: 3.14%
        - Max: 4.06%
        - Median: **3.60%**
        - Mean: 3.61%
        - Standard deviation: 0.30%
        - Variation: 0.08 (very stable)
    - NIM is stable NIM because the industry have lower cost of money than competitors
        - Banks can get funding from
            - Non-interest bearing deposit
                - free
            - Time deposit
                - Cost less than Fed funds
            - Other borrowings
        - Bank's average net operating cost is
            - Banks with assets over $10 billion: **1.1%**
            - Banks between $1 billion and $10 billion: **1.83%**
        - => Banks total cost of money is about **1-2%** more than Fed funds

            - Not far from risk-free rates
            - 1954-2014 Median (10-year treasury yield – Fed funds) is **1.06%**
        - => Banks have lower costs than competitors
            - Bond funds
            - Pension funds
            - Etc.
- Commerce's net yield on earning asset is mediocre
    - Net yield = (interest income – charge-offs)/average earning assets
    - Its net yield is lower than peers
        - (based on historical median gap in yield)
        - About 0.20-0.50% lower than other regional banks
        - About 0.75% lower than Wells Fargo
    - Its net yield is about the same as the industry average
        - 0.08% lower than all FDIC-insured institutions
        - 0.07% higher than FDIC-insured institutions with more than $10 billion assets
- Commerce's quality comes from its low cost of funding
    - Deposits are 90% of total liabilities
    - Low-cost core deposits are 89% of total deposits
    - Its funding sources as a % of average earning assets
        - Noninterest-bearing deposits, liabilities, and equity: 36%
        - Savings, interest checking and money market: 47%
        - Time deposit: 9%
        - Other borrowings: 8%
            - Mostly fed funds
    - Saving, interest checking and money market deposits have low costs
        - Rates were
            - 2002: 0.75%
            - 2003: 0.46%
            - 2004: 0.43%
            - 2005: 0.77%
            - 2006: 1.40%
            - 2007: 1.63%
        - Cost less than 50% of Federal fund rates (FFR)
            - 2002: 45% of FFR
            - 2003: 40% of FFR

        - 2004: 32% of FFR
        - 2005: 24% of FFR
        - 2006: 28% of FFR
        - 2007: 32% of FFR
      - Many banks pay about 50% of FFR for these types of deposits
        - U.S. Bancorp: 40% of FFR
        - Wells Fargo: 54% of FFR
        - Enterprise Financial: 40% of FFR
          - (a regional competitor)
          - Although Enterprise Financial offers a rate of higher than FFR on its time deposits
  - Time deposit and other borrowings have similar cost to Fed funds
  - => Commerce's cost of funding is less than **40%** of FFR
    - = 47% * 50% + 17% * 100% = 40%
  - The industry's liabilities consist of
    - (Based on McKinsey report in 2012)
    - Free funding: **22%**
      - Noninterest-bearing deposit
      - Equity
    - Interest-bearing deposits: **37%**
      - On average cost about 75-80% of fed funds
    - Other liabilities: **41%**
      - Cost much more than fed funds
    - => the industry's cost of funding would exceed **70%** of fed funds
      - 22% * 0% + 37% * 75% + 41% * 100% = 69%
  - => Commerce's funding cost advantage is more than 30% of FFR
    - 3% FFR results in more than **0.90%** cost advantage
    - Other things equals, 0.90% cost advantage results in ROE of about **9%** higher than average
  - Example in 2005
    - Average FFR: 3.21%
    - Commerce's cost of funding: 1.51%
    - Banks with more than $10 billion assets: 2.30%
    - => 0.79% cost advantage for Commerce
      - Commerce relied on expensive funding more than it does today
        - (Time deposits + other borrowings/earning assets)

            - 2005: 36%
            - Today: 17%

- Low funding sources make Commerce more sensitive to interest rates than the industry
    - There's not much room for reduce cost of low-cost funding
    - Example:
        - Net interest margin = yield on earning assets – cost of funding
            - (NIM)
        - Commerce's NIM:
            - 2006: 3.92%
            - 2014: 3.00%
        - All FDIC-insured institutions
            - 2006: 3.31%
            - 2014: 3.14%
        - Banks with more than $10 billion assets:
            - 2006: 3.12%
            - 2014: 3.01%
    - Commerce is interest rate neutral in the short run
        - 48% of its loan portfolio have fixed rates
        - 90% of its securities portfolio have fixed rates
        - => 63% of earning assets have fixed rates
    - But it's sensitive to interest rates in 3-5 year ranges
        - Short-term investments have floating rates
        - 79% of loans mature within 5 years
        - Securities have duration of 2.9 years
    - => **91%** of earning assets adjust to new interest rates within 5 years
- Commerce was able to make good ROE
    - Made **1.61%** return on earning assets (ROEA) in its worst year
        - 2009
    - Median ROEA was **2.16%**
    - Its leverage ratio is a bit lower than 10
        - 15% pre-tax ROE in its worst year
        - 21% pre-tax ROE in a normal year
- Commerce can make 19% after-tax ROE in normal times
    - Commercial demand deposits are about $4.1 billion[1]
    - Banks pay interests on commercial demand deposits in the form of earnings credit

        - To reduce service charges
        - This is more tax-efficient than paying interests
    - Earnings credit will increase if FFR increases
        - Lower noninterest income
    - To make it simple, we can assume no change in noninterest income
        - And adjust Commerce's funding cost
    - Moving $4.1 billion from noninterest-bearing deposits to interest checking
        - Commerce's funding sources as a % of average earning assets
            - Noninterest-bearing deposits, liabilities, and equity: 18%
            - Savings, interest checking and money market: **65%**
                - Cost less than 50% of FFR
            - Time deposit and other borrowings: **17%**
        - => Commerce's funding cost is less than 50% of FFR
            - 65% + 50% + 17% * 100% = 49.5%
    - Assuming 3% FFR
        - Commerce's funding cost would be 1.5%
            - 1.30% higher than it was in 2014
        - Commerce's yield would be higher than 5.5%
            - Implies 2.5% spread over FFR
            - Historically, the spread was 3.06%
            - Average yield was 5.6% in the 2003-2007 period
        - 5.5% yield is 2.37% higher than it was in 2014
        - => Commerce can improve ROEA by 1.07%
            - = 2.37% - 1.30%
        - => ROEA would be 2.91%
            - = 1.07% + 1.84% (in 2014)
        - => about 29% pre-tax ROE
            - 19% after-tax ROE
- Fee-based business can improve ROEA in the long run
    - There are little capital requirement in these businesses
    - As long as these businesses make profit and grow, it'll reduce Commerce's net operating cost
    - Commerce's net operating cost has declined overtime
        - 1991-1995: averaged 1.90%
        - 1996-2000: averaged 1.81%
        - 2001-2005: averaged 1.36%

        - 2006-2010: averaged 1.39%
        - 2011-2014: averaged 1.10%
        - 2014: 1.03%
- 8 dimensions of quality
    - Relative size
        - Great relative to customers
            - Commerce focuses on small business
            - Its bread and butter is making loans below $10 million
        - Great size relative to supplier of money
            - Consumers
            - Commercial customers
    - Focus
        - Commerce's deposits are concentrated in a few states
            - Missouri: 72%
            - Kansas: 19%
            - Illinois: 7%
            - Others: 2%
        - Expansion in other markets are on the commercial side
            - Sells payment system products
            - Opens loan offices
            - Then tries to sell banking products
        - Commerce is focused on 3 franchises
            - Payment systems
            - Traditional bank credit products
            - Wealth management
        - There're great synergies among these products
            - Payment systems helps initiate relationships with commercial customers
                - Sell traditional bank credit products
                - Sell wealth management products
            - Private banking helps initiate relationships with commercial customers
    - Customer engagement
        - High for commercial customers and private banking customers
    - Cross-selling
        - Commercial customers

            - Payment systems
                - Cash management
                - Commercial card
                - Merchant services
            - Wealth management
            - Credit lines
            - Primary debit account
        - Private banking
            - Deposit account
            - Credit cards
            - Mortgage loans
            - Wealth management
        - Consumers
            - Deposit account
            - Credit cards
            - Mortgage loans
            - Consumer loans
    - Retention
        - High
    - Words of mouth
        - No information
    - Reinvestment rate
    - Stock's popularity
        - No quarterly earnings call
        - Short-interest: 7.37%
        - Share turnover: 178%
            - 3-month average daily volume: 548 thousand shares
            - Float: 77.7 million shares

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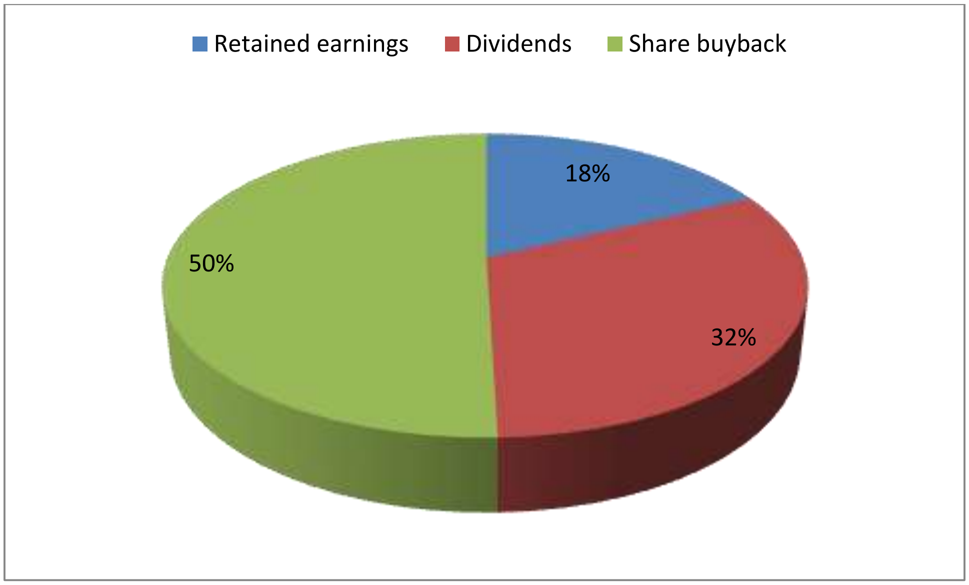
[1] "**Our commercial cash management business consists of numerous services, including remittance processing and payables solutions to many companies** in our markets across the Midwest and, increasingly, to companies in our rapidly growing expansion markets. **In 2014, this business provided $43 million in customer billings, which are paid for with both fees and compensating deposit balances of $4.1 billion at year end.**" – Commerce's annual report

Capital Allocation



Commerce returned 82% of its earnings over the last 22 years

- **Biggest Negative**:
  - Commerce doesn't have the capacity to reinvest
- Share-based compensation results in about **0.75%** dilution
  - Compensation includes
    - Annual cash compensation
      - Base salary: 25-40% of total compensation
      - Annual bonus: 20-40% of total compensation[1]
        - **Performance factor** is based on
        - 60% is based on annual net income
        - 20% is based on a comparison of adjusted ROE against 19 pre-established peers
        - 20% is based on revenue result
    - Long-term stock compensation[2]
      - Restricted stock units 35-45% of total compensation
        - Vests at the end of 5 years from the date of grant
        - Awarded annually based on 3-year average performance factor
      - Stock Appreciation Rights: 10% of total compensation
        - Aren't based on any set formula
        - Treated as being part of base compensation
- Commerce is controlled by the Kemper family

- The Kemper family owns about 3.1% of the company
  - The current CEO is the fifth generation of the family
- Commerce Bank owns 10.1% of total shares
  - Held in various trust capacities
    - Including 3,688,873 share held as Trustees for Commerce's 401 (k) plan for its employees
      - 3.8% of total shares

- Commerce focuses on its 3 core franchises
  - Payment systems
  - Traditional bank credit products
  - Wealth management
  - Its fee-based businesses are more closely tied to the traditional bank business
    - There are great sales synergies between these 3 products
      - Payment systems can help get the primary deposit account
      - Wealth management can initiate a commercial relationship
  - Fees account for more % revenue of BOK or UMB Financial
  - But there can be less synergies among their segments
    - UMB is very big in mutual fund and handling back operations for funds
      - These businesses aren't relevant to traditional wealth management and banking service
    - BOK is very big in brokerage and trading, and mortgage banking
      - Not relevant to other segments
- Commerce focuses on 4 metrics[3]
  - Topline growth
  - Pretax profit growth
  - Employee engagement
  - Customer satisfaction
- Commerce focus intrinsic value per share growth
  - Risk-adjusted earnings per share growth[4]
  - Revenue per share growth[5]
  - Commerce repurchased a lot of shares
    - Spent ½ of total income in share buyback over the last 22 years
      - Total income: $4,120 million
      - Total share repurchase: $2,079 million
    - Commerce repurchased few shares in 2008 and 2009

        - And started repurchasing shares in 2010
      - Share count declined by 2.62% annually between 1995 and 2007
        - 1995: 139 million shares
        - 2007: 101 million shares
        - (the number of shares was adjusted for 5% annual stock dividend)
      - **2.62%** annual decline makes sense
        - Commerce's shares traded at around 15x P/E
        - 50% of earnings can repurchase 3.33% of the company
        - Stock-based compensation results in 0.75% dilution
        - => about 2.6% net shrinkage
    - Deposit per share grew **7%** annually over the last 20 years
      - 1995: $54
      - 2014: $195
- Commerce returned most of earnings to shareholder
  - It doesn't grow much
    - Total deposit grew only 5.5%
    - There's period it grew only 3.4%
      - 1996-2006
  - Commerce maintains a consistent leverage ratio
    - Earning Assets/Equity is about 9.5%
  - Commerce doesn't like acquisitions
    - Always prefer organic growth
    - See acquisitions as the riskiest things[6]
    - Doesn't need to expand its retail footprint
    - Is interested in expanding its commercial footprint
      - Mostly by
        - Opening loan office
        - Leveraging its payment systems business
    - Spent only $159 million in acquisitions over the last 15 years
  - => Commerce has a lot of excess cash
  - Commerce returned about **82%** of total earnings
  - Over the last 22 years
    - Total income: $4,120 million
    - Total share repurchase: $2,079 million
    - Total dividends: $1,306 million
  - Share buyback: ½ of earnings

        - It prefers share buyback[7]
        - Results in **2.6%** annual shrinkage
    - Dividends: **1/3** of earnings
        - Results in **2-2.5%** dividend yield
        - Commerce doesn't want to commit to a high dividend payout ratio
            - It wants to have flexibility in building capital[8]
        - But Commerce has increased dividend payout rate overtime
            - In the low 20s in 1990s
            - In the high 20s in early 200s
            - Currently 33%
        - It has increased dividend for **47 years** in a row
- Commerce's capital allocation can give shareholders an adequate return
    - Without changes in multiple
        - Dividend + share buyback: 4.5-5%
        - Growth: 4-5%
        - => total return: 7.5-10%
- It's an fine stock to hold

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[1] "In determining the amount of annual cash incentives to be paid under the EICP in 2015 for 2014 performance, the Committee weighted the components of the Company Performance Factor as follows:

• **60% based on actual net income** of $262 million with the payout percent determined on a scale which targeted $262 million as the 100% payout level. For the net income component there is a 1% decrease in payment for each $1 million below target down to $237 million and a 1.3% decrease in payment for each $1 million below $237 million. There is no net income component allocation for net income below $199 million. For net income exceeding the 100% level there is a 2.5% increase for each $1 million above $262 million up to $274 million; a 5% increase for each million above $274 million up to $286 million; and a 10% increase above $286 million up to a maximum of $287 million;

• **20% based on a comparison of adjusted return on equity measured against 19 pre-established peer banks**. If the Company's adjusted ROE (performance assessed using end of 3Q data) is at or above the 75th percentile, 100% is credited for this factor; if the Company's adjusted ROE is above the 50th percentile but below the 75th percentile, 75% is credited for this factor; if the Company's adjusted ROE is above the 25th percentile but below the 50th percentile, 50% is credited for this factor; and if the Company's adjusted ROE is below the 25th percentile, 25% is credited for this factor. For 2014 the Company's adjusted ROE exceeded the 75th percentile compared to the peer banks; and

• **20% based on actual revenue results** of $1.07 billion with the payout percent determined on a scale of 0% to 120%, with achievement of target revenue of $1.05 billion resulting in 100% payout. The payout percent increases/decreases by 5% for every 1% that actual revenue results fall above or below target." – Commerce's 2014 Proxy

[2] "First, there is an annual equity award consisting of restricted stock, for longer-term profit growth (the "Long Term Restricted Stock"), given to NEOs and other select Company officers each year using the following formula: **35% of the average annual cash incentive target for the officer for the three prior years, multiplied by the average Company Performance Factor for the three prior years**. The number of shares granted is determined by dividing the value derived by that formula by the closing price of CBSH stock on the grant date. This formula was determined by the Committee in past years for long-term performance and the formula did not change in 2014. **The Long Term Restricted Stock award vests at the end of five years from the date of grant, except that in the case of the NEOs and other members of the Company's executive management committee, if and only if the Company has cumulative positive net income for the period beginning on January 1 of the year of the grant and ending on the December 31 that next precedes the date the award would otherwise vest**. For example: the Company Performance Factors for 2013, 2012 and 2011 were 105.5%, 162.8%, and 164.0%, respectively. Therefore, the three-year average Company Performance Factor in 2014 was 144.1%. If the NEO's three-year average annual cash incentive target was $100,000, the officer would receive restricted stock in 2014 equal to $50,435 ($100,000 * 35% * 144.1%). The Long Term Restricted Stock awards made to our NEOs during 2014 based on this formula were: David Kemper: 10,067 shares; Charles Kim: 2,776 shares; Jonathan Kemper: 3,375 shares; John Kemper: 1,773 shares; and Kevin Barth: 2,661 shares. The Committee retains discretion to reduce any such award until it is actually granted.

Second, the Committee also issues to our NEOs equity-based awards on an annual basis. **In 2014, 75% of the annual stock grant was awarded as restricted stock (the "Current Year Restricted Stock") and 25% of the annual stock grant was awarded as SARs (the "Current Year SARs"). These awards are not based on any set formula and are treated as being part of base compensation**, although the Committee has full discretion to reduce or eliminate any such award and vesting may be conditioned upon Company performance, as well as other factors. These awards are in the form of restricted stock or SARs in order to align our NEOs' interest with those of our shareholders. These shares reflect the performance of the Company's stock because their value is based on the stock's fair market value (restricted stock) or Black Scholes valuation (SARs). The value of the annual stock grant is generally intended to remain fairly constant from year-to-year, but is adjusted as a result of the process described in the next paragraph. The value of the Current Year Restricted Stock award is determined by multiplying the annual stock grant value by 75%. The number of shares of restricted stock is then determined by dividing the amount by the closing price of CBSH stock on the grant date. The value of the Current Year SARs is determined by multiplying the annual stock grant value by 25%. The number of SARs is then determined by dividing that amount by the Black Scholes valuation on the grant date. In order to provide a retention incentive, each Current Year Restricted Stock award has a vesting period such that the entire grant vests four years from the date of the grant. **The Current Year SARs have a vesting period such that one fourth of the award vests on the first, second, third and fourth year anniversaries of the grant date. All restricted stock will vest if and only if the Company has cumulative positive net income for the period beginning on January 1 of the year of grant and ending on the December 31 that precedes the date the award would otherwise vest**. The Current Year Restricted Stock awards made to our NEOs in 2014 were: David Kemper: 17,357 shares; Charles Kim: 5,143 shares; Jonathan Kemper: 8,357 shares; John Kemper: 6,738 shares; and Kevin Barth: 5,143 shares. The Current Year SARs awarded to our NEOs in 2014 were: David Kemper: 27,693 shares; Charles Kim: 8,205 shares; Jonathan Kemper: 13,333 shares: John Kemper: 10,751 shares: and Kevin Barth: 8,205 shares. The Committee retains discretion to reduce any such award until it is actually granted." – Commerce's 2014 Proxy

[3] "**We try to measure our organization on four basic metrics, so we talk about topline growth, about pretax profit growth, and then the other two cornerstones are employee engagement and customer satisfaction**. We take that very seriously and this just gives you an indication about -- we talk about Commerce Bank engagement, something we do every year. And you can get a proxy for the industry but you can see on that bottom line, we are significantly ahead of the market and also you can only go so high but we have continued to have improvement in people's attitudes, banker's attitudes, and how they feel about the Company.

We try to talk a lot about being owner managers. **We have a bank incentive stock program and a lot of people have that, but we really take that very**

seriously and try to get long-term ownership of the bank. **We think that's the best model where the employees really feel like they are owners of the organization** because we emphasized all the time that you have got to make long-term decisions to increase the value of the franchise." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[4] "Again, as I mentioned, being shareholder-oriented, we are very focused on long-term risk-adjusted earnings per share growth and we think again if we have consistent results that is going to drive stock price. Right now there's a lot of concern -- there is just a bigger risk premium in all financial instruments but, certainly, in bank stocks. I think that is one reason why we have done better and are trading in a little higher multiple. But we also think we have got higher growth quality in the kind of non-credit products that we are focusing on." – David Kemper, Commerce's CEO, Shareholder Meetings 2008

[5] "As you can see, **we continue over a long period over the last 10 years, have had very solid revenue per share growth. Again, we think that is one of the keys to long-term franchise profitability**." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Bank Conference, 02 February 2010

[6] "M&A, very disciplined -- it's about -- it's got to be strategic, it's got to make sense. In the retail banking space these days, we've got all the deposits that we need, that we can -- and can't do anything with the ones we have except for put them in the bond portfolio. **So we don't really need more of a retail footprint, but we are interested in expanding the Commercial footprint. And so as that makes sense, we might do that.**

However, we always favor organic growth over acquisitions. My boss likes to say that acquisitions are the riskiest thing that we can do as a bank, and so we've had some success at organic growth, so we continue to push on that. Sometimes that's management liftouts, a sort of a more risk-averse way of acquiring business. That's produced good results for us." – Charles Kim, KBW Regional Bank Conference, 27 February 2013

[7] "Capital, strong capital, we like to have good capital ratios. That said, we are very good are returning it to the shareholders as well and **we've got a good consistent dividend history over time; raised our dividend 45 years in a row.** The dividends are the dark-green bar. The light-green bar is the stock buyback. **We like the stock buyback and you can see we've used it. We like**

to point it out as a lever. As you can see in 2008, 2009, we backed off when we thought we needed to build capital up a little bit and then sooner than most anybody else did, we got back into the market in 2010, buying our stock back, probably had in 2011 about a 70% distribution of our earnings between the buyback and dividends.

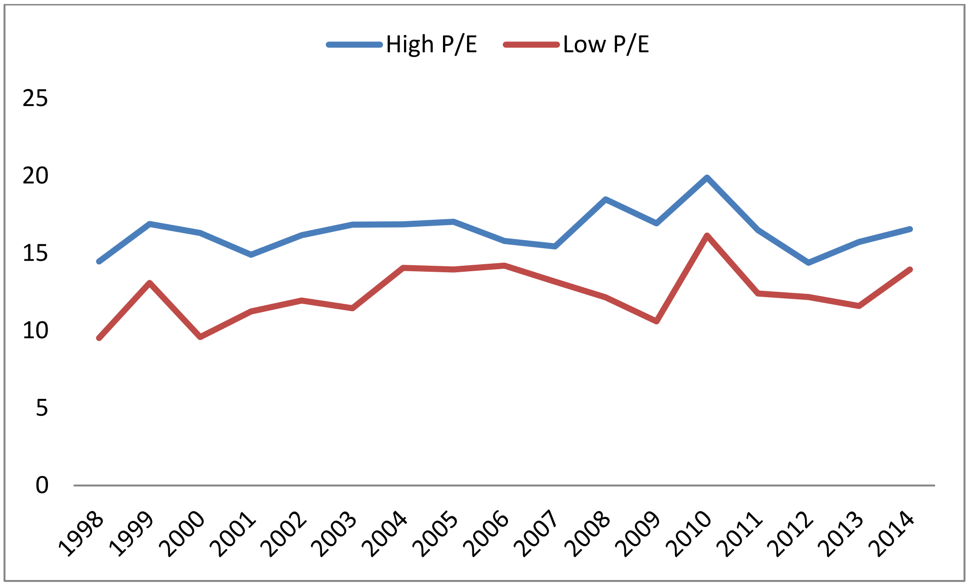
In 2012, I want you to know, this is -- we always talked before about we like our strong capital ratios because it gives us flexibility. We saw the changes in the tax rates that were on the way. **We have a very strong retail shareholder base at about 50%. A lot of those folks received a significant advantage in getting a special dividend before the end of the year that we might have trickled out over time in the future. So we were able to pay a nice special dividend at the end of 2012**, but generally speaking, sort of continuing on the same path on the capital side, but very good payout ratios even in a normal year for us versus everyone else." – Charles Kim, Commerce's CFO, KBW Regional Bank Conference, 27 February 203

[8] "I think one thing on the dividend policy, and we raised our dividend 5% in the first quarter, we have always had a more conservative pay out. But I think you are seeing that now in the industry is, **a lot of banks have gotten in problems because they have paid so much out and it is very difficult if you get your dividend payout too high to -- you have very little flexibility in building capital**.

So now you are seeing a number of large banks, Wachovia was the last one to do it just two days ago to cut their dividend. We don't ever want to be in that position." – David Kemper, Commerce's CEO, Shareholder Meeting 2008

Value

Mr. Market Pays Attention Only To Current Earnings



Commerce usually trades at 15x P/E

- **Biggest Negative**:
    - Commerce's earnings depends on interest rates
- Key inputs
    - Share price: **$46** per share
    - Outstanding shares: 93.34 million
    - Market cap: $4,293 million
    - Preferred stock: $145 million
    - EV: $4,438
    - Short-term investments: $1,261 million
    - Securities: $9,591 million
    - Loans: $11,734 million
    - Earning Assets: $22,587 million
    - Deposit: $19,315 million
- Pre-tax Owner Earnings is $667 million
    - **Assumptions**:
        - Cost of interest-bearing liabilities is **76%** of Fed funds
            - Cost of interest-bearing liabilities/Fed funds
                - (1990-2007)
                - Min: 52%

        - Max: 111%
        - Median: **76%**
        - Mean: 78%
        - Standard Deviation: 17%
        - Variation: 0.22 (stable)
    - This assumption overstate Commerce's costs
    - Two main components in BOK's interest-bearing liabilities
        - Savings, interest checking and money market
            - Cost less than 50% of Fed funds
                - 2002: 45% of FFR
                - 2003: 40% of FFR
                - 2004: 32% of FFR
                - 2005: 24% of FFR
                - 2006: 28% of FFR
                - 2007: 32% of FFR
        - Time deposits and other borrowings
            - Cost about 100% of Fed funds
    - Commerce relies on time deposits and other borrowings much less than it used to
        - This component was about 40% of earning assets in 2003-2007
        - It's only 17% today
    - It's okay to be conservative
    - => let's assume cost of interest-bearing liabilities to be 89% of Fed funds
- Net interest spread (NIS): **3.72%**
    - NIS = yield on earning assets – cost of interest-bearing liabilities
    - NIS was very stable about 3.72%
        - From 1990 to 2014
            - Min: 2.93%
            - Max: 4.19%
            - Median: 3.72%
            - Mean: 3.64%
            - Standard Deviation: 0.34%
            - Variation: 0.09 (very stable)
- Net Operating Cost: 1.03%

        - Good banks tend to have lower operating cost overtime
        - This is true for Commerce
        - => It's reasonable to use Net Operating Cost in 2014
        - **Notice**:
            - Higher interest rates can reduce noninterest-income
                - Commercial customers get more earning credits on their commercial demand deposits
                - => reduce service fees
                - => increase Net Operating Cost
            - We'll consider commercial demand deposits separately
    - Commercial demand deposits: $4.1 billion[1]
    - Commerce pay less than 50% of FFR for these deposits
        - It pays less than 50% of FFR for interest checking and money market accounts
        - Peers pay less than 50% of FFR
            - U.S. Bancorp: 40% of FFR
            - Wells Fargo: 54% of FFR
            - Enterprise Financial is a good example
                - It's a regional competitor
                - It pays very aggressive rates on time deposits
                    - Usually pays more than FFR
                    - Its cost of time deposits were
                        - 2005: 3.33%
                        - 2006: 4.54%
                        - 2007: 5.18%
                - Yet it pays only 40% of FFR for interest-bearing transaction accounts
- Normal fed funds is 3%
    - Cost of commercial demand deposits: **1.50%**
        - = 3% * 50%
    - Cost of interest-bearing liabilities: **2.28%**
        - = 3% * 76%
    - => yield is about **6.00%**
        - = 2.28% + 3.72%
        - This is lower than Commerce's yield in 2006-2007
            - 2006: 6.32%

        - 2007: 6.56%
  - Net charge-offs/average earning assets is 0.29%
    - The average from 1991 to 2014
  - Commerce funds earning asset from
    - Free funding: **18%**
      - $4.1 billion
      - Including
        - Noninterest-bearing deposits
        - Equity
    - Commercial demand deposits: **18%**
      - $4.1 billion
    - Interest-bearing liabilities: **64%**
      - $13.3 billion
      - Including
        - Interest-bearing deposits
        - Other borrowings
  - Pre-tax return on earning assets (ROEA) is 2.95%
    - Margin on free funding is **5.70%**
      - = yield – charge-offs
    - Margin on Commercial demand deposits is **4.10%**
      - = yield – charge-offs – cost of demand deposit
    - Margin on interest-bearing liabilities is **3.42%**
      - = yield – charge-offs – cost of interest-bearing liabilities
    - => weighted average margin is **3.98%**
      - = 5.70% * 18% + 4.10% * 18% + 3.42% * 64%
    - => ROEA is **2.95%**
      - = 3.98% - 1.03% (net operating cost)
  - Total earning assets is $22,587 million
  - => normal pre-tax earnings is **$667** million
    - = $22,587 * 2.71%
- A more conservative approach lead to a similar result
  - Moving $4.1 billion from noninterest-bearing deposits to interest checking
    - Commerce's funding sources as a % of average earning assets
      - Noninterest-bearing deposits, liabilities, and equity: 18%
      - Savings, interest checking and money market: **65%**
        - Cost less than 50% of FFR

        - Time deposit and other borrowings: **17%**
    - => Commerce's funding cost is less than 50% of FFR
        - 65% + 50% + 17% * 100% = 49.5%
- Assuming 3% FFR
    - Commerce's funding cost would be 1.5%
        - 1.30% higher than it was in 2014
    - Commerce's yield would be higher than 5.5%
        - Implies 2.5% spread over FFR
        - Historically, the spread was 3.06%
        - Average yield was 5.6% in the 2003-2007 period
    - 5.5% yield is 2.37% higher than it was in 2014
    - => Commerce can improve ROEA by 1.07%
        - = 2.37% - 1.30%
    - => ROEA would be **2.91%**
        - = 1.07% + 1.84% (in 2014)

- Commerce's current valuation
    - EV/2014 EBT: 11.18
    - EV/Normal EBT: 6.66
- BOK is cheaper than peers
    - We use apply the same approach in calculating normal ROEA to peers
    - Peers include
        - U.S. Bancorp (USB)
            - USB operates in the Midwest and West regions of the U.S.
            - USB is the top competitor in Commerce's markets
            - USB has strong fee-based business like BOK
            - Fee incomes are about 50% of total revenue
            - Deposits grew 7.4% annually since 2001
                - Firstar bought USB in 2001
                    - Doubled the size of the company
            - USB's current valuation
                - Share price: $42.18
                - Market Cap: $74.3 billion
                - Preferred stock: $4.7 billion
                - EV: $79 billion
                - EV/Deposit: **0.28**
                - EV/2014 EBT: 10.95
                - EV/Normal EBT: **8.20**

        - Using **2.63%** ROEA
- BOK Financial (BOKF)
    - BOK is a similar peer operating in a different markets
        - Deposit breakdown by states
            - Oklahoma: 54%
            - Texas: 25%
            - Colorado: 7%
            - New Mexico: 6%
            - Arizona: 4%
            - Kansas City: 3%
            - Kansas: 1%
    - BOK has a strong focus on fee-based business
        - Fee incomes are 50% of revenue
            - Brokerage & trading: 10% of revenue
            - Mortgage banking: 10% of revenue
            - Transaction card: 10% of revenue
            - Trust fees: 9% of revenue
            - Service charges: 7.1%
            - Other: 3.6%
    - BOK also sees fee-based businesses as a key to getting banking customers
    - Deposit grew **10.5%** annually over the last 22 years
        - 9.8% over the last 15 years
        - 8.2% over the last 10 years
    - BOK's current valuation
        - Share price: $67.18
        - Market Cap: $4,630 million
        - Preferred stock: $0 million
        - EV: $4,630 million
        - EV/Deposit: **0.22**
        - EV/2014 EBT: 10.29
        - P/Normal EBT: **6.17**
        - Using **2.71%** ROEA
- UMB Financial (UMBF)
    - This is a regional competitor
        - Run by another branch of the Kemper family
    - UMB gets 63% of its deposits from Kansas City

        - Has 18.7% market share in this market
            - #1
            - Next top players are
                - Commerce: 13.04%
                - Bank of America: 9.71%
                - U.S. Bancorp: 6.14%
    - UMB lends very conservatively
        - It makes much fewer real estate loans than Commerce
        - Its net charge-offs in its worst year was just 0.57%
    - UMB has a strong focus on fee-based business
        - Fees are almost 60% of its revenue
        - 60% of its fees are from "Trust and securities processing"
            - It offers fund services to institutional funds
                - Over $200 billion assets under administration
            - It also runs equity and bond funds
                - More than $30 billion AUM
    - Its card processing business is about 1/3 that of Commerce
    - UMB has lower ROE
        - Due to its conservative lending
            - Very low yield
        - After-tax ROE is just about 10%
    - UMB's current valuation
        - Share price: $49.08
        - Market Cap: $2,420 million
        - Preferred stock: $0 million
        - EV: $2,420 million
        - EV/Deposit: **0.18**
        - P/2014 EBT: 13.01
        - P/Normal EBT: **6.64**
        - Using **2.28%** ROEA
- Great Southern Bancorp (GSBC)
    - A competitor in Missouri
    - Average earning assets: $3.5 billion
    - 40% of its deposits is from Springfield, MO

        - Has **14.5%** market share in Springfield
            - Only behind Commerce
                - 14.80% market share
    - Has 0.35% market share in Kansas City
    - Has 0.29% market share in St. Louis
    - GSBC has
        - Higher net operating cost than Commerce: 2.57%
        - Higher cost of interest-bearing liabilities
            - Commerce: 76% of FFR
            - GSBC: 94% of FFR
        - Less free funding: just 10-15% of earning assets
        - High yield and high risk loans
            - Real estate loans: 72% of total loans
            - Consumer loans: 16% of total loans
            - Total net charge-offs was 7.23% in 2008-2012
                - 2008: 2.04%
                - 2009: 0.99%
                - 2010: 1.30%
                - 2011: 1.33%
                - 2012: 1.58%
    - Annual deposit per share growth was
        - 7.6% over the last 15 years
        - 7.0% over the last 10 years
    - SSBC's current valuation
        - Share price: $48.33
        - Market Cap: $670 million
        - Preferred stock: $58 million
        - EV: $727 million
        - EV/Deposit: **0.23**
        - P/2014 EBT: 9.83
        - P/Normal EBT: **8.93**
        - Using **2.19%** ROEA
- Enterprise Financial (EFSC)
    - A bank with $3 billion earning assets
    - Operates in Kansas City, St. Louis, and Phoenix
    - Has 2.27% market in St. Louis
        - **#6** in St. Louis

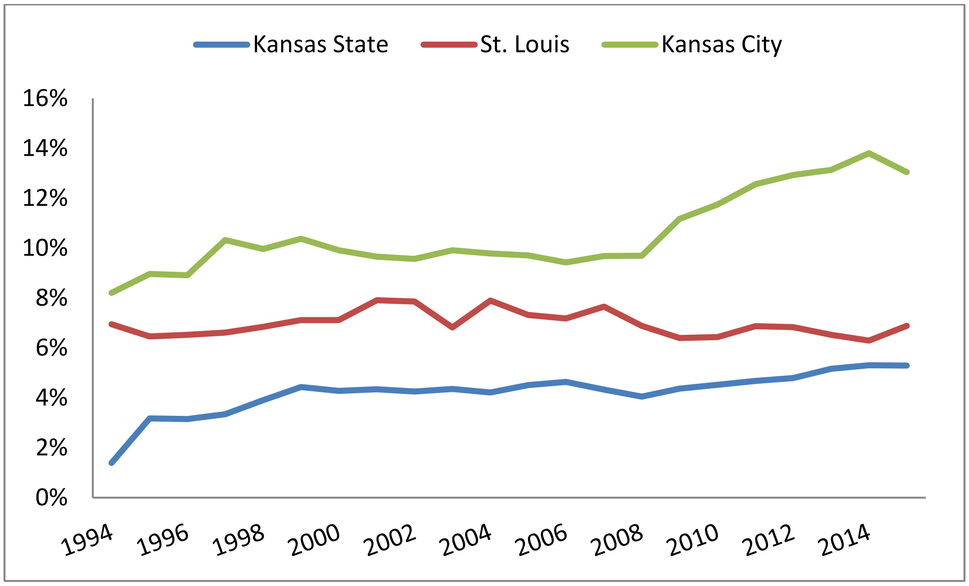
        - Has 1.19% market share in Kansas City
        - Enterprise has
            - Higher net operating cost than Commerce: 2.42%
            - Higher cost of interest-bearing liabilities
                - Commerce: 76% of FFR
                - Enterprise: 90% of FFR
            - Less free funding: just 15% of earning assets
        - Annual deposit per share growth was
            - 5.6% over the last 15 years
            - 3.8% over the last 10 years
        - Enterprise's current valuation
            - Share price: $28.36
            - Market Cap: $568 million
            - Preferred stock: $0 million
            - EV: $568 million
            - EV/Deposit: **0.20**
            - P/2014 EBT: 12.91
            - P/Normal EBT: **11.59**
            - Using **1.53%** ROEA
    - All these banks trade around 10-11 P/2014 EBT
        - EV/Deposits is around 0.18-0.22
    - => Mr. Market seems to neglect quality of funding
        - Low interest rates negate benefit of low-cost deposits
        - Mr. Market cares only about current P/E
            - This is consistent with Commerce's historical price
                - Usually trades within the 12-17 P/E range
    - If Commerce really has lower cost of funding than other banks
        - It'll outperform other banks when interest rates increase
        - => we'll beat the market
- Buying Commerce today can result in **14-15%** annual return over 5 years
    - How much earnings can Commerce make **in 2020**?
        - It's safe to expect 3% FFR in 2020
            - Most Fed members expect 3-4% FFR after 2017
    - Commerce won't make 2.95% ROEA immediately
        - But both assets and liabilities will re-price in 5 years
            - 79% of loans will mature within 5 years
            - Securities portfolio have 2.9-year duration

- In 5 years, Commerce can grow earning assets to **$32,737 million**
  - Current deposits: $19,315 million
  - Commerce expects to lose 6.5% of deposits under a 3% rising rate environment
    - $19,315 * 6.5% = $1,255 million
  - => deposits may decline to $18,060 million
  - Current earning assets are $22,587 million
  - => current earning assets may decline to $21,332 million
    - Earning assets wont' decline in a more realistic scenario
      - $1,255 million will change into
        - Time deposits, or
        - Other borrowings
      - => the cost of liabilities will increase a little bit
        - The increase could be absorbed by our conservative estimate
        - We assumed cost of interest checking, money market account, and commercial demand deposits to be 50% of FFR
          - It's in fact lower than 50% of FFR
  - At 3% annual growth rate, earning assets would be $24,730 million in 5 years
    - = $21,332 * 1.03^5
- Pre-tax earnings in 2020 would be **$730 million**
  - = $24,730 million * 2.95%
- After-tax earnings in 2020 would be **$465 million**
  - 65% * $730 million – 6% * $145 million
  - Commerce pays 6% on its prefer stock
- EPS in 2020 would be **$4.98**
  - = $465 million/93.34 million
- At 15x P/E
  - Share price is $74.7
  - **10.2%** annual increase from $46 per share
  - Real return is about 14-15%
    - Commerce returns 80-85% of its earnings
    - Dividend + share repurchase, net of dilution will add 4.5% return

[1] "**Our commercial cash management business consists of numerous services, including remittance processing and payables solutions to many companies** in our markets across the Midwest and, increasingly, to companies in our rapidly growing expansion markets. **In 2014, this business provided $43 million in customer billings, which are paid for with both fees and compensating deposit balances of $4.1 billion at year end.**" – Commerce's annual report

Growth

Commerce Is a Market Share Gainer in Low-growth Markets



Commerce has held or gained market share in its markets

- **Biggest Negative**:
    - Commerce is in very low growth markets
- Missouri and Kansas represent 91% of Commerce’s deposits
    - Deposits by state
        - Missouri: 72%
        - Kansas: 19%
        - Illinois: 7%
        - Others: 2%
    - => we’ll focus on these Missouri and Kansas
- Missouri economy
    - GDP mix
        - Services: 51%
            - Finance and insurance: 8.0%
            - Real estate and rental and leasing: 10.9%
            - Healthcare and social assistance: 8.4%
            - Professional, scientific, and technical services: 5.9%
            - Information: 4.4%
            - Others: 13.4%
        - Retail, wholesale, utilities, transportation: 18%

        - Wholesale: 6.5%
        - Retail: 6.1%
        - Transportation and warehousing: 3.5%
        - Utilities: 1.9%
    - Manufacturing: **13%**
        - (largest single sector of Missouri's economy)
        - Durable goods: 6%
        - Nondurable goods: 6.6%
    - Government: 12%
    - Construction: 4%
    - Agriculture & Mining: 2%
- Annual population growth is about 0.7%
    - Population was
        - 1950: 3,954,653
        - 1960: 4,319,813
        - 1970: 4,676,501
        - 1980: 4,916,686
        - 1990: 5,117,073
        - 2000: 5,595,211
        - 2010: 5,988,927
        - 2014: 6,063,589
        - 2030: 6,800,000 (expected)
    - Annual growth rate was
        - 1950-1960: 0.9%
        - 1960-1970: 0.8%
        - 1970-1980: 0.5%
        - 1980-1990: 0.4%
        - 1990-2000: 0.9%
        - 2000-2014: 0.6%
        - 2014-2030: 0.7% (expected)
- Missouri's GDP growth has lagged U.S. GDP growth
    - Missouri's GDP/U.S. GDP has declined
        - 1997: 1.86%
        - 2014: 1.61%
    - Compounding annual growth rate was
        - Since 2001

            - Missouri: **3.08%**
                - 2001: $192 billion
                - 2014: $284 billion
            - U.S.: **3.91%**
                - 2001: $10,703 billion
                - 2014: $17,616 billion
        - Since 1997
            - Missouri: **3.3%**
                - 1997: $164 billion
                - 2014: $284 billion
            - U.S.: **4.2%**
                - 1997: $8,788 billion
                - 2014: $17,616 billion
    - This is consistent with long-term deposit growth
        - CAGR of deposits since 2001
            - Missouri: 5.2%
                - 2001: $82 billion
                - 2014: $157 billion
            - U.S.: 6.5%
                - 2001: $5,189 billion
                - 2014: $11,764 billion
    - Missouri would have **3-4%** deposit growth in the future
        - Recent GDP growth was lower than normal
        - Recent deposit growth outperformed GDP because of low interest rates
        - These two trends will reverse
        - Missouri's deposit growth was **4.2%** over the last 22 years
            - 1993: $66 billion
            - 2014: $157 billion
- Kansas economy
    - Annual population growth is about 0.7%
        - Population was
            - 1950: 1,905,299
            - 1960: 2,178,611
            - 1970: 2,246,578
            - 1980: 2,363,679
            - 1990: 2,477,574

        - 2000: 2,688,418
        - 2010: 2,853,118
        - 2014: 2,904,011
        - 2030: 3,398,309 (expected)
    - Annual growth rate was
        - 1950-1960: 1.3%
        - 1960-1970: 0.3%
        - 1970-1980: 0.5%
        - 1980-1990: 0.5%
        - 1990-2000: 0.8%
        - 2000-2014: 0.6%
  - Kansas's GDP has been quite stable as a % of U.S. GDP
    - From 1997 to 2014
        - Min: 0.80%
        - Max: 0.87%
        - Median: 0.84%
        - Mean: 0.84%
        - Standard deviation: 0.02%
        - Variation: 0.02 (extremely stable)
  - Kansas's GDP grew annually 4.3% in the 1997-2014 period
    - 1997: $75 billion
    - 2014: $147 billion
  - Future growth would be 4-5%
  - => deposit growth would be 4-5%
- Commerce has been able to hold or gain market share
  - In St. Louis
    - 1/3 of its deposits
    - Its market share was stable about 6.88%
    - From 1994 to 2015
        - Min: 6.30%
        - Max: 7.91%
        - Median: 6.88%
        - Mean: 6.97%
        - Standard deviation: 0.50%
        - Variation: 0.07 (very stable)
  - It has gained market share in Kansas City

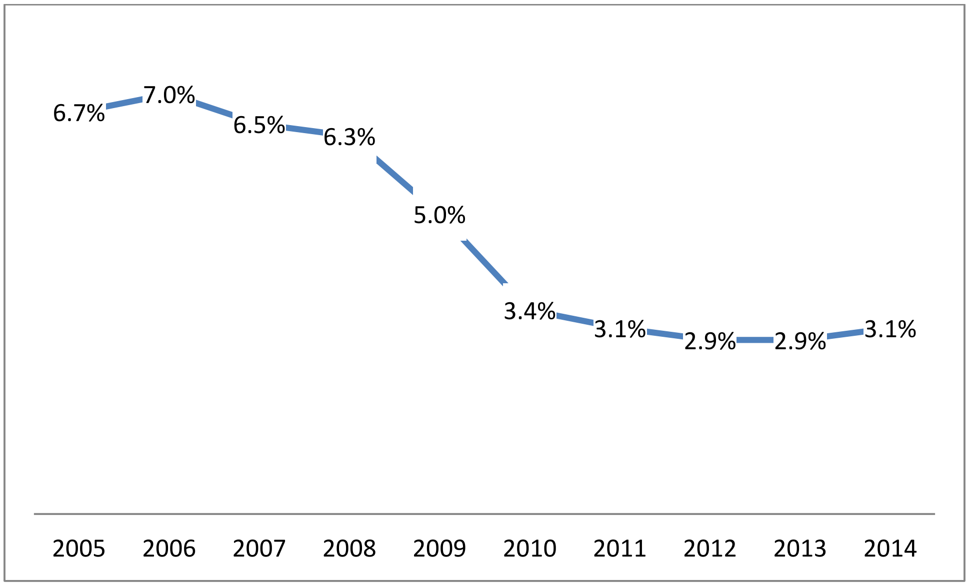
        - 1/3 of its deposits
        - Market share was
            - 1994: 8.20%
            - 2004: 9.78%
            - 2015: 13.04%
    - It has gained market share in Kansas state
        - 19% of its deposits
        - Market share was
            - 1995: 3.17%
            - 2004: 4.51%
            - 2015: 5.29%
    - Meanwhile, Bank of America and U.S. Bancorp has lost market share
        - In St. Louis
            - U.S. Bancorp
                - 1994: 27.75%
                - 2015: 15.44%
            - Bank of America:
                - 1994: 19.78%
                - 2015: 11.86%
        - In Kansas City
            - Bank of America
                - 1994: 16.07%
                - 2015: 9.71%
            - U.S. Bancorp
                - 1994: 7.55%
                - 2015: 6.14%
        - In Kansas state
            - Bank of America
                - 1994: 11.77%
                - 2015: 5.29%
            - U.S. Bancorp isn't a big player
                - 1994: 2.56%
                - 2015: 3.44%
- Commerce's "super community bank" model seems to work in these markets
    - Small enough to give customers personal touch
        - This is possibly the only reason for Commerce to perform better than U.S. Bancorp and Bank of America

- Large enough to have scale in
  - Wealth management
  - Payment systems
  - These services reinforce relationships with customers
    - Improve retention rate
    - Help Commerce to at least hold market share
  - Payment systems business is the weapon for Commerce to gain new commercial customers
  - This advantage is real
    - Smaller banks don't have significant fee-based businesses
    - Example:
    - Enterprise Financial (EFSC)
      - A bank with $3 billion earning assets
      - Operates in Kansas City, St. Louis, and Phoenix
      - Has 2.27% market in St. Louis
        - **#6** in St. Louis
      - Has 1.19% market share in Kansas City
      - Non-interest income is just **$17 million**
        - 13% of total revenue
    - Great Southern Bancorp
      - A competitor in Missouri
      - Average earning assets: $3.5 billion
      - 40% of its deposits is from Springfield, MO
        - Has 14.5% market share in Springfield
          - Only behind Commerce
            - 14.80% market share
      - Has 0.35% market share in Kansas City
      - Has 0.29% market share in St. Louis
      - Non-interest income is just **$31 million**
        - 16% of total revenue
    - National Bank Holding (NBHC)
      - A bank with $4.5 billion earning assets
      - Operates in Missouri and Colorado
      - Has 3.6% market share in Kansas City
        - **#6** in Kansas City
      - Non-interest income is just **$35 million**
        - 18% of total revenue

                - The market is fragmented
                    - Top 5 banks hold
                        - **42%** market share in St. Louis
                        - **52%** market share in Kansas City
                        - **22%** market share in Kansas state
                    - The rest of the market is shared between banks with 3% market share or less
            - Fee-based businesses don't guarantee Commerce's market share gain
                - But make Commerce's relationships with customers stronger than most competitors
            - => Commerce will hold or gain market share
- => Commerce's deposit growth can be in the 4-5% range
    - It may have only 2-3% growth in the near term
        - Current deposits: $19,315 million
        - Commerce expects to lose 6.5% of deposits under a 3% rising rate environment
            - $19,315 * 6.5% = $1,255 million
        - => deposits may decline to $18,060 million
        - At 4% annual growth rate, its total deposit would be $21,973 million in 5 years
            - => 2.6% annual growth rate from today's level
- Overall, Commerce's growth is below average
    - Low growth makes it difficult for margin expansion
        - The best chance is to grow the fee-based business faster
        - It's possible
        - But we shouldn't speculate on that
    - Low growth allows commerce to return 80-85% of earnings

Misjudgment

Will the Kemper Family Continue Leading Commerce Bancshares?



David Kemper's stake in Commerce has declined from 6.7% in 2005 to 3.1% in 2014

- **Biggest Negative**:
  - The Kemper family owns just 3.1% of Commerce
- Commerce has a more complicated loan portfolio than Frost
  - Frost don't make risky loans like
    - Mortgage loans
    - Credit cards
  - Frost's loan portfolio:
    - C&I: 52.7%
    - Commercial real estate: 36.3%
      - Owner-occupied: 20%
      - Non-owner-occupied: 16.3%
    - Consumer loans: 11.2%
  - Commerce's loan portfolio
    - C&I: 35%
    - Commercial real estate: 24%
      - Construction and land: 4%
      - Owner-occupied: 10%
      - Non-owner-occupied: 10%
    - Personal real estate: 16%

        - Consumer: 14%
        - Revolving home equity: 4%
        - Consumer credit card: 7%
- Deterioration in lending practice will be more costly to Commerce than to Frost
- Commerce has done a good job at controlling risks for 150 years
    - Has never needed government assistance in previous recessions
- Commerce's future safety will depend on how well it maintains its culture
    - The Kemper family has a long tradition in the banking business
        - The family run Commerce and UMB for 4 generations
            - Commerce's current CEO is the 4^{th} generation
            - Its COO is the 5^{th}
        - Commerce was founded by Francis Reid Long
            - In 1985
            - In Wild West Kansas City
        - W.T. Kemper became its first president[1]
            - In 1903
        - He acquired the failing UMB
            - In 1918
        - He died in 1938
            - His son "Big Jim" succeeded him at Commerce
            - His other son Crosby succeeded him at UMB
        - They usually joined the company at young age
            - At Commerce
                - James M. Kemper Jr. became president before he was 40 years old
                    - He's the son of "Big Jim"
                        - James M. Kemper Sr.
                - David W. Kemper
                    - The son of James M. Kemper Jr.
                    - Became president in 1982
                        - 32 years old
                    - Has been CEO since 1986
                - John W. Kemper
                    - The son of David W. Kemper
                    - Became President and COO in 2013
                        - 36 years old

- There are now 3 member of the family in Commerce's management team
  - David W. Kemper: CEO and Chairman
    - 64 years old
  - John W. Kemper: President and COO
    - 37 years old
  - Jonathan M. Kemper: Vice Chairman
    - 61 years old
    - He's the brother of David W. Kemper
- It's unclear how the family control Commerce
  - They owned about 10% in the 2000s
  - Today they own less than 5% of Commerce
- If John W. Kemper becomes CEO
  - Commerce might be in a good hand for 30 more years
  - He can maintain Commerce's strong culture
  - Employees who stay at Commerce for 10 years are newbies[2]
  - Commerce focuses on 4 metrics[3]
    - Topline growth
    - Pretax profit growth
    - Employee engagement
      - **94%** of employees are satisfied or better
        - The industry's average ratings: 70-75%
      - Commerce's employees know
        - What they do in their departments
        - What they do in their daily jobs
        - How that contributes to CBSH's success
        - => They're motivated
    - Customer satisfaction
      - It's consistently ranked highest for customer satisfaction
        - In the Midwest
  - Commerce remains a community bank despite its size[4]
    - Flat organization
    - 300 community directors
      - They're the eyes and ears of the organization
      - They understand the local markets

            - Commerce can hook up the top 10 markets every Monday mornings[5]
                - 100 people on the phone
                - Talk about what Commerce is going to do that week
                - Large banks can't do that
- Why is Commerce cheap?
    - Peers trade around 10-11 P/2014 EBT
        - EV/Deposits is around 0.18-0.22
    - => Mr. Market seems to neglect quality of funding
        - Low interest rates negate benefit of low-cost deposits
        - Mr. Market cares only about current P/E
            - This is consistent with Commerce's historical price
                - Usually trades within the 12-17 P/E range
    - If Commerce really has lower cost of funding than other banks
        - It'll outperform other banks when interest rates increase
        - => we'll beat the market
    - The only rationale for Commerce's current price is that Fed funds will stay near 0% for the next 5 years
        - Commerce will return 7-10% in that scenario
            - Dividends + share buyback: 4-5%
            - Growth: 3-5%

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[1] "One thing the cousins have in common is their grandfather, W.T. Kemper. The turn-of-the-century Kansas City businessman became chairman of Commerce Trust Co. and also bought a tiny bank called City National Bank, the precursor to United Missouri. **Before he died in 1938, W.T. was succeeded at Commerce by his son, "Big Jim," and at Citi National by another son, Crosby**.

The current chairmen both succeeded their fathers after starting at the bottom: James as an assistant cashier at Commerce and Crosby as a $130-a-month night clerk. Both were named president before they were 40 years old." – *One-Upmanship of the Kemper Cousins Is the Best Show in Missouri Banking*, John Curley, Wall Street Journal, 28 May 1985

[2] "**We have a very engaged team of long tenure. Somebody that's been with us for 10 years is a short-timer. We still look at them kind of as a newbie and that's just sort of the culture at Commerce and it's been very successful for us**. We have consistent execution, we hold people accountable and we give them good opportunities to develop themselves.

And all of that relates to really strong engagements scores, something we've been measuring for a long time. **Our employee engagement at 94% is better than financial services companies**, it's better than the US high-performance companies in general. It has gotten better every year. The key thing to that is our **people know what they do in their departments and what they do in their daily jobs, how that contributes to our company's success. They know that and they're very motivated**. They're personally motivated and they say that and they follow up with their actions and they do whatever they can to make Commerce Bank successful. People are proud to work at Commerce. We've got a good model; we've done well in the crisis and really, this has gotten nothing but stronger for us over time." – Charles Kim, Commerce's CFO, KBW Regional Bank Conference, 27 February 2013

[3] "**We try to measure our organization on four basic metrics, so we talk about topline growth, about pretax profit growth, and then the other two cornerstones are employee engagement and customer satisfaction**. We take that very seriously and this just gives you an indication about -- we talk about Commerce Bank engagement, something we do every year. And you can get a proxy for the industry but you can see on that bottom line, we are significantly ahead of the market and also you can only go so high but we have continued to have improvement in people's attitudes, banker's attitudes, and how they feel about the Company.

We try to talk a lot about being owner managers. **We have a bank incentive stock program and a lot of people have that, but we really take that very seriously and try to get long-term ownership of the bank**. **We think that's the best model where the employees really feel like they are owners of the organization** because we emphasized all the time that you have got to make long-term decisions to increase the value of the franchise." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[4] "We talk a lot about being a super community bank and the idea is that we are a community bank, a flat organization that we are very close to the market. **We have 300 community directors, a lot of banks have gone away from that, but we feel they are a very helpful group in being the eyes and ears of the organization**. **And we understand what the market is, so we operate like a community bank**. We've got a very strong culture. I will talk about that in a minute.

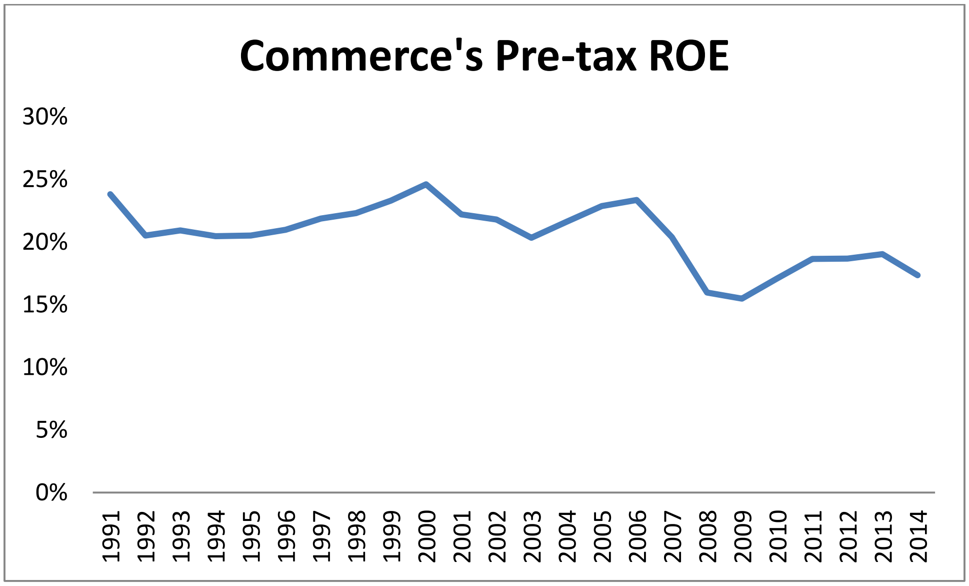
We think we have an advantage over the very large national banks, B of A and U.S. Bank would be our two major competitors in our large markets. **At the same time, at $18 billion, we have scale, so especially in businesses like the payment system and money management**, we are large enough and compete very effectively against any of the large providers throughout the country." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

[5] "And I think we've got the right kind of super community model to provide the service level and there's no question because I see it every day that we can outcompete the very large banks. I think one lesson that's been learned the last couple of years is **very large organizations are very difficult to manage. We've got the kind of culture that we think we can get everybody in one room**.

Just for an example, **every Monday morning we hook up our top 10 markets and we've got about 100 people on the phone. We talk about what we're going to do that week. We can do that in our organization. Large banks can't do that and small banks just don't have the product line**. So we think it's an excellent model in the market that should improve and even though it's going to be difficult operating environment the next year, we are very optimistic in the long run." – David Kemper, Commerce's CEO, Morgan Stanley U.S. Financials Conference, 02 February 2010

Conclusions

Commerce Is a Solid Value Stock



Commerce's pre-tax ROE has always been more than 15%

- Commerce is a boring stock
    - It's family-controlled
        - The family is publicity shy
    - It has no conference call
    - It has low growth
        - Missouri lagged the national GDP growth
        - Kansas's growth is just at the national average
        - Commerce makes few acquisitions
    - John Kemper (COO) said in an article:
        - "*My father always says banking should be a boring business*"
- Capital allocation is shareholder friendly
    - Commerce returns 80-85% of earnings to shareholders
    - Dividends: 1/3 of earnings
    - Share buyback: ½ of earnings
- Commerce is a fine stock to buy and hold
    - It's safe enough
        - ROE has always been more than 10%
        - Culture is strong
        - John Kemper may run the bank well for the next 20-30 years

  - Investors can get 8-10% long-term return
    - 4-5% yield from dividends and share buyback
    - 4-5% deposit growth
- Commerce deserves 10x EV/EBT
  - It’s a good business
  - but it doesn’t have the capacity to reinvest
  - it doesn’t deserve a premium multiple
    - but deserves an average price
- it’s a good stock to buy for the next 5 years
  - the price is great
    - 33.4% discount
  - Investors can make 14-15% return if interest rates rises to a normal level