

Butterfield Bank Group

June 2008

(NTB-BH)

BSX Financials – Banks

Share Price (06/27/08):	\$15.00
Stock Rating:	Hold
Risk Profile:	Low
1-Year Target:	\$15.00
1-Year Implied ROR:	4.3%

Annual Dividend:	\$0.64
Current Yield:	4.27%
Payout Ratio:	42%
Ex-Dividend Date:	07/31/08
Frequency:	Quarterly

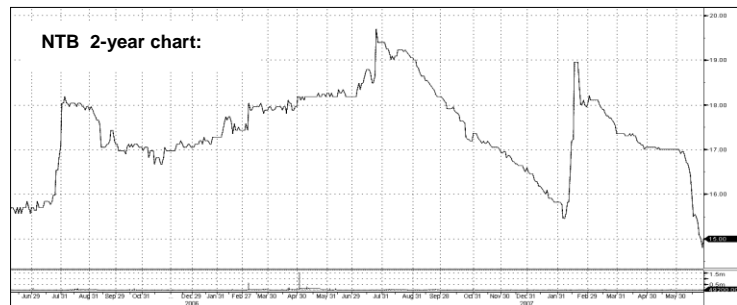
Shares O/S:	93.01m
Market Cap:	\$1,395m
BSX Weight:	55.34%
Book Value:	\$6.77
Price/Book:	2.22x

52-Week High:	\$19.70
52-Week Low:	\$14.70
Avg. Monthly Volume:	566k

Current P/E Ratio:	9.82x
Shareholder's Equity:	\$629.3m
Total Assets:	\$11.9b
Return on Equity:	23.2%
Return on Assets:	1.2%

Earnings Snapshot:	2005	2006	2007	2008E
EPS:	\$1.16	\$1.39	\$1.53	\$1.49
YoY Growth:	20.8%	19.5%	9.8%	(2.4%)
P/E Ratio:	11.03x	12.25x	10.86x	10.00x
Fiscal YE Price:	\$12.84	\$17.05	\$16.59	

Notes: -NTB issued a 1-for-10 stock dividend in February 2008 (per share figures have been adjusted accordingly.)
-NTB fiscal year end is Dec. 31st



Price chart as of June 27, 2008. Courtesy of Bloomberg LLP.

2007 Earnings Increase by 8.9%

INVESTMENT HIGHLIGHTS

- Butterfield reported strong operating income of \$146 million for fiscal 2007, or \$1.68 per share (pre the recent 1-for-10 stock dividend.) These earnings represent a year-on-year increase of 8.9%, and beat our per-share estimate by \$0.06.
- Top-line growth came in at a healthy 13.2%, as revenues rose from \$415 million to almost \$470 million.
- Assets Under Administration grew by 17.9% to reach \$145.7 billion; Assets Under Management were up almost 20% to \$11.9 billion; Customer deposits grew by 7.1% to \$10.4 billion.
- Group operating expenses rose by 14.4%, due primarily to employee headcount additions in Cayman, Guernsey, and Halifax as well as information systems upgrades and the acquisition of the Bentley Reid Group (with private client operations in Hong Kong, London, and Malta.)
- Return on Equity for the Group was 25.2%, well above management's target threshold of 20%, and the highest number ever reported by the Bank.

OPERATIONAL GROWTH REMAINS STRONG, BUT NEW INVESTMENTS A BIG CONCERN

- The Bank's loan-to-customer deposits ratio was 39.5% at year-end – a relatively conservative measure by international standards. Tier 1 capital stood at 8.6% of assets, with a total capital ratio of 13%.
- The Bank expanded into three new jurisdictions (Hong Kong, Malta, and Switzerland) with the purchase of The Bentley Reid Group (initial cost: \$28.4 million) and the establishment of a new trust operation in Zurich.
- Butterfield ceased any further purchase of asset-backed securities in the first half of 2007. However, they did report an unrealized loss of \$6.25 million related to credit derivatives held in a money-market fund. This problem appeared relatively minor and was financially subsidized by the Bank to protect client interests.

- During 2007, Butterfield made the unfortunate misstep of investing almost \$1 billion in CMO's (collateralized mortgage obligations) and ABS* (asset-backed securities). The majority of these new holdings had a term-to-maturity of "over 5 years". While these assets were likely seen as "investment grade" or of sufficient credit-quality upon purchase, they proved to be significantly impaired by fiscal year-end due to the deterioration in the U.S. housing market and the subsequent "credit crunch". Butterfield intends to hold these investments until maturity, and "expects the recovery of all amounts due".

* Note 4 of NTB's 2007 financials shows an asset-class entitled "Other, primarily asset-backed securities". We refer to these investments collectively as "ABS", under the assumption that any non-ABS investments are included in this category due to a similar structure and/or risk profile.

Q1 2008 Earnings Per Share Flat

INVESTMENT HIGHLIGHTS

- Diluted EPS for the 1st quarter came in at \$0.38, up just 1.0% year-on-year, and 5.5% quarter-on-quarter.
- Revenues rose to a new quarterly record of \$127.1 million, showing year-on-year growth of 14.7% and quarter-on-quarter growth of 4.1%.
- Net interest income before provisions was \$67.5 million – up 13.4% year-on-year, but relatively flat compared to Q4 2007.
- Assets Under Administration grew by 4.9% year-on-year to \$145.7 billion, but were down 1.6% from the \$145.7 billion of fiscal YE 2007. Assets Under Management were up almost 20% year-on-year to \$11.9 billion, but were also down 5.5% compared to Q4 2007. Customer deposits grew by 7.1% to \$10.4 billion.

EXPENSE GROWTH A CONCERN

- Total operating expenses increased year-on-year by \$15.7 million, or 21.4%, to \$89.3 million, due to significant headcount increases and information systems upgrades.

Price Target Down to \$15, Maintain "Hold" Rating

FORECAST AND RECOMMENDATION

- Management has expressed a relatively cautious tone for the remainder of fiscal 2008. Given the challenging operating environment for financials in 2008, we find this tempered guidance to be proper. Nonetheless, there remain distinct differences between Butterfield's predominantly "offshore" operating environments and those of its "onshore" peers: The Bank's earnings and revenue growth has traditionally derived from leading market positions in Bermuda, Cayman, and Guernsey. Recently, the UK, Barbados, and Bahamas operations have shown robust growth in a range of categories. Nascent ventures into Hong Kong, Malta and Switzerland could be poised for similar future successes. With its strong brand name and capital strength, Butterfield should be able to successfully expand into these proven financial markets.
- Recent changes in the Bank's "held to maturity" investment portfolio stand as our primary cause for concern. As of year-end 2007, Butterfield held \$1.46 billion (at cost) in CMO and (primarily) ABS investments, representing a year-on-year net increase of \$959 million, or 191%. The majority of these holdings (89% of CMO's and 75% of ABS) are long-term in nature (over 5-year term-to maturity.) Gross unrealized losses on the Bank's "held to maturity" portfolio totaled \$165 million as of Dec. 31st 2007.
- The inherent complexity of most CMO and ABS securities and the lack of a liquid market make them very difficult to value. Due to a widening in credit spreads and further deterioration in the U.S. housing market, we expect significant markdowns to the "held to maturity" portfolio by year-end 2008. The size of the Bank's loss provisions could be negatively affected by new, more rigorous accounting standards in the face of increased scrutiny regarding the conventional valuation methods of mortgage-related and asset-backed securities. Depending on the institution and adoption of such rules, we would estimate further impairment to Butterfield's "held to maturity" investment book of up to \$100 million.
- NTB shares have fallen substantially (over 22%) from late summer 2007 to the present. While we believe the Bank's core operations to be in good shape, we find this price decline to be reasonable, given the malaise of the global financial sector combined with the problems associated with Butterfield's investment portfolio. We apply a 10.0x multiple to our 2008 operating EPS estimate of \$1.49 to generate a one-year target of \$15.00. Butterfield Bank Group shares are rated as a "hold".

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