LOM EQUITY RESEARCH

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Butterfield Bank Group (BSX: NTB)

Research Update

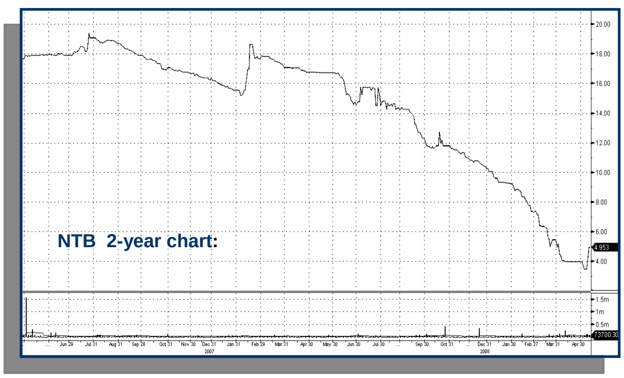
Rating: Buy
Target: $7.00

Key Data:	
Industry:	Financial Services
Price:	$5.00
52 Week Range:	$3.20-$16.93
Market Cap:	$481.5 mil.
Shares O/S:	93.6 mil.
Book Value/Share:	$5.27
Price/Book:	0.95x
Dividend Yield *:	3.20%
Trailing P/E Ratio**:	4.13x
2008 operating EPS:	$1.21
2009 operating EPS est.:	$0.88
* cash yield basis	** operating basis

Bank Reports First Quarter Loss on CMO Write Down
Rating Raised to "Buy", Price Target Now $7

First Quarter Results: Butterfield reported a net loss for 1Q09 of $20.8 million ($0.22 per fully diluted share), compared to a profit of $36.3 million ($0.38 per share) for the same period last year. The quarterly loss was the result of one-time losses of $40.9 million – of which $37.5 related to the write-down of a single CMO investment held in the Bank's held-to-maturity portfolio.

On an operating basis (excluding gains and losses), quarterly profit stood at $18.1 million, or $0.20 per share – a decline of 48.9% from 1Q08 operating income of $35.4 million. EBITDA came in at $22.5 million, or $0.23 per share – a year-on-year decline of 47.5%.



The Bank reported revenues before gains and losses of $88.9 million, which compared to $126.2 million last year – a decline of 29.6%.

Net interest income before credit-related provisions of $49.3 million was down year-on-year by $18.3 million, or 27.1%. The decline was due to the prevailing low levels of global interest rates and a lower asset base. Average interest-earning assets fell year-on-year by 14.0%, or $1.7 billion, to $10.4 billion – which contributed $9.5 million to the total decline.

Non-interest income was $40.6 million, representing a year-on-year decline of $18.2 million, or 31.2%. Factors contributing to this slump include the sale of Butterfield's fund services business in 4Q08 and sharp year-on-year declines in asset management, foreign exchange and trust revenues.

Total assets for the Group as of March 31, 2009 were $10.6 billion, down 17.2% from $12.8 billion a year ago, and down 3.3% from year-end assets of $10.9 billion. Assets under management decreased year-on-year by 26.9%, from $11.3 billion to $8.3 billion, and were down 8.8% from the year-end figure of $9.1 billion. Assets under administration increased during the quarter by 2.7% to $55 billion, reflecting continued growth in the Bermuda trust business.

Customer loans remained relatively flat at $4.3 billion, while customer deposits declined 20.0% year-on-year, from $11.6 billion to $9.3 billion. The bank's loan-to-customer deposits ratio of 46.1% compared to 37.8% a year ago and 47.0% at year-end 2008.

Total operating expenses decreased year-on-year by $16.3 million, or 18.3%, to $72.9 million. Salaries and benefits were down $8.9 million, primarily due to the sale of the Bank's fund services unit.

Shareholders' equity fell by $25.0 million, or 4.8% during the first quarter, from $518.4 million to $493.4 million. This decline was due, in most part, to the losses realized on Butterfield's held-to-maturity portfolio.

Financial Review and Outlook: The expected write-downs of Butterfield's investment book have continued to undermine the Bank's profitability into 1Q09. At year-end 2008, management stress-tested their CMO portfolio using 60% loss-severity assumptions (up from 50%.) The resulting estimate of "possible future discounts in the carrying value of potentially problematic CMO's" was $44.0 million. The Bank increased loss-severity assumption to 70% this past quarter and decided to realize a loss of $37.5 million on the most distressed security. We now anticipate that the majority of write-downs to the investment portfolio have been taken. With an estimated $450 million in CMO's (at cost) and $700 million in asset-backed securities remaining on Butterfield's balance sheet, we would estimate a worst-case scenario of $40-50 million in potential future losses. Given the underlying fundamentals of the Bank, they should be able to absorb such losses over the next 5 to 6 quarters.

The terms of Butterfield's $200 million preference share issue, announced in early March along with 2008 results, will soon be forthcoming and will serve to strengthen the balance sheet significantly. The Bank's first quarter Tier 1 and total capital ratios of 7.7% and 10.1%, respectively, have dipped below the 5-year averages of 8.8% and 12.3%. Management reports that the $200 million in new capital would boost these ratios to 11.1% and 14.5% – well above historical norms.

The Bank did not early adopt the new FASB rules (FSP 155-a, FSP 157-e, FSP 107-1) regarding inactive securities and mark-to-market accounting. They will employ these standards beginning in 2Q09 – which should further solidify the balance sheet, at least in the near-term. The long-term effects, however, will most likely be marginal.

After several quarters of rising costs due to headcount additions and infrastructure spending, Butterfield experienced some welcome expense relief during the past few quarters. The sale/merger of the Bank's fund services division and the conclusion of a large IT project contributed mainly in this area.

The weakening of the UK pound against the US dollar was significant factor in the decline in customer deposits, total assets, and AUM. The pound fell from a level of 1.98 in 1Q08 to 1.43 in 1Q09; this 28% decline had a profoundly negative impact when translating the balance sheets and AUM of Butterfield's UK and Guernsey operations.

Financial Summary:

BMD$ (in millions)	2006	2007	2008	2009E	2010E	1Q08	1Q09
Revenue, operating	$408.1	$470.0	$464.4	$385.0	$410.0	$126.2	$88.9
Net Income, reported	134.1	146.0	4.8	41.5	95.0	36.3	(20.8)
Net Income, operating	127.9	146.3	113.9	87.5	106.0	35.4	18.1
Reported EPS (diluted)	$1.39	$1.53	$0.05	$0.24	$0.90	$0.38	($0.22)
Operating EPS (diluted)	$1.32	$1.52	$1.21	$0.88	$1.10	$0.37	$0.20
Total Assets	11,133	11,911	10,912	10,800	11,200	12,900	10,600

Forecast and Recommendation: Butterfield has continued to write down their permanently-impaired mortgage and asset-backed investments on a gradual, systematic basis – a process which we foresaw following the release of the Bank's 2007 annual report. In fiscal 2008, Butterfield incurred losses and writedowns of $151.8 million, while 1Q09 saw a further $40.9 million. The uncertainty related to future losses, combined with weakening fundamentals for the banking industry, have had a devastating effect on Butterfield's share price; the stock has fallen by 51.4% year-to-date, touching a recent low of $3.20.

While we do not expect credit spreads to increase substantially over the next few quarters we do see two potential catalysts for a rebound in Butterfield's operating earnings: 1) a rebound in the UK pound/US dollar exchange rate, which should boost contributions from the Bank's UK and Guernsey operations; and 2) an increase in assets under management and a resulting improvement in fee income due to the recent rally in worldwide equity markets.

We apply an 8.0x multiple to our 2009 operating earnings estimate of $0.88 per share to arrive at our one-year target price of $7.00 on NTB shares. We currently rate Butterfield Bank shares with a Buy rating.

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