

Group 5

Bill Beck – Luke McKee – Roah Sham – Grant Taylor

Capitol Federal Financial (CFFN)

Sunday, February 15, 2009		
Ticker:	CFFN	Ind. Average
Price (2/13/09):	39.86	N/A
Market Cap(billions):	2.95	N/A
P/E (FY2008):	57.96	60.75
Adj P/E (FY2008):	17.1	19.7
Net Interest Margin(2008):	2.34%	1.34%
Efficiency Ratio:	49.90%	75.06%
Real Estate Loans (of total portfolio)	96.05%	51.05%

Investment Thesis:

We recommend a **HOLD** on Capitol Federal Financial for the following reasons:

- It is a well run financial company with risk averse lending practices that will help it weather the current adverse climate. Capitol Federal has a three year average efficiency ratio 24.5% below the industry average. In addition, 61.57% of their loan portfolio is in one to four family mortgages for applicants that have a credit score above 751.¹
- Relative to their industry, Capitol Federal has a lower net interest margin, which is a major factor in the profitability of a mutual holding company. Capitol Federal has a net interest margin of 1.34%, whereas the industry average is 2.14%.²
- Our relative evaluation projects that Capitol Federal is only undervalued by 13.8% with a target price of \$45.35. This reward is overshadowed by the risk of exposure to the housing market and the potential for further losses in secondary mortgage assets.

Company Overview:

Capitol Federal is a mutual holding company based in Topeka, Kansas. Currently, they serve the Kansas and the Kansas City area with 34 stand alone and 9 in store bank branches. Capitol Federal specializes in original one to four

¹ Capitol Federal Annual Report filed 12/1/08, pg 14

² Numbers attained from 2007 & 2008 10-K reports for CFFN, TFSL, BNCL, FCNCA, ISBC, KRNY, & NWSB

family home mortgage loans, but also provides home equity loans and other mortgages. The company has been traded on the NASDAQ since their 1999 offering, but only 29.95% of the company is publically owned.

Bear Market Case:

A prolonged recession could further depress the housing market. Real-estate loans make up more than 95% of the Capital Federal's loan portfolio and a poor housing market would cut deeply into new loan revenues. In addition, the banking industry would see a further decline in deposits, which will stifle lending. If external market rates go up, borrowers will be forced to pay higher rates, which will increase the amount of defaults. Net interest income will decrease, further reducing excess capital causing management to reduce dividends.³

Bull Market Case:

The local and national economy will rebound by year's end and credit markets will begin lending again. The government will create legislation that will encourage banks to lend and increase capital flow. The bank will experience a decrease in loan defaults as general economic conditions improve. The company will hold a stronger strategic position than competitors and increase market share. The housing market will return to normal and the bank will increase profitable mortgage activity. Interest expense will fall as market rates will decrease causing net interest income to increase.

Competitors:

Capitol Federal has many traditional banking competitors, which includes national branches, local branches, credit unions, and online banking service providers. Most of the competition is for consumer deposits, because they drive a banking institution's ability to lend money.⁴

At the lending level, Capitol Federal's competition is easier to define. The majority of their loans are to finance one to four family mortgages, which have very competitive lending rates. The most comparable mutual holding companies in terms of market cap were TFS Financial (TFSL), Beneficial Mutual Bancorp (BNCL), First Citizens BancShares

³ Capitol Federal Annual Report filed 12/1/08, pg 38-41

⁴ Capitol Federal Annual Report filed 12/1/08, pg 7-8

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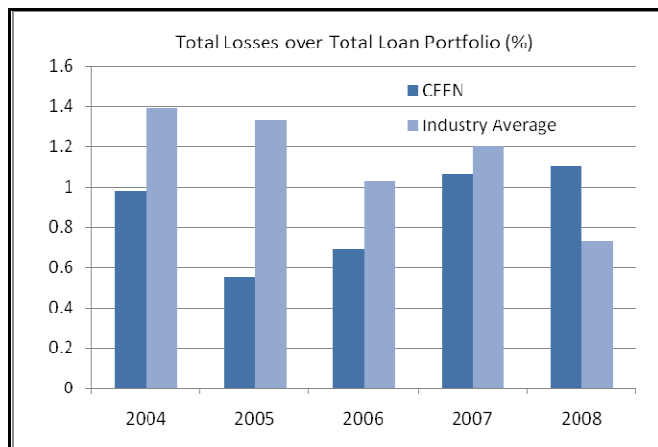
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(FCNCA), Investors Bancorp (ISBC), Kearny Financial (KRNY), and Northwest Bancorp (NWSB). Of these, TFSL, ISBC, and KRNY had the majority of their loan portfolios invested in one to four family mortgages.

Although many competitors have significant holdings in residential mortgages, Capitol Federal loans to this segment at a much higher rate. One to four family mortgages make up 93.43% of Capitol Federal's loan portfolio, whereas the industry average is 51.05%.

Risk Analysis:

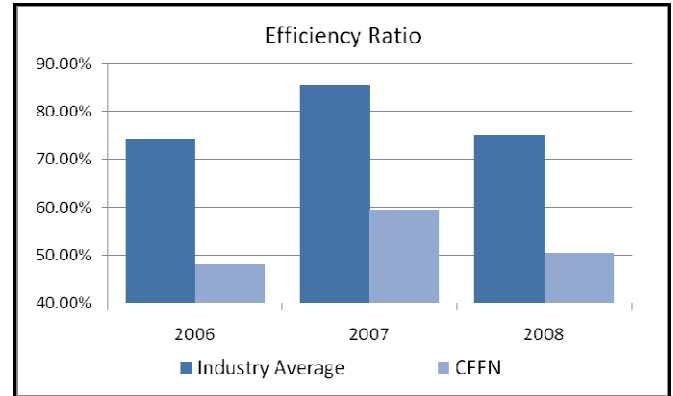
Traditionally, Capitol Federal has accrued losses to their loan portfolio at a lower rate relative to the industry average. The notable exception is 2008, which was mainly due to a heavy spike in losses on secondary mortgage investments.



This trend is most likely due to their more risk averse lending strategies. 65.9% of Capitol Federal's mortgages are lent out to applicants with credit scores above 751, and the majority of all mortgages have an LTV ratio of under 70%.⁵

Efficiency Analysis:

Capitol Federal is a more efficiently run company relative to their industry. Their efficiency ratio has outperformed the industry average for the last three fiscal years. This efficiency ratio can be found by taking non-interest expenses divided by net interest income plus other sources of income. If a business has a lower efficiency ratio, it is considered to be more 'lean'.



We believe that Capitol Federal's efficiency will slightly increase in 2009, and then continue to increase in the following years. We postulate that 2009 will see an increase in "other expenses", which will be caused by write-downs from credit losses and the devaluation of real estate.¹ Also, the yield curve is expected to start flattening in 2010, which will decrease the net interest income.

Mutual Holding Effect

The mutual holding corporate structure of Capitol Federal is deceiving. At the end of the FY2008, Capitol Federal had a total of 74,079,868 shares outstanding. This is deceptive because the Mutual holding company owns 52,192,817 of the outstanding shares, meaning the remaining 21,887,051 shares are available to the public. The reduced amount of shares outstanding needs to be accounted for because the Capitol Federal MHC waived its dividends in 2008, which effects the company valuation.⁶

Without the appropriate adjustment, a mutual holding company's stock appears to be overvalued. After the non-dividend receiving shares are removed from the valuation, the P/E and P/B ratios are reduced and more accurately describe Capitol Federal's share value.

Yield Curve Effects

The shape of the yield curve affects the borrowing and lending rates of banks. A bank usually borrows short term, but lends in the long term. When the yield curve is upward sloping, like in 2008, banks benefit because they are borrowing at lower interest rates than they are lending. This means that their interest expense is less than years with a flat

⁵ Capitol Federal Annual Report filed 12/1/08, pg 14

⁶ Capitol Federal Annual Report filed 12/1/08, pg 1

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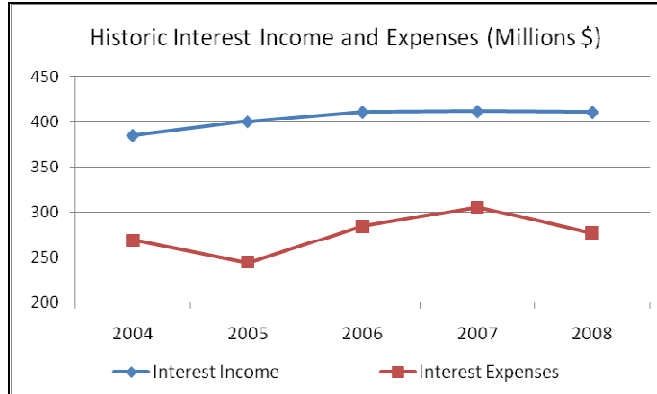
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yield curve, which increases their net interest margin.⁷ We believe that the yield curve will continue to slope steeply upward in 2009 before starting to level out in 2010 and 2011. This will allow Capitol Federal to favorably reprice many of their short term liabilities to gain a higher interest income.⁸

Interest Income Outlook

Over the past five years Capitol Federal's net interest income has been more driven by their interest expenses, rather than their interest income. Capitol Federal's interest income remained steady, while their interest expenses fluctuated. This is because the interest expenses are driven by market rates. For example, 2006 and 2007 expenses increased due to higher LIBOR rates.



Despite net income interest being driven primarily by external factors, Capitol Federal's net interest margin (NIM) is low relative to its competitors. By weighting the average lending rate (5.65%) and subtracting the weighted average interest rate (4.31%), Capitol Federal's net interest margin was found. Capitol Federal has a net interest margin of 1.34%, whereas the industry average was found to be 2.34%.

Relative Valuation

In order to determine the relative value of Capitol Federal, we used the adjusted P/E ratios of twelve comparable mutual holding companies, which averaged out to 19.7. After adjusting for the shares held by Capitol Federal, our 2009 EPS estimate of \$2.30 gave us an intrinsic value of \$45.35 per share. Using the most recent closing price of \$39.86 per share, we found the stock to be 13.8% undervalued.

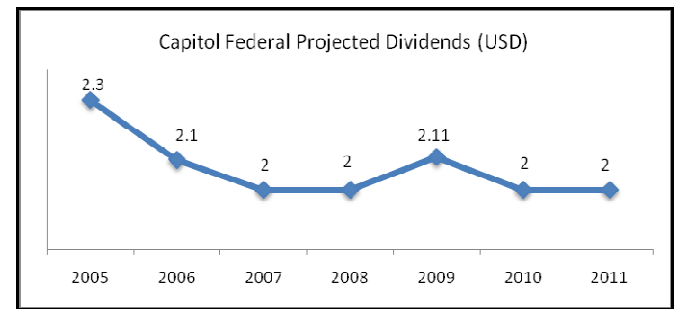
⁷ Capitol Federal Annual Report filed 12/01/08, pg 28

⁸ Capitol Federal Annual Report filed 12/01/08, pg 8

Intrinsic Value - Relative Valuation - P/E Multiple			
	Bull Case	Base Case	Bear Case
Comparable P/E Ratio	22.0	19.7	17.0
x 2009 Earnings (USD)	50,567	50,567	50,567
P* ÷ Shares Outstanding	1,112,474	993,642	859,639
Intrinsic Value/share (USD)	50.77	45.35	39.24
Current Price (USD)	39.86	39.86	39.86
% undervalued / (overvalued)	27.4	13.8	(1.6)

Dividend Discount Model

For our dividend discount model, we created dividend cash flows to get a present value price per share of Capitol Federal. We currently forecast that Capitol Federal will post \$2 dividends for 2010 and 2011 and assumed a growth rate of zero after 2011. We feel that Capitol Federal will post their traditional \$2/year dividend during the prolonged recovery of the economy.



Our dividend discount model also suggests a current price per share of \$45.35. Given the current price of \$39.86, our valuation shows that Capitol Federal is undervalued by 13.8%.

Summary

We recommend a **HOLD** on Capitol Federal Financial (CFFN).