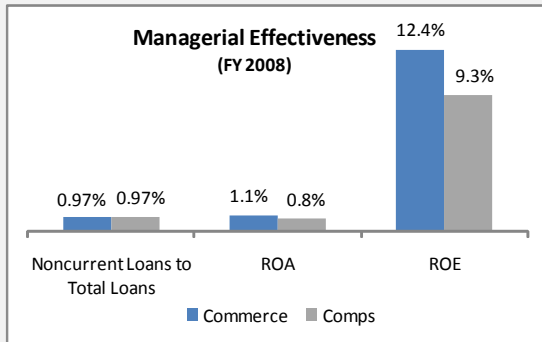


Recommendation: **HOLD**

### Solid and Sound, But Fairly Valued



Company: Commerce Bancshares  
 Ticker: NASDAQ: CBSH  
 Headquarters: Kansas City, MO

Price Target: \$ 36.00  
 Current Price (4/10/09): \$ 38.67  
 52 Week Range: \$27.80 - 52.86

	Comps	CBSH
Market Cap (M):	663.6	1,132.2
Equity to Assets (YE08):	8.3	8.3
Tier 1 Ratio (YE08):	9.6	10.0
Net Int. Margin (FY08):	3.55	3.88
Price/Earnings (2010):	16.1	13.2
Price/Book (2010):	1.4	1.8
Dividend Yield (%):	3.1	2.5

	Comps	CBSH
ROA (FY08):	0.80	1.05
ROE (FY08):	9.33	12.44
Efficiency Ratio (FY08):	60.8	63.4

**Comparables:** BOK Financial, City National, UMB Financial, Valley National Bancorp

## RECOMMENDATION

We place a **HOLD** on Commerce Bancshares stock.

## INVESTMENT THESIS

- Commerce management runs a stable and conservative banking operation as exhibited by its industry-low noncurrent loans to total loans of 0.97%. The stock is a low-risk, low-reward investment that currently provides a modest 2.5% dividend.
- Commerce's growth initiatives in commercial and private banking, which were established in 2007, should continue to drive growth and increase revenue in the coming years. The bank is also positioned to emerge from the recession in better shape than some of its competitors.
- There does not appear to be any short-term catalyst to drive the shares much higher than they have climbed over the past four weeks. Further upside potential should be limited over the next year due to continued weakness in the overall economy and the current "fair" valuation of Commerce's stock.

## COMPANY OVERVIEW

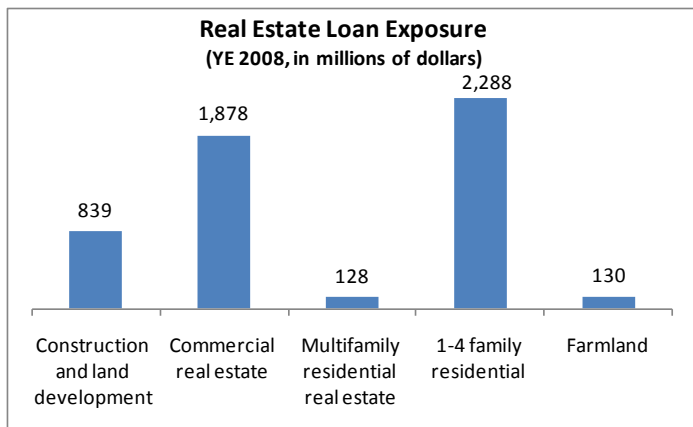
Commerce Bancshares is a regional banking firm in the Midwest with 360 locations throughout Missouri, Kansas, Illinois, Colorado and Oklahoma. The Company is one of the 50 top bank holding companies in the U.S., based on asset size. Commerce operates under a super-community banking format with local market orientation to develop strong relationships and quality service. In addition, regional advisory boards, consisting of local business professionals and other community representatives, assist Commerce in detecting and profiting from local banking trends.

The Kansas City, Missouri-based firm operates in three segments: Consumer, Commercial, and Money Management. Commerce provides financial services including: lending, personal banking, brokerage, and money management services to individuals and institutional clients.

## STABLE PERFORMANCE

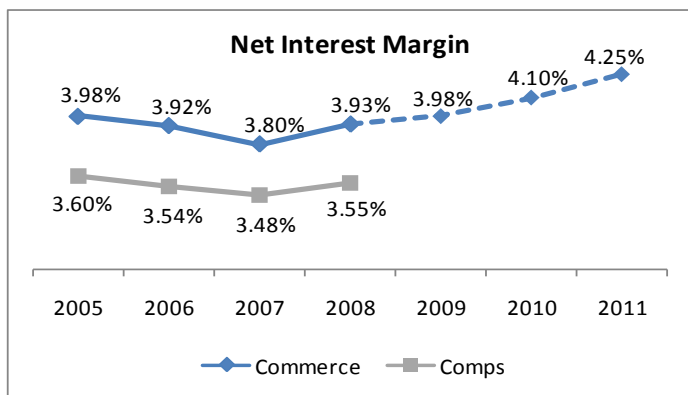
Commerce has not been immune to the global recession and saw a decline in overall performance in 2008. Even so, the company avoided much of the real estate losses experienced by other banks due to its position in the less volatile Midwest region and its conservative management. Commerce has pledged additional collateral with the Federal Reserve and Federal Home Loan Bank to

“backup” funding facilities, suspended stock buy-backs to conserve capital, and has avoided participation in TARP.



Commerce has a diverse revenue mix that depends less on interest income than its competitors, 61% vs. 71% of total revenue, and more on wealth management and card income, consisting of 11% and 12% of Commerce’s total revenue, respectively.<sup>1</sup> The diversified revenue streams should help Commerce emerge more quickly from the recession than competitors, which rely more heavily on interest income and fee income.

Net interest margins have increased due to the return of a more normal yield curve in recent months, but because rates are at record lows, interest income has decreased as well. Commerce has traditionally outperformed peers’ net interest margin by 30 basis points. We expect Commerce to continue to maintain a superior margin and for all banks’ net interest margins to slowly increase over the next few years. We anticipate rising rates as a consequence of an improving U.S. economy and current government stimulus plans, which should spark inflation.



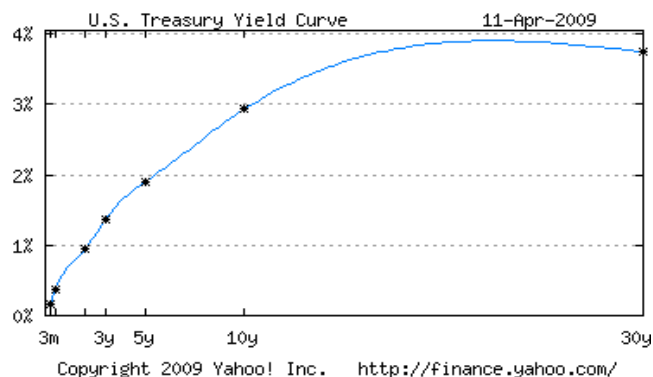
<sup>1</sup> Commerce presentation, “Investor Presentation.” Jan. 26, 2009. [www.commercebank.com](http://www.commercebank.com). Accessed 4/10/09.

Commerce’s loan loss provisions have skyrocketed over the last year to \$108.9 million, up from \$42.7 million in 2007, due to the deteriorating economy. Net interest income has risen over this same period, but not nearly enough to compensate for the increased loan losses. We expect this to be a temporary spike and not a continuing trend. Furthermore, the loan loss provision is only 1% of Commerce’s total loans. We expect provisions to decrease and net interest income to increase through 2011 as loan quality improves and interest rates rise to more normal levels.

	2007	2008	2009	2010	2011
Interest Income	936.1	849.9	892.3	963.7	1,060.1
Growth	12.5%	-9.2%	5.0%	8.0%	10.0%
Interest Expense	(398.0)	(257.1)	(282.8)	(353.5)	(424.2)
Growth	24.7%	-35.4%	10.0%	25.0%	20.0%
Net Loans	10,471.8	11,110.6	11,832.8	12,779.4	13,929.6
Growth	9.7%	6.1%	6.5%	8.0%	9.0%
Deposits	12,551.6	12,894.7	13,346.0	14,013.3	14,854.1
Growth	6.9%	2.7%	3.5%	5.0%	6.0%
Loan Loss Provision	42.7	108.9	94.7	63.9	55.7
Of Total Loans	0.4%	1.0%	0.8%	0.5%	0.4%

### YIELD CURVE

The yield curve is a key factor effecting Commerce’s net interest margin. A flat or inverted yield curve will harm its net interest margin as the company borrows short-term and lends long-term, making money off the spread. Net interest margin for Commerce and its competitors was declining until 2008, due to a relatively flat yield curve. The flat yield curve dramatically increased interest expenses and, in effect, decreased margins for all banks.



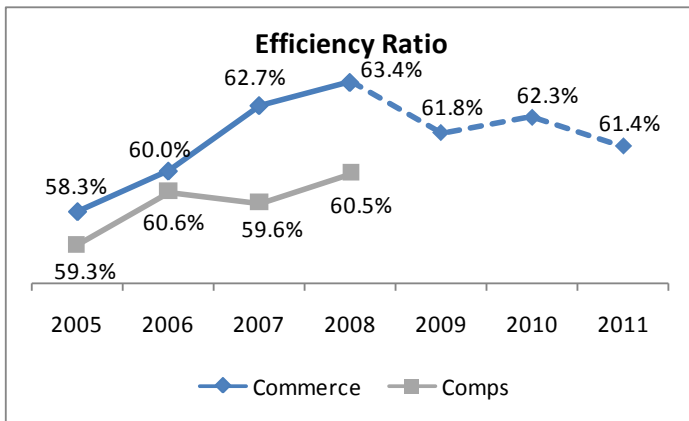
From the latest yield curve graph,<sup>2</sup> we expect the curve in 2009 to remain upward sloping and the net interest

<sup>2</sup> Found on [www.finance.yahoo.com](http://www.finance.yahoo.com). Accessed 4/11/09.

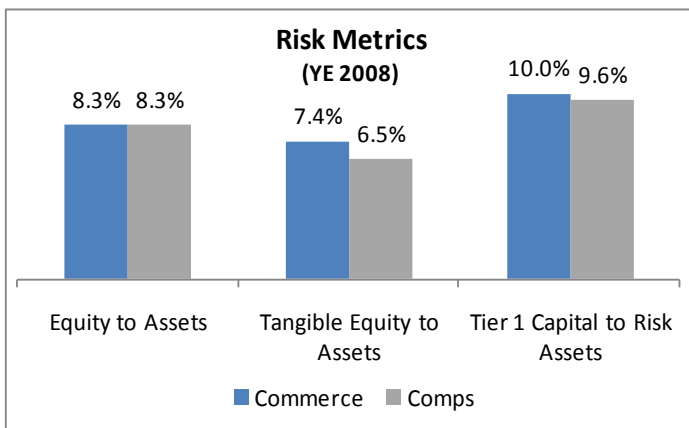
margin of Commerce and its peers to increase due to increasing long-term rates.

**INDUSTRY ANALYSIS**

Commerce started an initiative in 2007 to grow revenue in focused areas to balance growth, profitability, and risk management.<sup>3</sup> Due to this initiative, non-interest expenses have risen by 7.2%, partially from increased staffing in commercial bank card, commercial banking and the private banking divisions. The increase in non-interest expenses has led to an increase in Commerce’s efficiency ratio, which has historically been in line with its peers. The efficiency ratio should begin to decline over the next few years as the company begins to fully realize the cost savings and revenue increases of the 2007 initiative.



Unlike many of the larger banks – and even some smaller ones – Commerce is strong financially with healthy Tier 1 and tangible common equity capital ratios, so solvency is not a concern. Commerce’s capital ratios are in line with or better than its healthy regional banking peers.



<sup>3</sup> Commerce Bancshares, 2008 10-K. pg. 25. [www.commercebank.com](http://www.commercebank.com). Accessed 4/9/09.

**VALUATION**

We developed two models to value Commerce’s shares: a dividend discount model and a relative valuation model.

Using the dividend discount model, Commerce’s shares are overvalued by 28% (a price target of \$30.27). Our primary value drivers in the model included a 2008 dividend of \$0.96, dividend growth of 3% into perpetuity, and a cost of equity capital of 6.3%.

According to our inputs into the relative valuation model, Commerce’s shares are either 31% overvalued or 18% undervalued, by applying a Price to Book and a Price to Earnings multiple, respectively. We believe bank stocks trade with a stronger correlation to Price to Book multiples. As such, we place greater reliance on the 31% overvaluation that we derived from the Price to Book relative model, which was based on a 2010 book value per share of \$21.31 and a peer average P/B multiple of 1.4.

Although the value of the banking industry has fallen precipitously since the beginning of 2008, the regional banking industry has performed relatively well. Nonetheless, banks often trade near two times book value, substantially lower than the 1.4x multiple used in our relative valuation model. To understand how changes in the multiple impact the intrinsic value of Commerce we performed a sensitivity analysis.

Target Price: Sensitivity Analysis				
		2010 Book Value per Share		
		20.00	21.50	22.00
P/B Ratio	2.2	44.00	27.30	48.40
	1.8	36.00	38.70	39.60
	1.2	24.00	25.80	26.40

Based on this analysis, the most optimistic outcome for Commerce’s shares (2010 book value per share of \$22.00 and a P/B ratio of 2.2) provides a 20% undervaluation.

**CONCLUSION**

The conservative nature of Commerce’s banking operations has been fully recognized in the current financial environment. Further capital appreciation over the next year is possible, but likely limited. With the banking industry facing heightened regulation, only a modest dividend yield, and the prospect for a prolonged economic recovery, we do not believe the current time represents a compelling buying opportunity for Commerce shares. We recommend a **HOLD**.