H.M. Payson & Co.

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RESEARCH NOTES

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Citigroup ($36)

In the wake of mounting write-offs in the bank's Securities and Lending Division, Charles Prince, Citigroup's Chairman and Chief Executive Officer, has resigned from the firm as of November 4th. On a temporary basis, former U.S. Treasury Secretary Robert Rubin, a current Senior Vice Chairman and Citigroup Board Member, will serve as Chairman of the Board. Sir Win Bischoff, the head of Citigroup's European Operations, will act as interim CEO.

The write-offs Citigroup is taking are a result of the bank's direct and indirect exposure to sub-prime mortgages. As default rates rise on these mortgages, it ultimately impacts the derivative securities they comprise as packages of mortgages held widely by hedge funds, etc. As we all know by now, Citigroup was not alone in having exposure to these investment vehicles, as many banks and brokerages are now suffering from the fallout. The uncertainties surrounding the potential size of the write-offs, the quality of Citigroup's balance sheet, and the management changes are having a significant impact on Citi's stock price. Since Citigroup is widely held in our accounts, we are monitoring the developments closely and are obviously disappointed in the recent results.

We believe there is sufficient cash flow and adequate capital for management to sustain the dividend on the stock. Citigroup currently yields around 6%, roughly 200 basis points higher than a 5 year US Treasury. This yield alone should help support the stock and ultimately help its recovery. Secondly, there are several steps that the bank can take to shore up its capital ratios to maintain statutory requirements. Finally, we believe new management will aggressively address the mortgage loan issues and the entire corporate structure in an effort to restore investor confidence. Considering these factors, we conclude that low-basis positions in taxable accounts should be held at this juncture. However, since a recovery may take some time, we will take tax losses where appropriate and revisit the stock at a later date.

The banking industry's exposure to the sub-prime mortgage problem is symptomatic of the pressure on managements to elevate earnings by venturing into riskier loans. For some time now, we have been concerned about declining net interest margins due to a flat yield curve as well as the potential for a cyclical deterioration in the industry's overall loan quality. Although the steep declines in bank stocks may appear to represent investment value, we believe the group may be in a protracted period of slow earnings growth. Therefore, we would not rush to establish new positions at this time, and would continue to underweight them in most portfolios.

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