

Northern Empire Bancshares

OTC-BB: NREB - \$19.00

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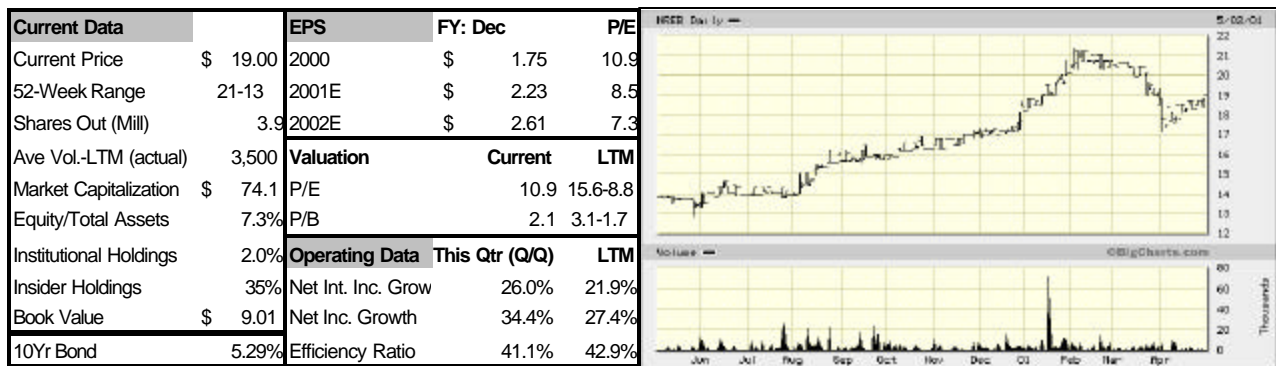
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1Q01 Results

Loan Growth and Strong Net Interest Margins Boost EPS 29% in 1Q01



Source: Big Charts

Key Investment Points:

- 29% EPS growth resulted from solid loan growth and strong net interest margin.
- Loans increased 23% as the bank experienced steady demand during the quarter.
- The net interest margin rose to 4.69% from 4.57%.
- Operating efficiencies improved despite the opening of a new branch and introduction of iBanc.
- Our 12- 18 month target price remains \$30.00

Company Description

Northern Empire Bancshares (NREB) is a bank holding company that conducts its business through its wholly owned subsidiary, Sonoma National Bank (The Bank). The Bank operates five branches in suburban communities located throughout Sonoma County, California and has loan production offices in Phoenix, AZ, San Francisco, Walnut Creek, and Sacramento, CA.

Investment Thesis

NREB has an impressive operating history, solid management, and is focused on a niche that has allowed it to continually grab market share. The Bank generally outperforms its peer group thanks to a growing economic market and focused management. Yet the stock remains undervalued, largely because it has not received any notice outside its current market area.

In addition to solid fundamentals, NREB should also benefit from a change in market attitude toward bank stocks. Community bank shares have been the "Rodney Dangerfield" of the stock market. Despite solid earnings growth, the sector has languished as attention was focused on dotcoms, growth stocks, and the impact of generally rising interest rates. With the dotcom bubble burst, we think investors are rediscovering the importance of value investing. In addition, with interest rates expected to fall during 2001, community bank operating margins should provide an added boost to the sector.

1Q01 Results

EPS increased 29% to \$0.53 in 1Q01 as NREB experienced a robust net interest margin, steady loan growth, and increased operating efficiencies. Net interest income rose 26% to \$5.8 million as NREB benefited from the declining interest rate environment.

- The net interest margin improved to 4.69% from 4.57% in 1Q00 as NREB's deposits reacted to declining interest rates faster than the Bank's loan portfolio. The loan portfolio reacts relatively slower to interest changes because the majority of the loans are tied to the 11th District Cost of Funds, which has fallen slower than the Prime Rate.
- Total loans increase 23% to \$457.2 million versus \$370.6 million at March 2000. Management indicated that loan growth was steady throughout the quarter.
- The efficiency ratio improved to 41.1% from 44.0% in 1Q01 and 43.0% in 4Q00, as growth in service charge income offset increased expenses from a new branch (Petaluma opened in November) and the introduction of NREB's internet banking service. Service charges on deposits increased to \$148,000 from \$122,000 in 1Q00 and \$78,000 in 4Q00 as the Bank benefited from lower interest rates.

Total assets grew 19% to \$521.8 million from \$438.2 million a year ago. This growth was funded by a 20% increase in deposits (\$478.2 million in 1Q01 versus \$398.1 million in 1Q00).

NREB remains a "well capitalized" bank with a risk-based capital ratio of 10.7%

Table 1 compares 1Q01 operating performance.

Table 1: 4Q00 Operating Summary					
(\$Thousands)	1Q00		1Q01		Growth
Total Assets	438,257		521,819		19.1%
Loans-Net	370,640		440,087		18.7%
Net Interest Income	4,619		5,821		26.0%
Net Income	1,547		2,079		34.4%
EPS (diluted)	\$	0.40	\$	0.49	22.5%
ROAA	1.48%		1.70%		14.9%
ROAE	20.68%		22.37%		8.2%
Ret. On AEA*	4.57%		4.74%		3.9%
Efficiency Ratio	44.0%		41.1%		-6.7%
* Annualized return on average earning assets					
Equity/Assets	7.02%		7.33%		4.3%
Share Price					
End of Period	\$	15.13	\$	19.50	28.9%
High	\$	18.87	\$	19.56	3.7%
Low	\$	16.19	\$	16.56	2.3%
Book Value	\$	7.67	\$	9.01	17.5%
P/B (average)	2.61		2.12		-18.4%

5% Stock Dividend

On March 3, 2001, NREB announced its eight consecutive annual 5% stock dividend. Since January 1985, when NREB opened Sonoma National Bank, the Company has had two stock splits (both 2-for-1), six cash dividends (totaling \$2.06), and eight 5% stock dividends. In 1994-5, the Bank transitioned from paying cash dividends to stock dividends (see Table 2).

Table 2: Stock Splits and Dividends				
Effective Date	Type	Amount		
1989 17-Jan	Split	2 for 1		
1991 9-Apr	Dividend	Cash	\$ 0.25	
1992 1-Apr	Dividend	Cash	\$ 0.60	
1993 3-Apr	Dividend	Cash	\$ 0.30	
		7-Oct	Dividend	Cash \$ 0.35
1994 15-Apr	Dividend	Cash	\$ 0.18	
		29-Jul	Dividend	Stock 5%
		15-Nov	Dividend	Cash \$ 0.18
1995 28-Apr	Dividend	Cash	\$ 0.20	
		14-Oct	Dividend	Stock 5%
1996 14-Jun	Dividend	Stock	5%	
1997 31-Mar	Dividend	Stock	5%	
1998 1-May	Dividend	Stock	5%	
		16-Oct	Split	2 for 1
1999 7-Jun	Dividend	Stock	5%	
2000 17-May	Dividend	Stock	5%	
2001 5-May	Dividend	Stock	5%	

Outlook

We raised our EPS forecast as the result of better than expected growth in earning assets in 1Q01. Our forecast for 2001 and 2002 are now \$2.23 (up \$0.07) and \$2.61 (up \$0.05). This forecast includes the effect of the may 5th, 5% stock dividend. Our assumptions are relatively unchanged, except that the new base (1Q01) is higher than our prior forecast. Table 3 contains our annual forecast details.

Table 3: Annual Operating Performance & Forecast				
	\$Million	2000	2001e	2002e
Net Interest Income		20,399	24,379	28,009
Loan Loss Prov		-960	-960	-1,000
Service Chrgs		362	598	622
Gain on sale of loans		451	677	691
Other Non-Int.		643	496	516
Tot. Non-Int Inc		1,456	1,771	1,828
Securities G/L		0	0	0
Salaries & Benefits		5,468	6,315	7,161
Office/Equip		855	915	988
Other Non-Int Exp		3,207	3,394	3,649
Tot. Non-Int Exp		9,530	10,625	11,798
Pre-Tax Inc		11,365	14,565	17,039
Taxes		4,513	5,821	6,816
Net Income*		6,852	8,745	10,224
* May not sum due to rounding.				
Eff Tax Rate		39.7%	40.0%	40.0%
Diluted EPS	\$	1.75	\$ 2.23	\$ 2.61
<i>Growth Rate</i>		19.0%	27.4%	16.9%
Shares (MM)		3,915	3,923	3,923
Ave. Earning Assets		431,994	522,091	607,578
<i>Growth Rate</i>		24.2%	20.9%	16.4%
Ret./Ave. Earning Assets		4.72%	4.67%	4.61%
Efficiency Ratio		43.6%	40.6%	39.5%
Boldfaced data are estimates				

Valuation

Our 12-18 month target price remains \$30.00 because NREB's fundamentals remain strong (see our February 1, 2001 report for more details). Despite our higher forecast, our target price range is relatively unchanged. We think the stock's recent pull back from its 52-week high is due to some profit taking and, perhaps to a lesser degree, concerns about the California economy. While California faces some serious issues, NREB's has a diversified market base that runs from Santa Rosa to San Francisco and to Phoenix. And, with lending experience that spans many business cycles, the bank has avoided lending to high-risk concerns like the dot-coms (see Table 4, below).

(\$000)	1996	1997	1998	1999	2000
Total Charge-Off	62	222	0	32	66
Total Recovery	0	69	0	0	0
Net	62	153	0	32	66
Net C/O to Ave. Ln	0.04%	0.08%	0.00%	0.01%	0.01%
Allowance/Loans*	1.4%	1.6%	1.4%	1.3%	1.2%

* Excludes SBA guaranteed loans

Our 12-18 month target price of \$30.00 is based upon our 2002 forecast and assumptions factored into our price/earnings (P/E) and price/book (P/B) multiples. Our assumed P/E multiples reflect our expectations that the market will find this stock more attractive than it did last year for three reasons:

- Lower interest rates generally make bank stocks more attractive,
- After being burned by growth stocks in last year's market, value investing could gather more converts, and
- NREB itself should garner more attention as its reputation spreads.

The P/B ratio is usually the dominant ratio used by investors in bank stocks. We chose to be more conservative and assume a multiple equivalent to the trailing 12-month average. We view this as a conservative multiple because during the last year, the market basically ignored the community bank sector, giving it a low valuation.

	LTM Average	Est. Mult	2002 Estimate	Target Range
P/E			EPS	
High	13.6	14.0	\$ 2.61	\$ 36.49
Low	9.3	11.0		\$ 28.67
P/B			Book Val.	
High	2.7	2.4	\$ 14.27	\$ 34.24
Low	1.8	1.8		\$ 25.68
Average Range				
			High	\$ 35.36
			Low	\$ 27.17
			Ave.	\$ 31.27
% From Current Price				
			High	68%
			Low	29%

Investment Risks

Investors should consider the following risks when investing in these shares:

These shares are not very liquid due to a fairly high percentage of insider ownership.

The banking sector has been out of favor due to interest rate fears and the potential for greater returns in other sectors. However, in the wake of the dotcom meltdown, the market appears to be refocusing its attention on the value stocks that have great fundamentals and less hype.

Operating performance may not be reflective in the stock's price because the market is generally ignorant of the performance of small cap stocks because Wall Streets on big cap companies.

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