

WEDGEWOOD VIEW. 3RD QUARTER 2004

1ST NATIONAL BANK OF WEDGEWOOD

Over the course of our investing careers we have only invested in a handful of banks. The two most prominent cases involved the likelihood of a merger (Boatmen's Bank: 1994) and Street skepticism over the merits of a merger (Norwest and Wells Fargo: 1996). Our reluctance to invest in a typical full-service bank was due to the superiority of monoline financial service companies. Most full-service banks, either local, regional or nationwide, offer a wide array of lending and related financial services. If an investor had a magic wand and could build the ideal bank, such a bank would cherry-pick the most profitable and steadily growing lending and service markets. Such a bank would offer unique customer service and industry-leading market share and economies of scale. Our ideal bank would, of course, be conservatively financed with the highest possible lending standards. Most important, our ideal bank would possess management depth, breadth, and experience throughout each division as opposed to a typical full-service bank that operates in commodity-like markets. Our atypical bank would have nearly impenetrable, non-commodity, sustainable competitive advantages.

Sound improbable? Perhaps. But with the high competitive hurdles just outlined, we would like to present the "1st National Bank of Wedgewood."

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The 1st National (stock symbol: ROE) is a full-service "bank." Its services and products are focused on only those markets where it has demonstrated a competitive advantage. Part and

parcel of businesses with outstanding competitive advantages (and rarely found at full-service banks) are proprietary products or services, economies of market and technological scale, growth with limited acquisitions, and deep and seasoned management. Such businesses should generate consistent and industry-leading returns on equity or capital. Most important is the market opportunity to reinvest accumulated profits to earn future returns on equity at sustainable high rates; we believe this is the best definition of a growth company. A smart fellow in Omaha often describes such outstanding businesses as “moats.”

The board of the “1st National” has identified a handful of what we believe are the most bountiful markets in which to offer our financial products and services. They include local community banking, home mortgage origination and servicing, student lending, affinity credit cards, fee-based money management, electronic money transfers and the electronic processing of credit and debit cards. In this Letter we will discuss two divisions - our community banks and our student lending operations.

Community Banking

What could be more highly competitive, growth-restricting, commodity-like and profitability-restricting than local branch community banking? You could probably count such lousy businesses on one hand. So why on earth do we want to be in community banking? Maybe if you turn the traditional bank business model on its head, you just might gain a competitive advantage. Maybe if you could compete on services instead of price (deposit rates)? Maybe if you could drive growth by the quality of your services rather than the price of your product? Maybe if you could be the low-cost provider in a commodity market, you just might capture growth many times in excess of market growth. Maybe if our banks were open every day of the week with weekday hours as late as 8:00PM, customers would find our bank more convenient with their time-constrained schedules. Maybe if our customer service and convenience was so much better than our competitors, our depositors would hold deposits with us an industry-leading average of 14 years? Maybe if word spread throughout the community of a unique shopping (banking) experience, in many markets our branch banks

would not even need to publish our already low deposit rates? Maybe if our culture of service was so successful and pervasive, the only limit to our individual store (branch) growth would be the size of our parking lots? (No, we are not kidding!)

Sound impossible? Well, this is exactly what our community branch banks provide. Turning a deep-rooted business “on its head” requires more than differentiation. It requires a total change of culture. It requires thinking of traditional cookie-cutter, monotonous branch banks as local “stores.” It requires a willingness to invest and build such stores in magnitudes and degrees of design and cost greater than plain vanilla local banks to insure shoppers (depositors) a unique shopping (banking experience). It requires taking a page out of the manual of McDonald’s University to train and inculcate all of our employees in our store culture at our own Community Bank University. In short, it requires such a marked distinction in customer service, relative to our community competitors, that even in the face of numerous bank and non-bank alternatives our customers want to come to our unique “stores.” An aside: Could something as simple as free self-service coin-counting kiosks increase traffic at our stores? You bet. Coin counting transactions should exceed 400,000 across our stores.

In the banking business lending rates less deposit rates define operating margins. But the profitability chain must first start with deposit growth - in your community bank’s case - low cost deposit growth. The economics of your branches are stunning. Yes we build very expensive stores (\$4,000,000 per store) on prime real estate. Yes, we have the highest cost staffing ratios in the industry. However, being the low cost deposit funder (currently just 0.70%), while also growing deposits at industry leading rates is profitability nirvana.

A smaller \$30 million deposit base store of ours typically generates pre-tax income of \$700,000 per year. The annual pre-tax return on such a store is a respectable 17%. At the highest end of our store base - \$150,000,000 deposit base stores – generate pre-tax income of \$6,600,000, or a return on store capital expenditures (capex) of 165%. Our stores in operation at least one year average \$100,000,000 in deposits. Our seasoned stores generate on average \$4,300,000 in pre-tax income. These seasoned stores average a return on capex of 107% per year. *(We hope that we have captured your attention by now!)*

Deposit growth at your community banks over the past five years have been nothing short of spectacular, growing 36%. Revenue, net income and earnings per share growth have compounded over the past five years at 30%, 31% and 25%, respectively. Longer still (since 1991), deposits, revenues and earnings per share have compounded at 30%, 31% and 22%. This performance is better than any of the top 100 banks in the country.

If we are growing so fast (winning), who is losing? Almost every bank we compete against. Our results in New Jersey are illustrative (and would make Darwin proud). At the end of 1991 we had \$1.1 billion in deposits and a 1% market share. Fleet had 20% market share and \$29.1 billion in deposits. First Union and PNC had 18%: \$24.7 billion and 11%: \$14.4, respectively. Over the course of the next 12 years, and including acquisitions, at the end of 2003 Fleet lost -\$1.8 billion in deposits and their market share dropped to 15%. First Union dropped seven market share points and lost -\$4.5 billion in deposits. PNC dropped four market share points and lost -\$1.1 billion. Our community banks gained five market share points and gained +\$11.1 billion in deposits.

The Board of Directors of the 1st National sleeps well at night given the conservative lending standards at our community banks. Credit quality will not be sacrificed for the sake of loan growth to keep pace with our rapid deposit growth. Your bank continues to have one of the lowest loan-to-deposit ratios in the industry. Our asset quality is superb (as compared to the average top 50 bank).

- Non-Performing Assets: .11% (.60%)
- Charge-Offs: .17% (.37%)
- Loan-Loss Reserves: 1.50% (1.52%)
- Non-Performing Loan Coverage: 419% (278%)

Can such growth rates continue? If the history of your community banks is any guide, +20% growth rates are not only likely, but we expect periods of accelerated growth rates from time to time. Consider our experience upon entering Manhattan in 2001. Defying most banking

experts, we forged ahead and opened our first store in September 2001 and deposits now exceed \$350,000,000. Deposits at our 15 NYC stores are currently growing at \$75 million per year, per branch.

Our community banks currently have over 170 stores in the Metro New York/New Jersey area and over 150 in Metro Philadelphia. In fact, annualized growth per store has exceeded \$25 million in deposits so far this year. In these two markets we expect to max out at 600 stores. Our newest market is Metro Washington D.C./Baltimore. We will open 10-15 stores in this new market in 2005. We believe that this market has a 200 store potential. We believe Metro Boston could become another 200 store market.

Our community bank division has not only been one of the fastest growing banks in the country, but one of the fastest growing companies in any industry. In existing markets we only have a 3.5% deposit market share. We expect to be a \$100 billion bank with over 700 stores by 2009. Our 50% (not a typo) annual cash flow will fund our future growth.

Of course, our community bank is Commerce Bancorp.

Student Lending

On the short list of sacrosanct American institutions which include, among others, home ownership and apple pie, we would add college education. When just a couple of short decades ago a college graduate was the source of family and neighborhood pride, today a college degree – and increasingly, post-graduate study – are minimally lauded personal achievements. According to the U.S. Census Bureau and the Bureau of Labor Statistics, unemployment rates continue to be remarkably low for the educated – Bachelor degree (3.3%), Masters (2.9%), Doctorate (2.1%) and Professional (1.7%). In addition, “continuing education” is a permanent part of the landscape for advancement in the corporate world.

The student lending arm of the 1st National is the country's recognized leader as the largest private source of education funding and loan servicing support. As a lender, our student lending division enjoys a very unique credit profile. The federal government has long played a key role in the advancement and support of higher education. Under the Federal Family Education Loan Program (FFELP) the U.S. government guarantees student loans provided by accredited lenders. In fact, 92% of the student loans underwritten by our bank are federally guaranteed. We entered the student lending business 30 years ago. Today we command nearly 25% of the guaranteed student loan market. Our nearest competitor is a distant second at 7% market share. We are the leader in education credit, loan delivery, and related fee-based services. Our customers include over 7 million borrowers as well as over 6,000 universities and colleges.

Of all of the markets in which the 1st National competes, the student loan market has the most rapid and durable growth. According to the College Board, over the past ten years the cost of attending a four-year private and/or public college or university increased more than 40% on a cumulative basis in inflation-adjusted 2003 dollars. Supporting the potential growth of the student loan market, the National Center for Education Statistics projects that college enrollment will likely increase 12% over the next decade. According to the College Board, the current total cost of a full-time private education is \$118,000 and full-time public education \$55,000. (I think we just heard a collective groan from our clients with pre-college age children.) However, the annual loan limit under the FFELP is just \$17,125. The opportunity for credit is obviously large and will be a key driver of our future growth. In fact, our private loan portfolio grew 43% in 2003. So despite the fact that our student lending arm has nearly \$100 billion in managed loans, future growth looks to be robust. We expect our student lending arm to grow by at least 15% for the foreseeable future.

As the student loan market has changed, so has our student lending business. At our inception in 1972 we were known as a Government Sponsored Enterprise (GSE). In 1997 we secured congressional and shareholder support to become a completely private entity. Our goal was to wind down the GSE by 2008. Today it is almost complete. Our business has diversified beyond merely the wholesale servicing of loans. Today, in addition to federal and private

credit lending, we now offer a growing array of fee-based debt management/collection and guarantor services. Fees make up nearly 30% of our revenue base. Better still, our fee-based operations cover nearly 90% of our division-wide operating expenses.

Our asset composition and quality are outstanding. 90% of our managed student loans are under the federal guarantee program. 10% of managed loans are private, non-guaranteed credit. Our net loan losses, as a percent of student loans, are just .12%. Relative to banks whose credit ratings are AA or higher, our loss coverage ratios are exceptionally strong.

- Margin Coverage of Loan Losses: 15X (6X)
- Capital Coverage of Loan Losses: 23X (14X)
- Private Credit Reserve Coverage: 2.9X (1.7X)

In addition to outstanding credit control, our student lending arm is minimally interest rate sensitive. Interest rate risk is minimized by the FFELP program which effectively guarantees fixed spreads over market interest rates. Our student lending arm further mitigates risk via match asset/liability funding.

The student lending business, due to its relatively immunity and insensitivity to economic cycles, is one of the most steady state and predictable of most any lending/spread business we have studied. In addition, given the low financing and interest rate risk, the capital requirements of our student lending arm are quite low. In essence, this means that we can leverage the assets in this division with debt to generate quite high returns on equity. Our current debt to equity ratio is 22X. Our current return on equity is 55%. Our 5-year average ROE is 46%. Our student lending arm has generated positive net income every year since its founding in 1973.

Our student lending arm is SLM Corp. – more formally known as Sallie Mae.

Over the next two quarters we will chronicle our credit card, asset management and electronic debit and credit card processing division. Here are a few teasers from these outstanding

businesses. The 1st National's credit card division has "branded" credit cards through innovative affinity partnerships. Over 5,000 endorsing organizations and financial institutions have partnered with our credit card division. Our asset management division revenues have grown 57 of the last 58 quarters. The growth rate of our asset management division is the fastest of asset managers of like size in the nation – growing organically three times as fast as the industry average. Our card processing division is the largest in the world. We process credit and debit card transactions for 3.5 million businesses and merchants. We process card transactions for over 42 million card holders. We own and operate 9,000 ATM machines. We have over 200,000 agents around the world in our 144 year-old global cash transferring division. Our card processing division generates \$2 billion in free-cash flow per year. Our mortgage banking division is both the nation's leading mortgage originator and mortgage servicer (\$800 billion servicing portfolio).

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Chief Investment Officer

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