

# 1st Source Corporation SRCE (NAS)

| Last Close | Industry                                    | Sector |
|------------|---|--------|
| 14.36 USD  | Regional - Midwest Financial Services Banks |        |

## Profile

Pricing data through 19 Nov 2009

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1st Source Corporation is a bank holding company that provides, through its subsidiaries, an array of financial products and services. Through its principal subsidiary 1st Source Bank, 1st Source offers commercial and consumer banking services, as well as trust and investment management, and insurance, to individual and business clients.

The bank offers specialized financing services for new and used private and cargo aircraft, automobiles and light trucks for leasing and rental agencies, medium and heavy duty trucks, construction equipment, and environmental equipment. 1st Source is not dependent upon any single industry or client. 1st Source Bank provides commercial and agriculture loans to corporations and other business clients primarily located within 1st Source's regional market area. 1st Source Bank provides a full range of consumer banking services, including checking accounts, on-line banking, savings programs, installment and real estate loans, home equity loans and lines of credit, drive-in and night deposit services, safe deposit facilities, automated teller machines, overdraft facilities, and brokerage services. 1st Source Bank provides a wide range of trust, investment, agency, and custodial services for individual and corporate clients. 1st Source Bank, through its Specialty Finance Group, provides a range of comprehensive lease and equipment finance products addressing the financing needs of diverse companies. 1st Source also generates equipment rental income through the leasing of construction equipment, various trucks, and other equipment to clients through operating leases.

The Specialty Finance Group also consists of separate wholly owned subsidiaries of 1st Source Bank which include: Michigan Transportation Finance Corporation, 1st Source Specialty Finance, Inc., SFG Equipment Leasing, Inc., 1st Source Intermediate Holding, LLC, 1st Source Commercial Aircraft Leasing, Inc., and SFG Equipment Leasing Corporation I. Trustcorp Mortgage Company, is a mortgage banking company with five offices in Indiana and Ohio and a wholly owned subsidiary of 1st Source

Corporation. 1st Source Insurance, Inc., is a wholly owned subsidiary of 1st Source Bank which provides insurance services to individuals and businesses covering corporate and personal property products, casualty insurance products, and group health and life insurance products.



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## Management & Ownership

### Management Activity

| Name                     | Position                                    | Shares Held | Report Date* | InsiderActivity |
|--------------------------|---|-------------|--------------|-----------------|
| MURPHY CHRISTOPHER J III | Chief Executive Officer, Chairman, Director | 836,592     | 04 Nov 2009  | -               |
| JONES WELLINGTON D III   | President, Director                         | 160,300     | 18 Feb 2009  | -               |
| STIFEL RICHARD Q         | Executive Vice President                    | 104,474     | 18 Feb 2009  | -               |
| LENTYCH LARRY E          | Chief Financial Officer, Treasurer          | 43,040      | 03 Sep 2009  | -               |
| FITZPATRICK DANIEL B     | Director                                    | 38,900      | 01 Sep 2009  | -               |
| PHAIR JOHN T             | Director                                    | 33,134      | 04 Nov 2009  | -               |
| JOHNSON WILLIAM P        | Director                                    | 18,383      | 29 Oct 2009  | -               |
| OZARK TIMOTHY K          | Director                                    | 17,184      | 04 Nov 2009  | -               |
| MARTIN REX               | Director                                    | 5,122       | 06 Mar 2009  | -               |

\*Report date represents the date on which the owner's common shares held was audited.

### Fund Ownership

| Top Owners                        | Morningstar Rating | % of Shares Held | % of Fund Assets | Change (k) | Portfolio Date |
|-----------------------------------|--------------------|------------------|------------------|------------|----------------|
| DFA US Small Cap Value I          | QQQ                | 2.50             | 0.21             | 0          | 30 Jun 2009    |
| DFA Tax-Managed US Targeted Value | QQ                 | 0.93             | 0.26             | 0          | 30 Jun 2009    |
| DFA US Micro Cap I                | QQQ                | 0.82             | 0.13             | -8         | 30 Jun 2009    |
| Vanguard Small Cap Index          | QQQ                | 0.75             | 0.02             | 4          | 31 Jul 2009    |
| Vanguard Total Stock Mkt Idx      | QQQ                | 0.65             | 0.00             | 7          | 30 Jun 2009    |
| Concentrated Holders              |                    |                  |                  |            |                |
| FBR Small Cap Financial           | QQQQQ              | 0.40             | 1.01             | 19         | 30 Jun 2009    |

### Institutional Transactions

| Top 5 Buyers                           | Morningstar Rating | % of Shares Held | % of Fund Assets | Shares Bought/Sold (k) | Portfolio Date |
|--|--------------------|------------------|------------------|------------------------|----------------|
| FBR Small Cap Financial                | QQQQQ              | 0.40             | 1.01             | 19                     | 30 Jun 2009    |
| American Beacon Small Cp Val Inst      | QQQQ               | 0.15             | 0.03             | 13                     | 31 Jul 2009    |
| Vanguard Small Cap Value Index         | QQQ                | 0.47             | 0.05             | 10                     | 30 Jun 2009    |
| DFA US Targeted Value I                | QQQ                | 0.24             | 0.08             | 8                      | 30 Jun 2009    |
| Vanguard Total Stock Mkt Idx           | QQQ                | 0.65             | 0.00             | 7                      | 30 Jun 2009    |
| Top 5 Sellers                          |                    |                  |                  |                        |                |
| DFA Tax-Managed US Marketwide Value II | QQ                 | 0.15             | 0.04             | -15                    | 30 Jun 2009    |
| DFA Tax-Managed US Marketwide Value    | QQ                 | 0.15             | 0.04             | -15                    | 30 Jun 2009    |
| DFA US Micro Cap I                     | QQQ                | 0.82             | 0.13             | -8                     | 30 Jun 2009    |
| SEI Instl Mgd Small Cap Value A        | QQQ                | 0.02             | 0.02             | -8                     | 30 Jun 2009    |

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## Industry Focus: US Regional Banks

### Our Outlook for Regional Banks

01 June 2009

Jim Sinegal  
Stock Analyst

A new normal or  
back to the future?

Following the conclusion of the Supervisory Capital Assessment Program stress tests and the resulting infusions of new capital into many banks, investors' focus has shifted from the banks' ability to survive the current downturn to their potential earnings power on the other side. Some sources of profits, such as securitization, already appear to be relics of the distant past. Similarly, excessive leverage is unlikely to return for at least a decade, and the need for major changes in the regulatory system is painfully obvious. Although the specific changes to come are difficult to predict, we think some helpful generalizations can be made after a simple examination of banking industry dynamics.

#### Competition Is Here to Stay

In our opinion, regional banking is very much a commodity industry. Competition is generally intense, and there are few barriers to entry, aside from the approval of regulators. While financial innovations like CDOs, credit derivatives, and other products temporarily boosted profitability, nothing prevented industry participants from competing away excess profits resulting from these new products--in fact, a strong case can be made that competitive forces led to the demise of several financial companies and virtually the entire "shadow banking" system. This comes as no surprise--any student in a freshman microeconomics course knows that excess profits unprotected by an economic moat will eventually be competed away. Similarly, when industry profits decrease below cost of capital, firms will exit through failure, acquisition, or other means. We therefore believe profits across the banking industry should once again approximate costs of capital once the crisis is resolved.

As in all commodity industries, companies that excel at controlling costs--operating, credit, and funding--should be able to continue earning excess profits. Wells Fargo's WFC extremely low cost of deposits is a perfect example

of this, as is the company's history of superior underwriting. In other cases, banks benefit from high-return businesses other than banking. PNC Financial PNC has a profitable fund servicing business, US Bancorp USB owns a payment processing operation, and both have profitable wealth management arms. The low capital requirements of these service businesses tend to boost overall returns as well, and their relative stability helps to keep these banks from venturing too far afield in search of higher returns. It's therefore not surprising that these narrow-moat banks have fared better than most in recent months. We don't believe the advantages developed by these companies over many years are likely to disappear anytime soon, and we expect that these banks are likely to continue producing returns well in excess of their cost of capital.

#### Regulation Will Not Affect All Participants Equally

Much has been made of the prospects for increased regulation of the banking industry, and for good reason. Lax regulation of subprime mortgages, derivatives, and other areas of the financial system no doubt contributed to the mess plaguing the financial system.

Some industry observers have put forth the possibility that banking could begin to resemble a utility in the future, rather than the profitable growth industry it has been over the past few decades. In our opinion, this comparison is tenuous at best. As Josh Peters, equities strategist and editor of Morningstar DividendInvestor points out in "The Ultimate Dividend Playbook", utilities are naturally endowed with a substantial economic moat. In most cases, a particular utility is the sole supplier to a geographic area. Additionally, utilities are capital intensive, creating a sizable barrier to entry. It should be obvious that the banking business has neither of these features. Utility regulation is meant to limit profitability and protect customers--the banking industry suffered from the opposite problem. It is now obvious that the banking sector's problem was not excess returns, but in fact the inability to generate acceptable returns without taking on unacceptable risk.

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Furthermore, any attempts by regulators to control pricing in the banking industry are likely to end in disaster. On the other hand, regulation meant to reduce leverage and excessive risk-taking is almost a certainty. In assessing the effects of this change on a particular bank, it is important to identify the source of past returns. In the case of banks like Flagstar Bancorp FBC, excessive leverage and overreliance on new financial products undoubtedly were the factors responsible for the 20%-plus returns on equity it achieved earlier in the decade. However, Wells Fargo was earning 20% returns on equity in the 1980s, long before irrational exuberance took hold across the lending industry, and the superior economic characteristics of the business outlined above are still in place. In our opinion, banks like Wells are therefore less likely to suffer from a regulatory crackdown.

Furthermore, as leverage is reduced across the industry, the irresistible forces of competition will eventually drive industry returns back to an appropriate level, as firms react to the new operating environment. In fact, lending spreads are already the highest they have been in years, as rational competition has returned to the market. New regulatory policies could also benefit banks--higher capital and loan loss reserve requirements should help smooth the boom/bust cycle that periodically plagues the banking industry. Making the banking system safer will not necessarily reduce profitability--the pharmaceutical industry is heavily regulated for safety, yet quite profitable. Finally, regulators must also consider the second-order effects of overly harsh new requirements. If profitability is artificially limited, investors will be reluctant to provide the capital necessary to keep the financial system--and the economy--functioning. From a macroeconomic perspective, growth is likely to be muted as the economy deleverages, but how will the system recover if future growth and profitability are hampered by regulation?

### It's Not Time to Swing for the Fences

The implications of the coming changes are most serious for the weakest banks. Those that struggled to achieve their

cost of capital during the boom years will face enormous pressures as the recession continues, and many will likely exit or be acquired at distressed prices, as assets are transferred to more productive uses. The mismanaged assets of Washington Mutual and National City are no doubt better off in the hands of J.P. Morgan Chase JPM and PNC, and we expect this trend to continue for some time. Banks that could not achieve satisfactory returns in the boom years will surely fare even worse without the tail winds provided by excessive leverage, perfect credit, and structured products. While a few of these weaker banks are likely to survive and perhaps experience a spectacular increase in stock price from current levels, we place these types of bets firmly in the category of speculation. Some of these players will surely not make it.

### Stick to the High Ground, and Focus on Moats

On the other hand, the strongest regional and superregional banks--those with established economic moats--could benefit from the changes to come. The ability to cheaply acquire assets and market share from weakened or failed competitors could result in a nice boost to short-term growth, and the reputational benefits from passing through the crisis relatively unscathed could last for a long time, further strengthening competitive advantages where they already exist. Though Warren Buffett popularized the concept of economic moats, our own research also suggests that moats are a key factor in achieving investment success. In a highly competitive industry like banking, where truly durable competitive advantages are rare, moats are often even more important. For this reason, we recommend that investors focus their attentions on banks with narrow or wide moats and strong management teams, leaving the low-priced lottery tickets in the industry for others.