March 2015

Webster Financial (WBS)

Healthy Bank with a Hidden Gem: 34% Upside and a Potential Spin-Off

Webster Financial (WBS) is a mid-sized regional bank holding an undiscovered multi-billion-dollar asset. On the surface, Webster is just another depository, albeit one with leading market share in Connecticut and surrounding areas. Despite consistently strong performance, including positive operating leverage and robust loan growth, Webster trades in line with its less impressive peers at 15x consensus 2015 earnings. Simply based on traditional banking metrics, Webster's valuation is too cheap. But what truly makes Webster special is its HSA Bank unit, which, in the wake of its recently closed acquisition of a similar operation from JPMorgan, is now the nation's largest provider of health savings accounts. These HSAs – tax-advantaged deposits tied to high-deductible health plans and used to pay for a wide range of qualified medical expenses – have exploded in popularity as employers and policy-makers search for ways to restrain health spending. HSA Bank has been at the forefront of this trend, growing its deposits organically at a 29% CAGR since 2005; today, with more than $4 billion under management and approximately 15% market share in a sector that is forecast to more than triple in size over the next several years, HSA Bank is poised for even greater success.

Investors recognize HSA Bank's attractive growth prospects and unique value *qualitatively,* but have failed to recognize the *magnitude* of the upside. Making matters worse, Webster's financial disclosures, though improving, have made it difficult to observe the HSA segment's profitability directly. Fortunately, there is now a very clear comparable: last July, an HSA Bank competitor called HealthEquity (HQY), which is roughly half HSA Bank's size, went public and has now garnered a $1 billion valuation. Scaling this valuation based on a variety of metrics, we estimate that HSA Bank could easily trade for $2 billion. Given Webster's overall market cap of only $3 billion, shareholders are in effect getting the core regional bank – with $14 billion of loans and deposits and a mid-teens return on tangible common equity – at an incredible discount. To our knowledge, almost no one else has undertaken this simple analysis; indeed, few are even aware of HealthEquity's existence, despite its obvious relevance.

Going further, we pull together the available information about the *pro forma* HSA Bank's earnings power and, making straightforward assumptions, estimate a standalone DCF value of almost $17 per share. Using conservative peer multiples for the core bank, we value the combined business at $46, 34% above the current stock price. To cure the dramatic undervaluation of Webster's solid, well-run regional franchise and high-growth HSA business, we urge the company's board to consider a simple prescription: spinning off HSA Bank.

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I. Investment Highlights

- **<u>Webster has 34% upside to a conservative sum-of-the-parts valuation</u>**. Webster has two key components: a high-performing, traditional regional bank focused on the Northeastern market and a specialized, rapidly growing national franchise providing health savings accounts (HSAs). In January, Webster closed its acquisition of JPMorgan Chase's HSA business, quietly making it the largest HSA custodian in the country. Yet the market has failed to ascribe an appropriate value to Webster's HSA Bank, even as it accords a smaller competitor (half of HSA Bank's *pro forma* size) with a billion-dollar valuation. Though this competitor, HealthEquity (HQY), has a somewhat different business model than HSA Bank, the valuation discrepancy is simply too large to justify: we estimate that, if valued like HealthEquity, HSA Bank would be worth $2 billion on its own, accounting for the vast majority of Webster's overall market value. Using a more conservative DCF approach (and giving no credit for increased incremental profitability in the future as a result of higher short-term interest rates), we estimate that HSA Bank is worth at least $1.5 billion. Assuming that Webster's core regional bank trades in line with its peers, the total company is worth almost $46 per share, 34% higher than its current price.

Illustrative Sum-of-the-Parts Valuation

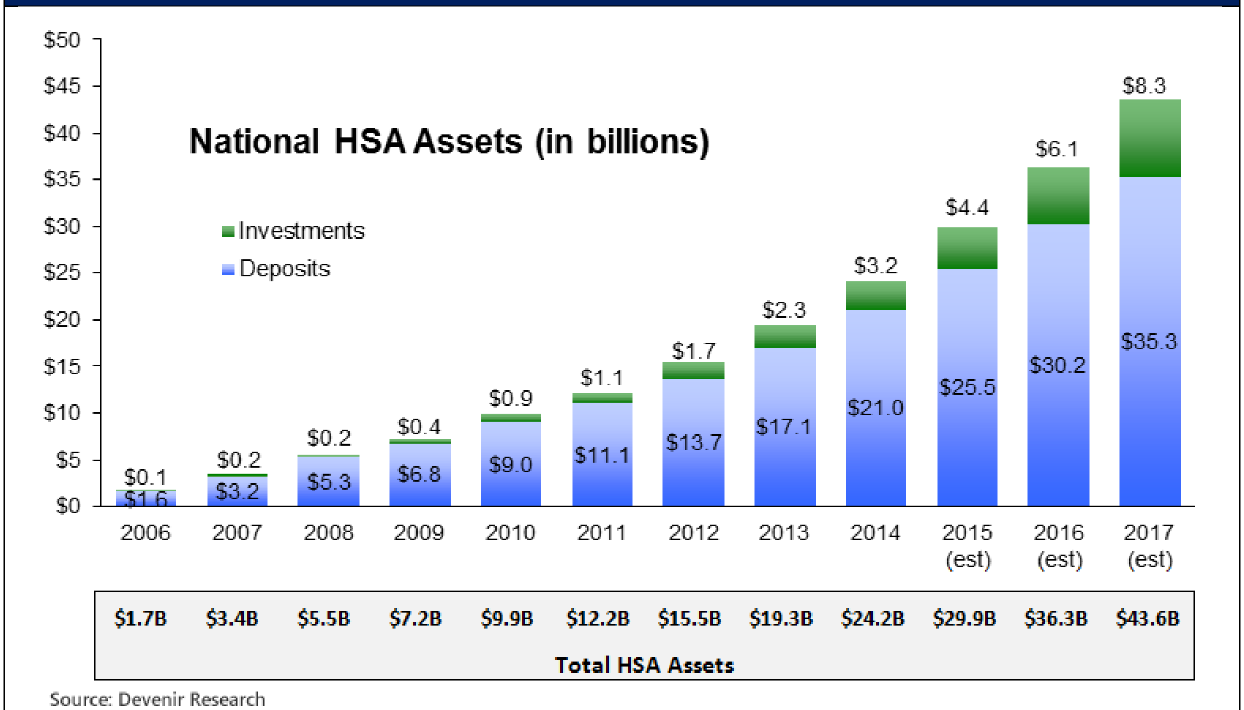
	Core bank	HSA Bank	Total
Run-rate EPS	$ 1.84	$ 0.40	$ 2.25
Fair value ($mm)	$ 2,664	$ 1,534	$ 4,198
Fair value per share	$ 29.36	$ 16.90	**$ 46.26**
P/E ratio	*15.9x*	*41.9x*	*20.6x*
% upside			***<u>34%</u>***

Source: WBS filings, Capital IQ, Kerrisdale analysis

- **<u>The HSA market will continue to enjoy steady secular growth</u>**. According to the industry group America's Health Insurance Plans (AHIP), enrollment in HSA-eligible health plans has grown from 1 million to more than 17 million since March 2005 – a CAGR of 38%. As HSAs have become more popular, the deposits and securities housed in these accounts have also ballooned, going from $1.7 billion in 2006 to $24.2 billion in 2014, according to the consulting firm Devenir. Since the average balance per account tends to increase dramatically over time (from ~$800 for new accounts to more than $6,000 for seasoned ones), as users and their employers make additional contributions and become comfortable with the product, deposit growth will enjoy a strong tailwind over time even if accounts were to stop growing. But, to the contrary, industry experts project total HSA accounts to increase rapidly, with one recent white paper predicting enrollment of 50 million individuals across 37 million accounts as soon as January 2019, driven in part by the ongoing rollout of private health-insurance exchanges. Having capitalized on these developments from very early on and now ranking as the largest player in the HSA market, Webster's HSA Bank unit is well positioned to benefit from continued industry growth for years to come.

Current trends support these longer-term forecasts. The 2014 *Employer Survey on Purchasing Value in Healthcare*, published by Towers Watson and the National Business Group on Health, found that "companies continue to adopt account-based health plans (ABHPs)" like those tied to HSAs, with more employers offering such plans and employee enrollment growing; indeed, 30% of surveyed employers expected to offer such a plan as their *only* option in 2015. An important reason for the rapidly growing popularity of HSAs and their associated "consumer-driven" health plans is their effectiveness at restraining costs, but data from Cigna (an HSA Bank partner) also suggests that HSA users "are healthier and are more likely to receive recommended care," boasting better health-status metrics and making fewer emergency-room visits. Furthermore, the Affordable Care Act is likely to spur additional growth: starting in 2018, its "Cadillac Tax" will drive up the price of high-premium "luxury" plans by 40%, contributing even more momentum to the growth of high-deductible plans tied to HSAs.

Devenir Research Predicts Total HSA Deposits Will Grow Unabated



Source: 2014 Year-End Devenir HSA Research Report

- **Webster's core regional bank is healthy and strong**. While Connecticut-area banking may not offer the open-ended growth of the HSA market, Webster's core business is profitable, well managed, and growing, with an enviable operational track record relative to peers. In a difficult environment for regional banks, Webster has defied low interest rates and tepid demand for credit and achieved positive operating leverage and steady loan growth. Moreover, unlike other banks whose reported earnings are temporarily inflated by reserve release, Webster has actually begun to build reserves again to support its expanding balance sheet. The bank's impressive performance, coupled with its attractive, affluent footprint in Connecticut – where it ranks second only to Bank of America in total deposits – makes it a perfect long-term acquisition candidate.

Webster Financial: Recent Financial Performance

	2009	2010	2011	2012	2013	2014
Net interest income	$495	$537	$564	$579	$597	$628
Core non-interest income[1]	196	185	175	189	198	198
Core operating revenues	$692	$723	$739	$768	$794	$826
% growth		*4%*	*2%*	***4%***	***3%***	***4%***
Less: Core operating expenses[2]	477	494	497	497	492	499
% growth		*4%*	*1%*	***0%***	***-1%***	***1%***
Core pre-provision net revenue	$215	$229	$242	$271	$302	$327
% growth		*7%*	*6%*	*12%*	*11%*	*8%*
Less: Net charge-offs	196	135	111	78	58	31
Core pre-tax income	$18	$94	$131	$193	$244	$296
Loans outstanding	$11,033	$11,018	$11,225	$12,029	$12,700	$13,900
% growth		*0%*	*2%*	***7%***	***6%***	***9%***
Net interest margin	3.14%	3.36%	3.47%	3.32%	3.26%	3.21%
Efficiency ratio[3]	66%	67%	65%	63%	60%	59%

Source: company filings, Kerrisdale analysis

1. As defined by WBS. Excludes gains and losses on securities (including the 2009 TruPS exchange).

2. As defined by WBS. Excludes foreclosed property expense and one-time charges.

3. As defined by WBS. Excludes e.g. intangible amortization. Based on FTE net interest income.

Robust Capital and Credit Metrics

Webster Financial: Capital Position

	2009	2010	2011	2012	2013	2014
Tier 1 common equity ratio	7.8%	9.9%	11.1%	10.8%	11.4%	11.4%
Tangible common equity ratio	5.6%	6.8%	7.0%	7.2%	7.5%	7.5%

Sources: WBS filings, Kerrisdale analysis

Webster Financial: Credit Performance

	2009	2010	2011	2012	2013	2014
Nonperforming loans	$ 373	$ 274	$ 188	$ 195	$ 163	$ 132
As % of total loans	3.38%	2.48%	1.68%	1.62%	1.28%	0.95%
Net charge-offs	193	135	111	78	58	31
As % of average loans	1.68%	1.23%	1.00%	0.68%	0.47%	0.23%
Provision for loan losses	303	115	23	22	34	37
Reserve build/(release)	110	(20)	(88)	(56)	(25)	7

Sources: WBS filings, Kerrisdale analysis

- **<u>Bank-focused market participants overlook and underestimate the scale of the HSA opportunity</u>**. While buy-side and sell-side analysts tend to acknowledge Webster's high quality and certainly understand that HSA Bank *exists*, few have attempted to *quantify* the upside. In particular, though Webster's management has tersely alluded to HealthEquity a handful of times, few appear to have put two and two together and stacked up HSA Bank's implied valuation alongside that of its smaller competitor. Once pointed out, the valuation disconnect is glaring; we believe others have simply failed to notice it, especially because the HSA market, with its ties to healthcare, exists somewhat outside the comfort zone of bank-sector specialists. Since HSA Bank is managed separately from Webster's core operations, with a headquarters in Wisconsin and a different set of customers, we urge Webster's board to explore spinning off HSA Bank or taking other, similar steps to unlock the shareholder value that it has been patiently building for more than a decade.

Comparable Company Valuation

Webster Financial: Peer-Group Comparison

	Share Price	Mkt cap ($B)	P/E ratio 2014	P/E ratio 2015E	RoTBV 2015E
WBS	$ 34.53	$ 3.1	16.6x	15.3x	*12.5%*
Peer median		2.8	15.9x	15.2x	*10.8%*
% difference			***4%***	***1%***	
Peers:					
ASB	$ 18.64	$ 2.8	16.1x	15.2x	*10.0%*
BXS	22.39	2.2	17.8x	15.5x	*10.8%*
BOKF	59.00	4.1	13.5x	13.5x	*10.4%*
CYN	90.37	5.0	21.3x	20.2x	*12.1%*
CBSH	41.52	4.0	15.9x	16.0x	*12.3%*
CFR	67.80	4.3	15.6x	15.0x	*14.0%*
FNFG	8.86	3.1	12.6x	14.6x	*9.1%*
FULT	12.10	2.2	14.3x	14.1x	*10.5%*
HBHC	29.27	2.4	12.5x	12.6x	*10.9%*
PBCT	15.13	4.5	18.7x	17.8x	*10.1%*
SUSQ	13.41	2.4	17.4x	18.0x	*9.3%*
TCB	15.69	2.6	14.1x	13.1x	*12.1%*
VLY	9.60	2.2	16.7x	15.3x	*11.7%*

Source: Capital IQ, Kerrisdale analysis

II. Situation Overview

Webster Financial is a strong regional bank with an overlooked billion-dollar asset. Its HSA Bank unit, already one of the largest players in the HSA market, has now become the clear leader following its acquisition of JPMorgan's HSA business, doubling its account base from 691,000 to almost 1.5 million. We believe the *pro forma* HSA Bank is worth almost $17 per Webster share. Combined with a conservative ~$29-per-share valuation for the core regional bank, the consolidated Webster Financial is worth $46, a 34% premium to the current stock price.

Illustrative Sum-of-the-Parts Valuation

	Core bank	HSA Bank	Total
Run-rate EPS	$ 1.84	$ 0.40	$ 2.25
Fair value ($mm)	$ 2,664	$ 1,534	$ 4,198
Fair value per share	$ 29.36	$ 16.90	**$ 46.26**
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% upside			***34%***

Source: WBS filings, Capital IQ, Kerrisdale analysis

Today, Webster trades in line with its regional banking peers at 15x 2015 EPS notwithstanding its relatively strong execution: since 2012, revenue has grown by 3 – 4% per year, loans have grown 6 – 9% per year, and core expenses are roughly flat. Its capital position is strong, with an 11.4% Tier 1 common equity ratio well above both its own internal target of 10% and the regulatory "well capitalized" threshold of 6.5%. With 12% deposit share in its key Connecticut market – second only to Bank of America – Webster enjoys, for a bank of its size, unusual local dominance. In short, unlike some sum-of-the-parts "stories" in which a small, attractive division is mixed up with a weak core business, Webster's regional bank can clearly stand on its own.

Webster Financial: Capitalization and Multiples

Capitalization Table

Capitalization		
Share price		$34.53
Shares outstanding (mm)		91
Market cap		**$3,133.3**
Book Value	$ 2,323	1.3x
Tangible book value*	**1,594**	**2.0x**
Tangible assets*	22,233	
Total deposits*	17,010	
HSA deposits*	3,184	

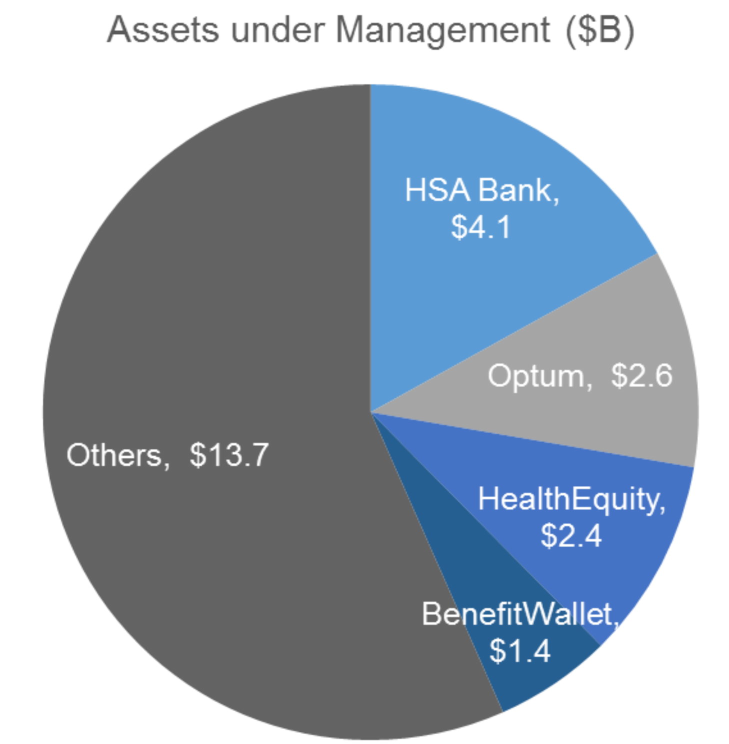
Share Multiples	**#**	**Multiple**
2014 EPS	$2.08	16.6x
2015E EPS	**$2.26**	**15.3x**
2016E EPS	$2.46	14.0x
2014 return on tangible BV		*11.9%*
2014 return on tang. assets		*1.0%*

Sources: WBS filings, Kerrisdale analysis

*Pro forma for JPM transaction.

With $4.1 billion of assets under management, including $3.2 billion of deposits, HSA Bank is now the undisputed leader in the high-growth HSA sector. Over time, it has three clear paths to further drive asset growth: i) new accounts; ii) additional contributions from existing accounts; and iii) investment returns.

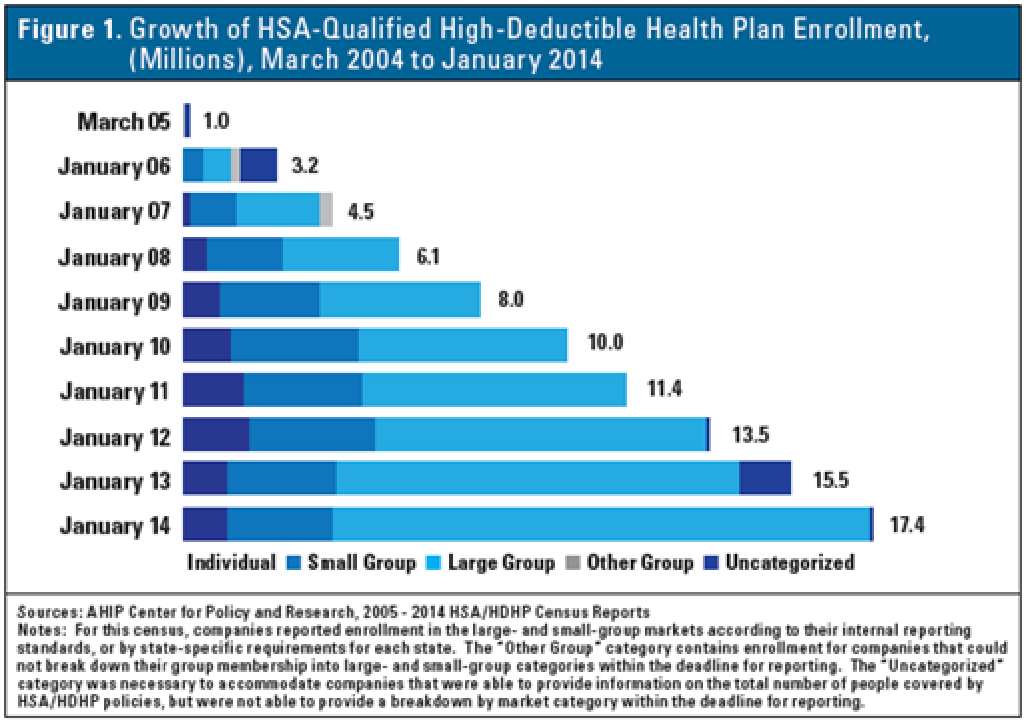
HSA Bank: The Undisputed Market Leader



Source: Kerrisdale analysis, WBS and HQY filings, JPM Aug 25, 2014, report on HQY

Over the past eight years, HSA enrollment has compounded at a 24% annual rate – and Webster's HSA Bank has grown its deposit base by 26% per year, all organically. To cope with rapidly inflating healthcare costs, both the public and private sectors are instituting reforms, and so-called consumer-driven healthcare has been at the center of these efforts. Consumer-driven healthcare, in the form of high-deductible insurance paired with tax-advantaged savings accounts, is intended to make costs more transparent for patients and thus incent more thoughtful spending. As HSA-linked insurance becomes more common, evidence is mounting to validate the benefits of this emerging paradigm. Reviewing the recent slowdown in healthcare cost growth, one team of researchers noted, "Some of this slower growth in private health insurance benefit spending may be due to the increased enrollment in high-deductible health plans. Consumers enrolled in high-deductible plans tend to use services at a lower rate than those enrolled in plans with lower or no cost sharing." It is these high-deductible plans that will drive continued HSA growth.

HSA Usage Is Growing by 15 – 20%+

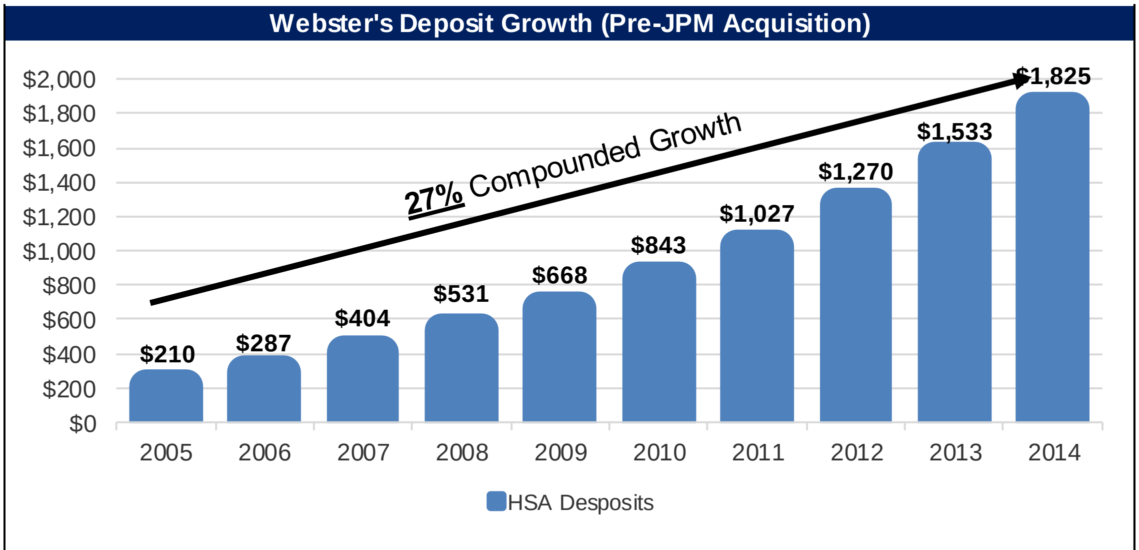


Source: Towers Watson 2014 Employer Survey on Health Care

Another driver of future HSA growth not yet reflected in current metrics is the Affordable Care Act's impending excise tax on expensive, all-inclusive plans. This "Cadillac Tax" imposes a punitive 40% surcharge starting in 2018 on all health plans costing at least $10,200 for individuals and $27,500 for families. Nobody intends to pay this tax. Instead, employers who seek to provide rich benefits are opting to shift toward high-deductible plans while simultaneously contributing pre-tax dollars into employees' HSAs to reduce employees' out-of-pocket burdens.

Stepping back to examine the big picture, today there are just 14 million HSAs in America, as compared to 175 million people under the age of 65 who are privately insured. Assuming 2.3 covered individuals per account, total HSAs could ultimately reach 80 million. In the nearer term, Devenir Research predicts that HSA balances will continue to balloon, growing from $24 billion in 2014 to $44 billion by 2017. It's rare to find sectors with this kind of secular growth, especially in the often mundane world of regional banking.

To support this growth, HSA Bank's President, Chad Wilkins, expects to double his 2014 workforce of 366 employees by the end of 2016; in his words, "We're in continuous hiring mode right now." Wilkins and HSA Bank have proven themselves excellent operators who have successfully seized the opportunity the HSA market has presented.



Source: WBS filings

How do HSA custodians like HSA Bank profit from this growth? They capture three key revenue streams: i) net interest income derived from investing customer deposits in higher-yielding assets; ii) monthly account-maintenance fees of $2 to 4 (which employers sometimes cover); and iii) interchange fees earned on users' spending on their HSA debit cards. Unfortunately, Webster has not heretofore provided clear financial information for HSA Bank, lumping it together with its small Private Banking unit in a catch-all "Other" segment. But during a November 2014 investor presentation, Webster revealed for the first time the exact amounts of HSA Bank's year-to-date non-interest income and non-interest expense, noting that the former largely paid for the latter. To complete the picture of HSA Bank's economics, we estimate net interest income to be 2% of average deposits, reflecting low deposit rates but modest imputed asset yields. (For the newly acquired JPMorgan business, we assume a lower margin of 1.75%, since Webster must reinvest a large influx of deposits all at once at today's low rates.) In sum, we estimate $37 million of *pro forma* net income in 2014.

Illustrative HSA Bank Pro Forma for JPM Acquisition	HSA Bank	JPM	Pro forma
($mm)			
Total deposits	$1,825	$1,359	$3,184
As % of deposits:			
Net interest income	2.00%	1.75%	1.89%
Noninterest income	1.67%	1.67%	1.67%
Noninterest expense	1.89%	1.89%	1.89%
Net interest income	$37	$24	$60
Noninterest income	31	23	53
Total revenue	$67	$47	$114
Noninterest expense	35	26	60
Pre-tax income	$33	$21	$53
Income tax expense	10	7	17
Net income	$22	$14	**$37**

Source: WBS filings, Kerrisdale analysis

What multiple do these high-growth earnings deserve? Consider HealthEquity. In July 2014, this firm – a pure-play HSA custodian – went public, supplying an obvious comparable for HSA Bank. To be sure, as a non-bank custodian, HealthEquity has a somewhat different business model from HSA Bank: since its customers' deposits are housed on partner banks' balance sheets, it circumvents regulatory capital requirements, albeit at the cost of giving up much of its float income to those partners. Nuances aside, HealthEquity's valuation has clear implications for HSA Bank's, and investors have rightfully priced HealthEquity at the high multiples that its high-growth sector merits: it currently trades for 14x LTM revenue, 82x LTM earnings, and 0.5x total deposits. At these same multiples, HSA Bank would be worth $1.6 billion - $3.0 billion, for an average of $2.1 billion. But Webster's *entire market cap* is just $3.1 billion, and HSA Bank contributed just ~11% of Webster's total earnings in 2014, implying an absurdly low valuation for Webster's healthy core bank. The market has simply overlooked the HealthEquity IPO and failed to draw the logical conclusion about how much Webster is truly worth.

Illustrative HSA Bank Valuation: HQY as Comparable					
			HSA Bank Valuation Based on:		
($mm)	HQY	HSA Bank	Revenue	P/E	Deposits
Revenue	$80	$114	$114		
Market cap to revenue	*13.9x*		*13.9x*		
Net income	$14	$37		$37	
Market cap to net income	*81.5x*			*81.5x*	
Deposits	$2,100	$3,184			$3,184
Market cap to deposits	*0.5x*				*0.5x*
Market cap	$1,110		$1,576	$2,983	$1,683
Average of methodologies		**$2,081**			

Source: WBS filings, Capital IQ, Kerrisdale analysis

While HealthEquity's valuation offers a welcome external benchmark, reasonable bottoms-up analysis taking into account the HSA market's growth runway further underscores the upside to Webster shareholders. Shown below is a relatively conservative view of the prospects for HSA Bank. New account adoption combined with growing account balances (consumers can add $3,300 per year to individual accounts and $6,650 per year to family accounts) should lead to ~20% annual deposit growth. If HSA Bank merely maintains its existing (*pro forma*) 15% market share, its deposit base would grow from $4.1 billion today to $21.3 billion by 2024. Interim cash flow would be negative since, as a bank, it would have to accumulate capital to support this deposit base; we assume a 7% required tangible common equity ratio. But, in return, HSA Bank's net income would grow to $200 million in 2024, representing a mid-teens return on equity. Using an 8% discount rate and a 3% terminal growth rate, HSA Bank would be worth $1.5 billion, or roughly $17 per WBS share.

Illustrative HSA Bank Valuation: Discounted Cash Flows

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Industry-wide HSA deposits ($B)[1]	$21.0	$25.5	$30.2	$35.3	$42.4	$50.8	$61.0	$73.2	$87.8	$105.4	$126.5
% growth	*25%*	*21%*	*18%*	*17%*	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*
HSA Bank market share	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
HSA Bank deposits ($B)	$3.2	$3.9	$4.6	$5.4	$6.4	$7.7	$9.2	$11.1	$13.3	$16.0	$19.2
HSA Bank net inc. to avg deposits	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
HSA Bank net income ($mm)		**$41**	**$49**	**$57**	**$68**	**$81**	**$97**	**$117**	**$140**	**$168**	**$202**
Return on required equity		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
HSA Bank required equity ratio[2]	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%
HSA Bank required equity	$240	$291	$345	$403	$483	$580	$696	$835	$1,002	$1,203	$1,443
Gross capital build required		$51	$54	$58	$81	$97	$116	$139	$167	$200	$241
Less: net income		41	49	57	68	81	97	117	140	168	202
Net capital build required		$11	$5	$1	$13	$15	$19	$22	$27	$32	$38
Free cash flow (Capital build)[3]		($11)	($5)	($1)	($13)	($15)	($19)	($22)	($27)	($32)	($38)
Terminal value		-	-	-	-	-	-	-	-	-	$3,545
Trailing P/E ratio											*17.5x*
P/TBV ratio											*2.5x*

Discount rate	*8.0%*
Terminal growth rate	*3.0%*
Present value of interim cash	$ (108)
Present value of terminal value	1,642
Total present value	**$1,534**
HSA Bank value per WBS share	**$16.90**

1. 2014-17 values from 2014 Year-End Devenir HSA Research Report; thereafter, 20% growth assumed through 2024.
2. Tangible common equity divided by tangible assets.
3. Net income less gross capital build required.

Source: WBS filings, 2014 Midyear Devenir HSA Research Report, Kerrisdale analysis

However one chooses to value HSA Bank, it's clear that Webster overall shouldn't trade for a modest 15x 2015 earnings, in line with regional-bank peers that lack anything like HSA Bank's growth prospects and market leadership; moreover, Webster's core bank is itself well above average. Yet market consensus fails to acknowledge this embedded value.

Since HSA Bank is what investors least appreciate about Webster, it is our focus in the discussion that follows. After delving into key trends in the market for high-deductible health plans and health savings accounts, we review the successful operating history of Webster's core bank. Pulling together the available information, we estimate that Webster is worth at least $46 per share, representing a 34% premium above the current share price.

III. Health Savings Accounts and HSA Bank: An Overview

> [*After adopting a consumer-driven health plan*] *we saw generic usage increase from 73 to 81 percent…* [*Employees*] *are increasingly choosing more wellness visits, more convenience care, fewer unnecessary ER visits, and choosing generic medications over expensive brand names.*
>
> —Nancy Rhode, manager of benefits, City of Lakewood, Colorado (via Cigna)

> *Although it would be hard to make the case that consumerism in itself can be the single silver bullet to all that ails the industry, it's easier to imagine the industry collapsing in on itself from the weight of unchecked cost trend growth, without the positive influence of consumerism.*
>
> — Bart Halling, vice president of customer solutions, UMR/UnitedHealthCare (via *Benefits Pro*, "Seven Reasons HSAs Are Taking Off")

The Meteoric Rise of High-Deductible Health Plans and Health Savings Accounts

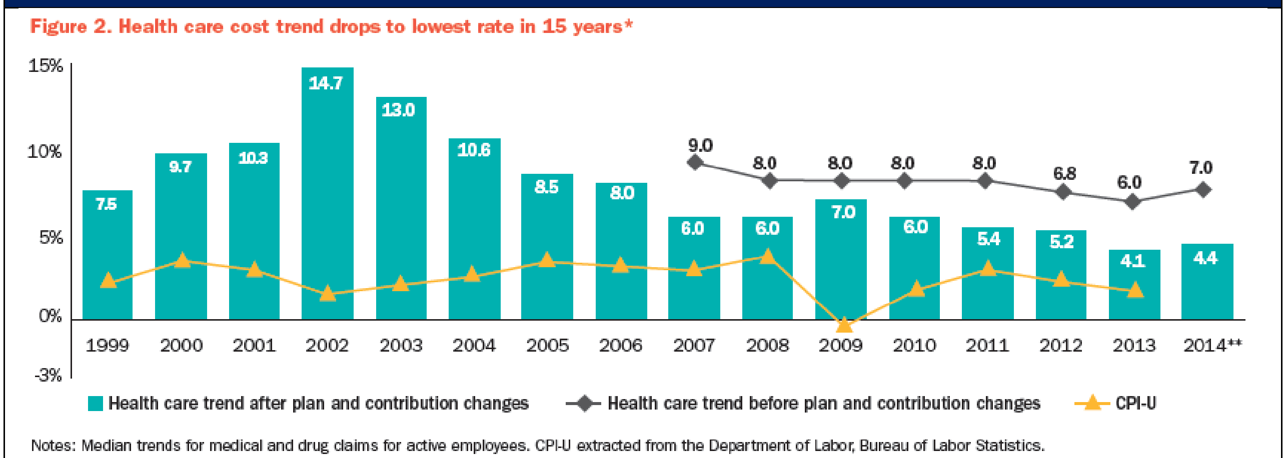
The legislative framework for health savings accounts was created in 2003 to foster the adoption of lower-cost health insurance that gives consumers more choices – and more responsibility. HSAs are the most recent addition to the universe of consumer-directed healthcare (CDH) accounts, alongside flexible spending accounts (FSAs) and healthcare reimbursement accounts (HRAs). HSA Bank offers all three options (which need not be mutually exclusive), but HSAs have become the most prevalent. Unlike HRAs and FSAs, HSA funds can be invested in stocks and bonds and do not expire. To the extent balances exceed healthcare spending over the long term, account holders can withdraw their savings at age 65 and pay income taxes then (after enjoying years of tax-free growth), just like an Individual Retirement Account (IRA).

To qualify for an HSA, an individual must be covered by a high-deductible health plan (HDHP). As the name implies, a high-deductible health plan differs from traditional (PPO and HMO) coverage because beneficiaries must pay for their own care (except for preventive care) up to a relatively high threshold before insurance kicks in. In 2015, HDHPs carry minimum deductibles of $1,300 for individuals and $2,600 for families. Saving via HSAs allow individuals to cope with these high deductibles: in many cases, employers contribute pre-tax dollars to accounts that they open for their employees, and employees often contribute on a regular, pre-tax basis via payroll deductions. In 2015, the limit on tax-deductible HSA contributions is $3,350 for individuals and $6,650 for families, with annual increases to come based on inflation. Users can choose to contribute just what they expect to spend on healthcare in the near term, or they can use HSAs as a longer-term savings vehicle for future spending or retirement.

Premiums for HDHPs are lower than for comparable traditional plans because insurance companies believe that more cost-conscious consumers will bring down overall spending. While it's difficult to establish this claim definitively – few employers would subject their workers to a randomized controlled trial – key industry participants, from insurers to large businesses to governments, are backing the shift to HDHPs, and early evidence points to success. As *Harvard Business Review* noted:

> In January 2014, federal actuaries released their annual report on U.S. health spending; it documented relatively slow, stable increases in 2012. This may sound boring, but it should be shocking, in light of our nation's history of "crisis level" cost escalations. The actuaries state that the ACA had nothing to do with this slowdown in cost growth — they specifically credit the influence of HDHPs.

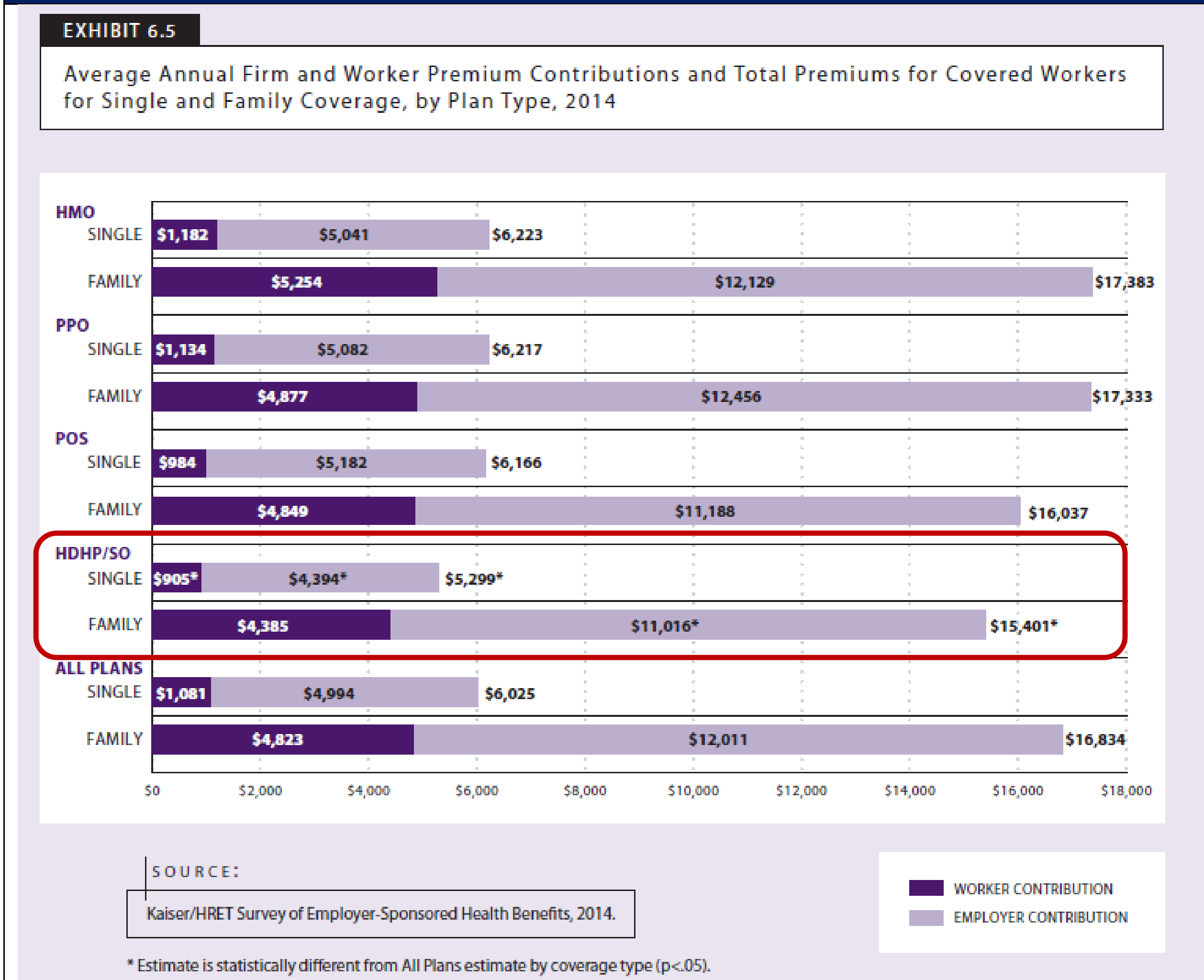
Growth in U.S. Health Care Cost have Decelerated



Source: Towers Watson 2014 Employer Survey on Health Care

In the current low-growth macroeconomic environment, employers are desperate to dampen rising employee healthcare costs. To them, the main rationale for HDHPs is simple: lower premiums. According to a 2014 Kaiser Foundation report, the average HDHP family premium is 11% lower than the average PPO family premium; anecdotally, in high-cost regions like the Northeast, the savings can approach 30%. Employers often choose to reinvest some of these savings by contributing fixed amounts directly to employee HSAs; roughly 70% of workers with HSAs receive such contributions.

HDHPs Carry Lower Employer Premiums than Traditional Plans Workers

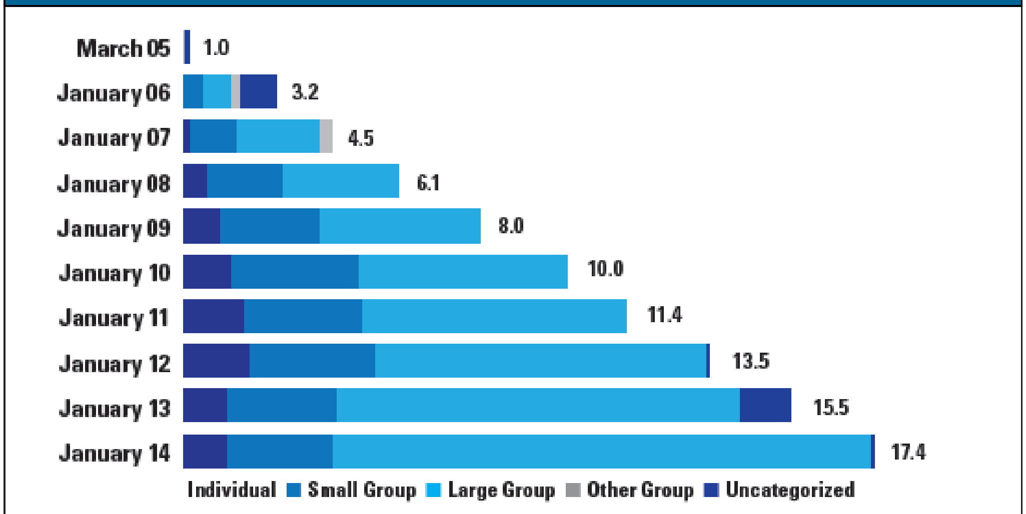


Source: The Kaiser Family Foundation, 2014 Employer Health Benefits *report*

As traditional-plan premiums rise, it's little wonder that HDHP and HSA adoption have been rapid. A decade ago, high-deductible plans were nonexistent; today, they represent over 20% of health-plan enrollment. At a December 2014 investor conference, the mega-insurer UnitedHealth Group (UNH) said that it expects some 50 million customers to move into high-deductible health plans, up from just 15.5 million today (*source: Wedbush report, December 3, 2014*). According to UnitedHealth, these new HDHP accounts would incur $400 billion of out-of-pocket expenses, much of it funded by HSAs. Earlier this year Goldman Sachs hosted a call with Steve Lewis, a director of the employee benefits consultant Willis North America. Based on his experience in the field, Mr. Lewis observed, "While PPO still is the dominate *[sic]* plan design, the high deductible health plan with an account based option associated with it is going to become – in our view – the predominate *[sic]* plan. There is continued interest and continued strategy around driving more participation into these plans and even elimination of other product alternatives that are not high deductible health plans."

HDHP adoption begets HSA growth. The industry group America's Health Insurance Plans (AHIP) began tracking HSA usage in March 2005 and has charted the sector's relentless growth ever since. Since 2005, HSA-qualified plan enrollment has risen from 1 million Americans to 17.4 million as of January 2014 (based on the number of covered individuals including dependents, not the number of accounts). It's difficult to think of any other banking niche with such rapid growth on such a large scale.

Figure 1. Growth of HSA-Qualified High-Deductible Health Plan Enrollment, (Millions), March 2004 to January 2014

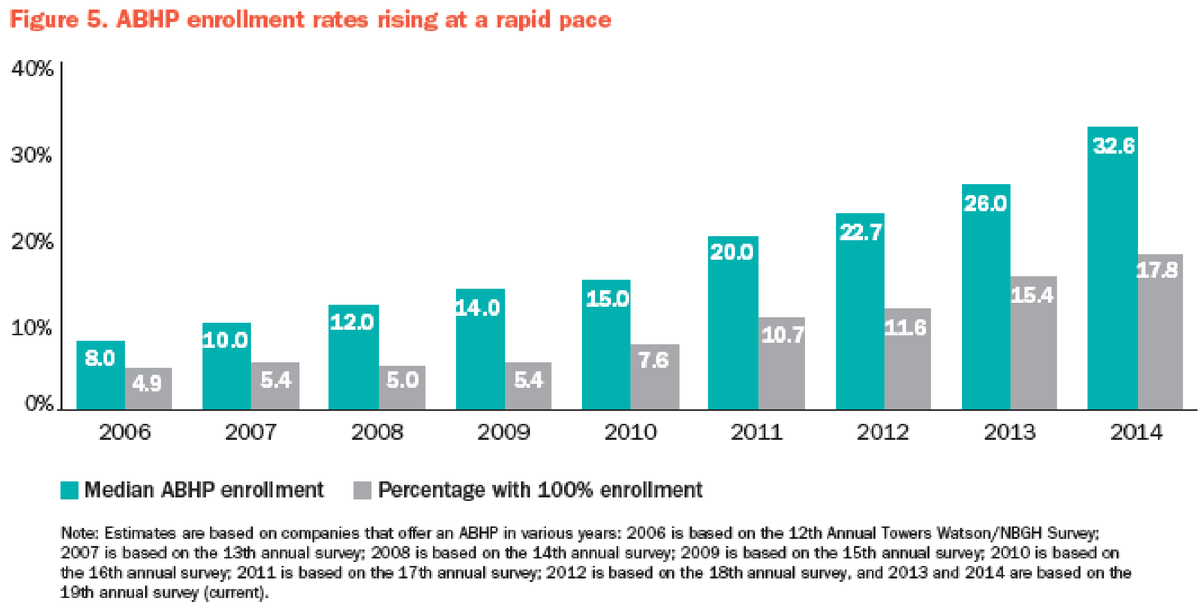


Sources: AHIP Center for Policy and Research, 2005 - 2014 HSA/HDHP Census Reports
Notes: For this census, companies reported enrollment in the large- and small-group markets according to their internal reporting standards, or by state-specific requirements for each state. The "Other Group" category contains enrollment for companies that could not break down their group membership into large- and small-group categories within the deadline for reporting. The "Uncategorized" category was necessary to accommodate companies that were able to provide information on the total number of people covered by HSA/HDHP policies, but were not able to provide a breakdown by market category within the deadline for reporting.

Source: AHIP, Center for Policy and Research, July 2014

A recent Towers Watson survey reinforces the conclusions of the AHIP census, finding that nearly a third of employers now offer some form of account-based health plan (defined as any group insurance plan paired with tax-advantaged medical spending accounts, primarily HSAs). The prevalence of these account-based plans has increased in each of the past eight years. Instead of rotating entire employee groups immediately, employers usually offer ABHPs to a subset of their population and increase that subset as acceptance grows. These trends clearly bode well for HSA Bank's long-term prospects.

Account-Based Health Plans Are Becoming More Popular at Workplaces that Offer Them



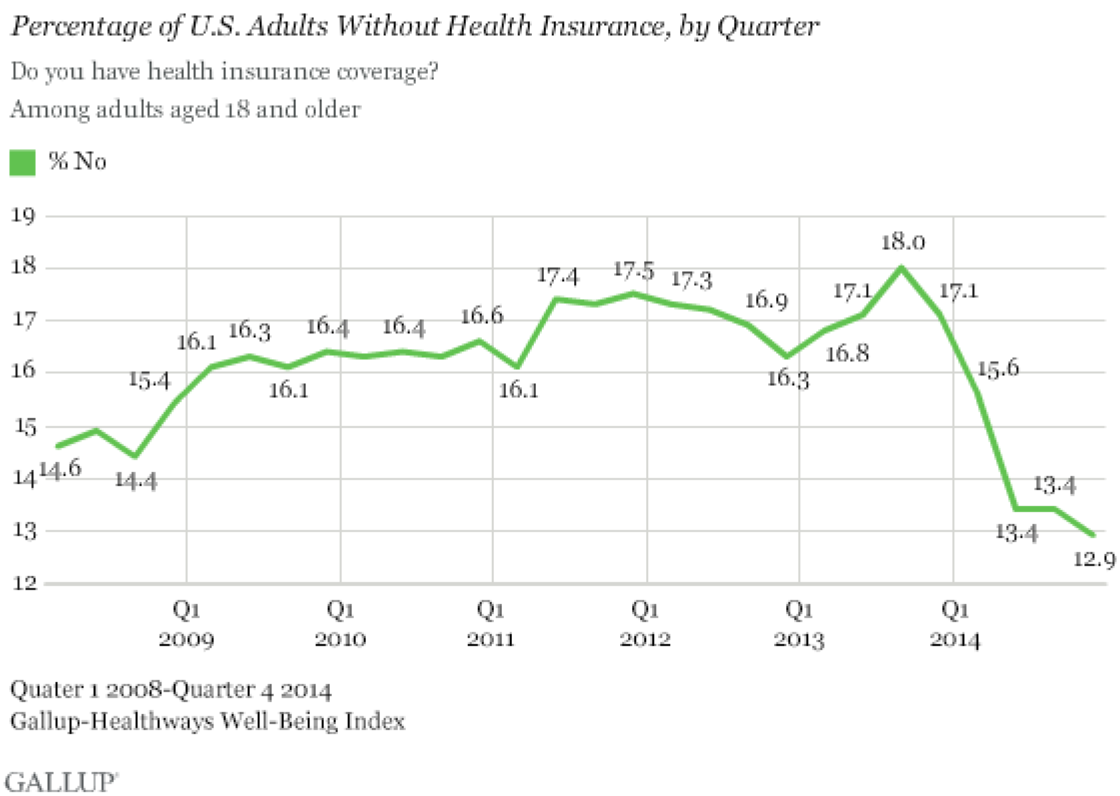
Source: Towers Watson 2014 Employer Survey on Health Care

Policy Changes Will Drive Additional HSA Growth

While current HSA-plan enrollment of 17.4 million represents tremendous growth over a short period of time, this figure is dwarfed by the total opportunity: 170 million privately insured Americans. Aside from simple economics – cost-sensitive employers will continue to move toward money-saving HDHP/HSA arrangements – ongoing policymaker creations like the ACA insurance exchanges and 2018 Cadillac Tax will further foster HSA growth.

Favored for their low premiums, HDHPs are the plans of choice for many new insurance-exchange participants, and “bronze” and “silver” plans (as defined by healthcare.gov) are usually HSA-eligible. The Affordable Care Act was designed to enroll the ~50 million uninsured, all of whom are currently ineligible for HSAs since, by definition, they lack insurance coverage. Gallup polls indicate that insurance exchanges are indeed reducing the ranks of the uninsured, thereby supplying more potential HSA users for HSA Bank and other providers.

Healthcare Exchanges Are Reducing the Number of Unisured



Another HSA-positive change put in place by the Affordable Care Act is the impending "Cadillac Tax" on expensive, low-deductible health plans. Starting in 2018, the IRS will levy a 40% surcharge on such plans (specifically, those with premiums exceeding $10,200 for individuals or $27,500 for families). In the words of Steve Wojcik, the VP of public policy for the National Business Group on Health, "I don't think there's any employer that's planning on paying that tax." Employers wishing to avoid the Cadillac Tax will be forced to switch to higher-deductible plans, and an attractive way to make this move while still keeping high-value employees happy is to open and fund HSAs on their behalf. Thus at both the low end – formerly uninsured individuals signing up for HDHPs via public exchanges – and the high end – well-paid workers transitioning away from "Cadillac" plans – changes in public policy will continue to redound to the benefit of the HSA market.

HSAs as Supplementary Retirement Accounts

Those unfamiliar with HSAs may have heard of their elder cousins: Flexible Spending Accounts ("FSAs") and Health Reimbursement Arrangements ("HRAs"). All three cover medical expenses with pre-tax dollars, but HSAs, unlike FSAs and HRAs, are legally the properties of employees, not employers. Just as important, HSAs, unlike FSAs are HRAs, can be invested in long-term securities, and only HSAs allow holders to withdraw savings for non-medical purposes after age

65 without incurring a tax penalty. Depending on their account provider, HSA users can choose to invest in mutual funds, ETFs, money-market funds, or other assets. These investments compound on a tax-deferred basis and, if withdrawn to cover medical expenses, are never taxed at all. FSAs and HRAs, in keeping with their lack of investment options as well as other drawbacks like annual roll-over limits and non-transferability when switching employers, are expected to grow more slowly than HSAs.

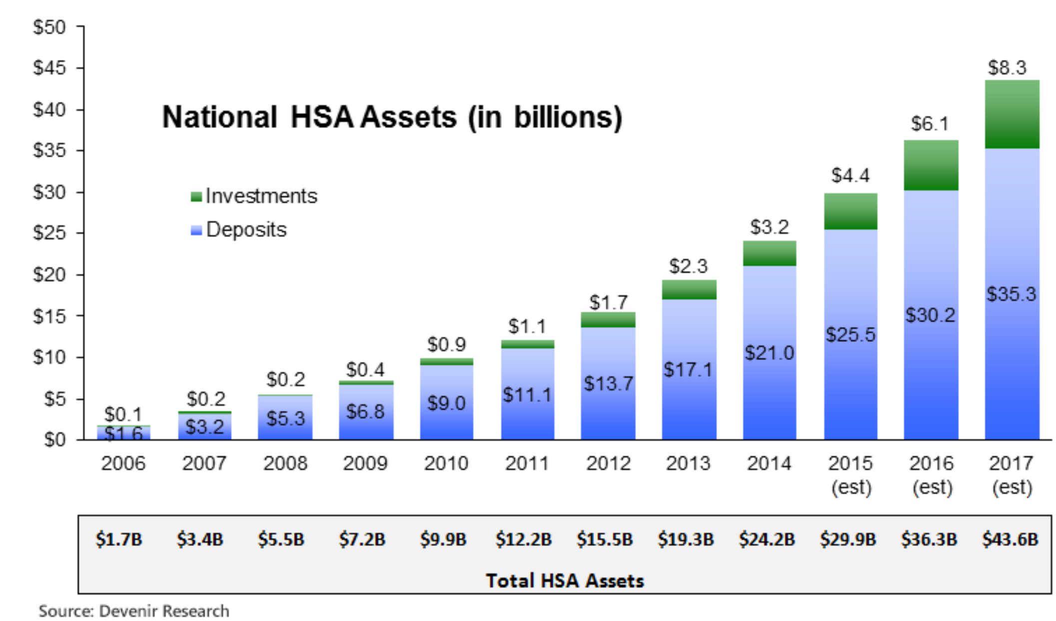
Over time, regular HSA contributions can accumulate to substantial amounts, in effect allowing HSAs to serve as supplementary retirement accounts alongside 401(k)s and IRAs. A person contributing $3,350 per year (the 2015 maximum) would wind up with more than $400,000 after 40 years at a 5% annual return. If used for healthcare expenses, these savings would never be taxed; if not, they'd face the same tax treatment as an IRA. As one commenter put it, "It is nice to eat your cake and have it too, but if you need cake, eat it."

Investment options vary by HSA provider, and HSA Bank's are among the best. A common complaint about other providers is that they only funnel savings into a small number of sponsored mutual funds that often charge high fees. But, rare among its competitors, HSA Bank offers access to many low-cost investment options, including a wide range of commission-free ETFs, via self-directed brokerage accounts from TD Ameritrade. This open-architecture approach has helped keep HSA Bank's customers happy as they put the "savings" in "health savings accounts."

HSAs Could Reach 50 Million People by 2020

Thanks to the ever mounting evidence of the benefits of HSAs, the industry should continue its rapid growth. The predictions of subject-matter experts support this view. For instance, the consultancy and mutual-fund provider Devenir Research has estimated that as of December 31, 2014, there were 13.8 million HSAs (as measured by number of accounts, not individuals covered by the associated health plans) with $24.2 billion of assets, up 29% and 25%, respectively, from the prior year. After surveying 100 HSA providers, Devenir went on to project that total HSA assets would reach $43.6 billion by 2017, almost doubling over three years.

Devenir Research Predicts Total HSA Deposits to Grow Unabated



Source: 2014 Year-End Devenir HSA Research Report

ConsumerDriven Market Report, a widely cited industry publication, came up with a similar medium-term estimate: after reaching an estimated population of 20 million by 2014, HSAs may cover 50 million by 2020. (Here the figure refers to the number of people covered by HSA-eligible health plans, not the number of accounts themselves.) And a white paper co-authored by two consumer-driven-healthcare consultancies came to an even more dramatic conclusion: "By January 2020, we estimate we will grow from nearly 11 million accounts today (according to Devenir) to nearly 45 million accounts, with 20 million accounts created by Public and Private Exchanges."

Interpro Forecasts 50 million HSA Accounts by 2020, Driven by Exchanges

Source: Interpro Publications, Consumer Driven Market Report 2014

HSA Adoption on Private Exchanges

Private Exchange	% Electing HSA-Qualified Plans in 2014
Bloom Health	48%
AON Hewitt	49%
Liazon	65%
Arthur J. Gallagher	65%
Gravie	70%
BrocorXchange	67%

Within the realm of exchanges, the researchers expect public exchanges – backed by government subsidies – to contribute 5 million new HSAs, while private exchanges – backed by employer subsidies and designed to allow employees to choose their own insurance products from a range of competing alternatives – contribute 15 million new HSAs. These private exchanges are widely expected to become critical parts of the insurance market in the next few years: from a base of 7 million users today, Goldman Sachs expects private exchanges to grow to 35 million by 2019; Oliver Wyman, 39 million by 2018; and Accenture, 40 million by 2018. Since cost-sensitive shoppers are likely to favor HSA-eligible high-deductible plans, companies like HSA Bank are likely to benefit from the growth in private exchanges.

Consider a concrete example. On the user-friendly exchange operated by the insurer Humana, a non-smoker household of two, each born in 1975, living in the ZIP code 33324 (in Ft. Lauderdale) with a combined income of $75,000, can choose from 16 available health plans. By default, they're ranked by monthly premium, with the cheapest plans shown first. The Humana Bronze 6300/South Florida HUMx plan costs $463 per month and carries a family-wide deductible of $12,600, well above the minimum required for HSA eligibility. Indeed, most "bronze" and "silver" plans are HSA-eligible. One could splurge for the Humana Platinum 1000 plan, with a family-wide deductible of only $2,000, but this plan's monthly premium is a hefty $729. Faced with a 57% difference in cost, many people choose higher-deductible plans combined with tax-efficient HSAs to help fund the deductibles. In the benefit summary of the Humana Bronze 6300 plan, the second paragraph explains:

> ***Save for healthcare expenses with a Health Savings Account (HSA) –*** *With this plan you can set aside tax-free money to pay for qualified medical expenses with an HSA. The funds always belong to you and help you save for future health care needs. HSA funds can be used to satisfy your deductible. Contact your local banking institution to open your HSA.*

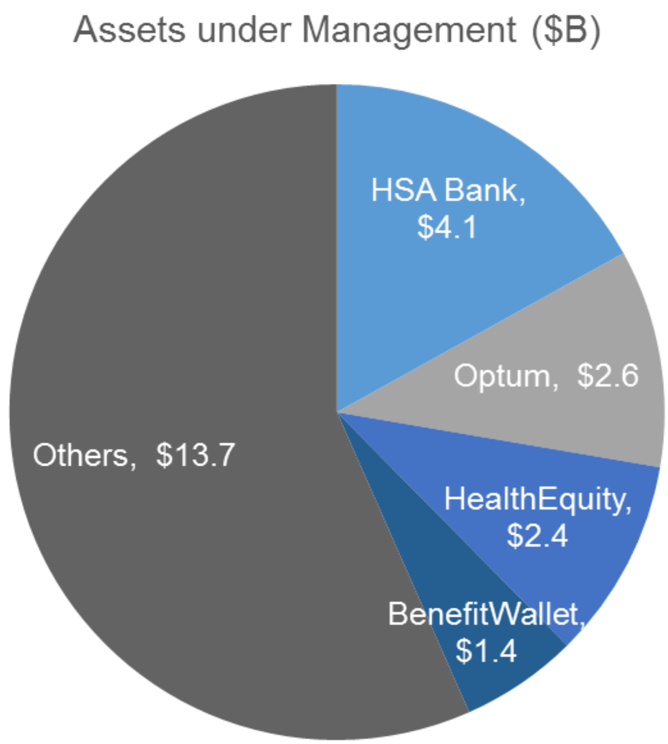
Referrals like this should drive substantial HSA uptake in the coming years. And as a result of its leading market position and straightforward name, HSA Bank currently ranks as the number-one Google search result for "HSA."

Webster's HSA Bank Is the Industry Leader

Before the HSA industry took shape, Webster had no special expertise in healthcare, but its chairman and CEO James Smith showed great foresight in jumping into the market early on. In September 2004, just nine months after the bill creating HSAs became law, Webster announced the $26 million acquisition of Eastern Wisconsin Bancshares, then one of the largest HSA providers by way of its State Bank of Howards Grove subsidiary (doing business as HSA Bank). This Wisconsin heritage explains why HSA Bank is headquartered in Sheboygan, WI, more than 1,000 miles away from Webster's own headquarters in Waterbury, CT. Webster's intent was clearly "entry into the health savings account market," as it said in its press release; unrelated Wisconsin retail branches acquired as part of the deal were quickly divested.

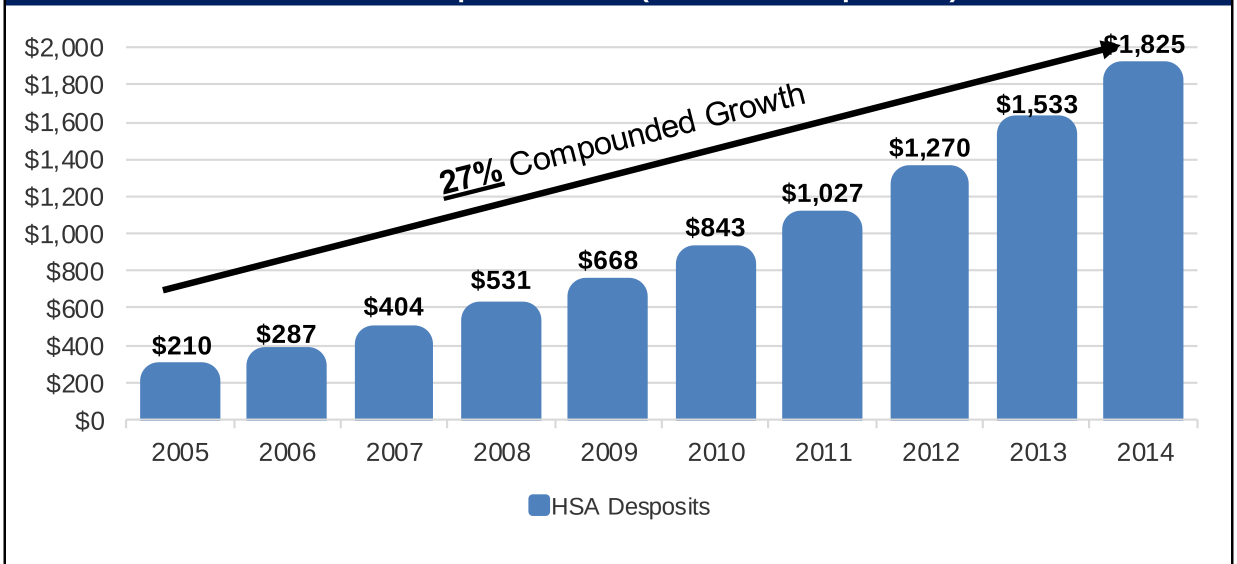
From a starting point of $100 million at the end of 2004, HSA Bank has organically grown its deposits to $1.8 billion ten years later. This made HSA Bank one of the top HSA providers, trailing only Optum Bank, UnitedHealth's captive entity, in number of accounts. But with the recent closing of the JPMorgan acquisition, HSA Bank has now become the clear HSA leader by both assets under management and number of accounts.

HSA Bank: The Undisputed Market Leader



Source: Kerrisdale analysis, WBS and HQY filings, JPM Aug 25, 2014, report on HQY

HSA Bank now manages almost 1.5 million accounts holding $4.1 billion of assets, for an average account balance of ~$2,800. Over time, these totals will increase in three ways: i) new accounts; ii) additional contributions from existing accounts; iii) investment returns. Combined, these forces will generate powerful ongoing growth for HSA Bank. As discussed above, the number of HSAs is growing by ~20%+ annually. Each year, account holders can add thousands of additional dollars to their accounts. And while HSA deposits and money-market funds currently pay little interest, higher long-term rates and the potential for higher returns from riskier investments like stocks can further expand the asset base in the future. Of course, healthcare spending will tend to reduce balances, but typical out-of-pocket expenses are less than typical contributions: Devenir, for example, found that in 2014 HSA contributions exceed HSA withdrawals by 47%. HSA Bank's own history demonstrates its ability to grow rapidly year after year: since being acquired by Webster, HSA Bank has built deposits at an almost 30% CAGR.

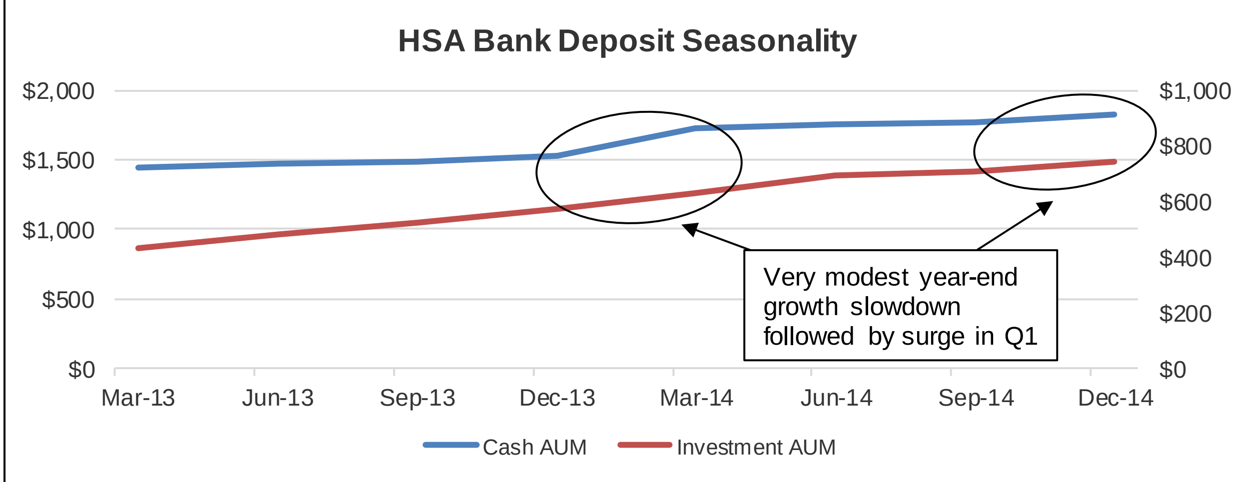


Source: WBS filings

Not only do these assets grow, but they're beautifully sticky. Unlike FSAs, HSAs don't expire at the end of each year; users can contribute to their accounts knowing that they'll survive any change in insurance coverage or employment, even retirement. Despite an underlying seasonal pattern of heavier employer contributions at the beginning of the year, HSA Bank's quarter-to-quarter results show consistent, continuous growth:

HSA Bank Assets Exhibit Minimal Seasonality

	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Cash AUM	$1,436.0	$1,471.0	$1,479.0	$1,533.0	$1,720.0	$1,755.0	$1,766.0	$1,825.0
Investment AUM	432.0	480.0	521.0	571.0	632.0	693.0	707.0	746.0
Total AUM	$1,868.0	$1,951.0	$2,000.0	$2,104.0	$2,352.0	$2,448.0	$2,473.0	$2,571.0



Source: WBS filings

HSA Bank Has a Strong Competitive Position

HSA custodians are effectively specialized banks, and winning in the HSA market requires many of the same things as winning in the broader banking market: a trusted brand, good customer service, and scale. With its long track record of single-minded focus on the HSA market and its reputation for good user experiences, HSA Bank is an easy, attractive option for brokers to recommend and for insurers to turn to as a preferred partner. For example, in connection with the JPMorgan acquisition, Cigna – which previously used JPMorgan as its HSA partner – chose to work with HSA Bank going forward. Cigna had no obligation to select HSA Bank just because it acquired JPMorgan's deposits; indeed, in the ordinary course of business, Cigna had been considering whether to switch from JPMorgan to a different provider. But, as Cigna's announcement of the HSA Bank relationship made clear, it found HSA Bank uniquely attractive:

> "We are delighted to team up with HSA Bank, a seasoned, customer-focused, health savings account administrator that is fully invested in supporting the continued growth of our flagship consumer-driven health plans," said Matt Manders, Cigna President of U.S. Commercial Markets and Global Health Care Operations. "With HSA Bank's experience and expertise combined with our fully integrated approach to consumer-driven health our current and future Choice Fund HSA customers will be able to access a highly customized and superior service experience."
>
> ... HSA Bank offers a vast breadth of account capabilities and industry leading technology features to help HSA clients and customers manage their healthcare funds including:
>
> - myHealth Portfolio - an online dashboard that gives individuals a consolidated view of their financial health situation along with the ability to pay healthcare bills easily and conveniently from one online portal and with one debit card.
> - Robust investment options including an open architecture brokerage account and a powerful mutual fund lineup that will allow Cigna customers to maintain the funds in which they are currently invested.
> - Online investment tools, education and guidance to help HSA customers manage their funds.

As this ringing endorsement – presumably the result of an intensive diligence process on the part of Cigna – reveals, HSA Bank has a strong brand and a quality product, and the JPMorgan acquisition has helped it to achieve the greatest scale in the industry. It has all the ingredients for long-term success.

To be sure, competition can be fierce, and certain insurers like UnitedHealth (with its Optum Bank unit) and Aetna have sought to capture some of the benefits of HSA market growth by setting up their own captive custodians. However, such ventures require significant upfront investment and offer uncertain benefits, including the risk of alienating customers with any small administrative mishap. For example, the BlueCross BlueShield Association (BCBS), seeking to jump on the HSA bandwagon, created its own provider in 2007: Blue Healthcare Bank. But, in the words of an executive involved in the roll-out to whom we spoke, the bank was a "complete disaster." Bad customer service, slow account transfers, and frustrated customers led BCBS to put the HSA business up for sale in August 2009, just 30 months after the initial launch. Even as HSA adoption grew, BCBS came to realize that it was far more effective to use a trusted, experienced HSA provider and focus on insurance rather than make a high-risk, low-reward gamble on an adjacent market.

Unlike captive providers that might win customers purely by association with their parent entities, HSA Bank has had to work for every customer it has, an experience that has honed its customer-service and marketing skills. Prior to the JPMorgan acquisition, HSA Bank's business was built entirely organically, primarily by forming and maintaining relationships with numerous small and medium-sized insurance brokers. Building these relationships was no easy task, requiring years of sales effort, but has paid off in spades: insurance-market participants now recognize HSA Bank as a trusted name and a known quantity. This strong brand will serve the company well as it works to make the most of the vast opportunity before it.

HSA Bank's Robust Profitability

Webster does not currently disclose HSA Bank's standalone financials. But, for now, we can approximate the key figures using the Management's Discussion and Analysis (MD&A) section of Webster's 2009-2013 10-Ks. In each 10-K, Webster discloses an abbreviated income statement for the "Other" segment, consisting of both HSA Bank and Webster's small private-banking unit. The verbal commentary goes slightly further, breaking down annual *changes* in net interest income between the private bank and HSA Bank. Examining the past four years' worth of this MD&A data and considering the very small size of the private bank's loan and deposit portfolio, we conclude that the vast majority of the "Other" segment's net interest income and earnings come from HSA Bank.

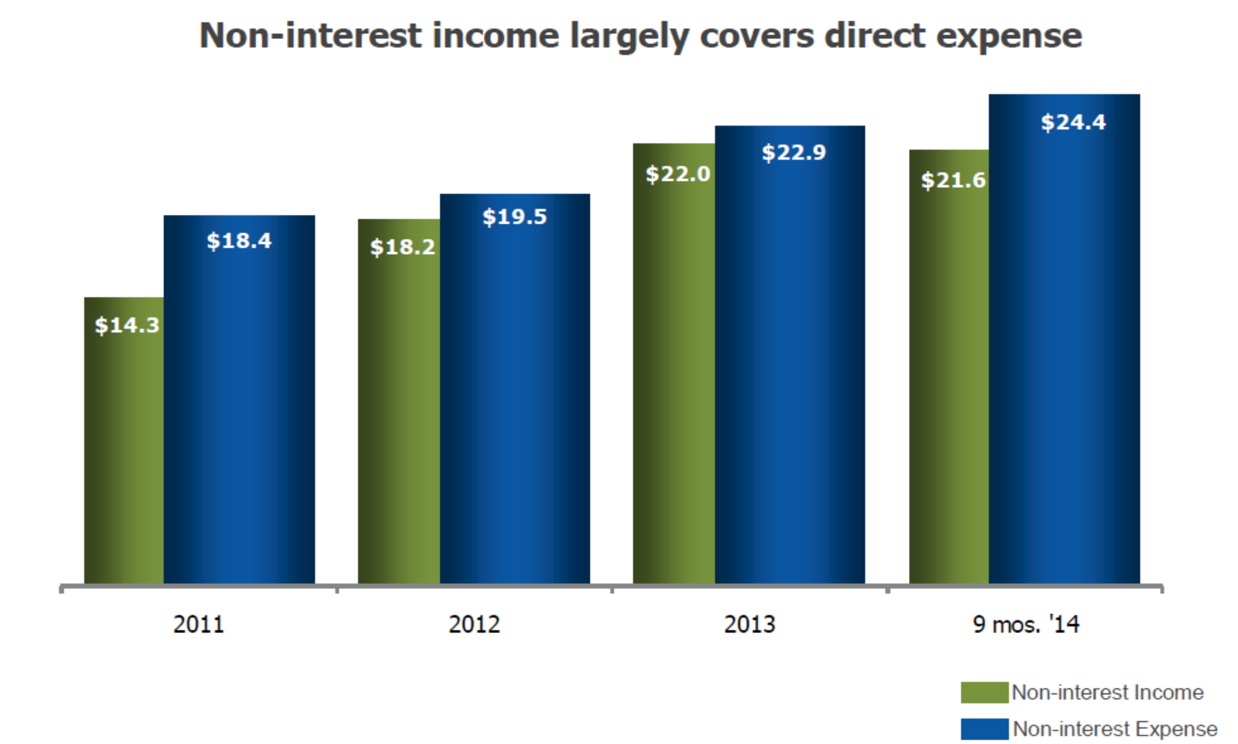
HSA Bank Historical Financials

	2010	2011	2012	2013	
"Other" Revenue	$40.3	49.2	$62.7	$73.8	
"Other" PBT	2.9	8.9	18.0	24.1	
"Other" Net Income	2.4	6.4	12.6	16.9	
Other Net Interest Income	18.5	25.4	33.3	41.0	
Net int inc growth (HSA)	$5.8	6.1	$6.7	$6.6	MD&A
Net int inc growth (PB)	0.0	0.8	1.2	1.1	MD&A
** Note: Mgmt MD&A indicates that majority (~80%) of Other income is from HSA Bank*					
HSA Non-Interest Income		$14.3	$18.2	$22.0	Nov '14 Pres
HSA Non-Interest Expense		(18.4)	(19.5)	(22.9)	Nov '14 Pres
HSA Non-Interest Net Income		($4.1)	($1.3)	($0.9)	

At a November 2014 conference, Webster further disclosed that HSA Bank's fee income roughly offsets its non-interest expenses and provided the exact numbers for these two line items from 2011 till the first nine months of 2014. If we assume that 75% of the Other segment's net interest income comes from HSA Bank, then we estimate that HSA Bank generated more than $20 million of net income in 2013, a return of ~1.4% relative to average HSA deposits of ~$1.4 billion. Thus not only is HSA Bank growing rapidly; it's also earning an attractive profit while doing so, especially compared to conventional banks that today struggle to achieve a 1% return on assets despite enjoying higher NIMs than a deposit-driven business like HSA Bank.

With its strong competitive position, robust profitability, and wide array of secular tailwinds, HSA Bank is an immensely valuable asset that the market has failed to appreciate. Given its distinct business model, customer base, and even headquarters location, HSA Bank is best assessed on its own merits, not as part of Webster – but its ongoing success is a testament to the flexibility and good judgment of Webster management, which knew a good thing when it saw it back in 2004.

HSA Bank's Well Managed Cost Structure



Source: Webster November 2014 BancAnalysts Association of Boston presentation

IV. Webster's Core Bank is Well-Run, Well-Capitalized, and Inexpensive

Setting aside Webster's fast-growing, overlooked HSA Bank unit, its core business is strong, if perhaps less exciting. As the second-largest depository in Connecticut (outranked only by Bank of America), and with additional branches extending from Westchester County, NY, to Boston, MA, Webster engages in the bread-and-butter activities of a typical regional bank: lending to and gathering deposits from local consumers and businesses. In a difficult environment for regional banks – with low interest rates putting pressure on net interest margins (NIMs) and a subdued economy suppressing loan demand – Webster has managed to grow its loan portfolio, increase its revenue, and achieve positive operating leverage, all while maintaining high credit quality and strong capital ratios. HSA Bank has certainly been a boon to Webster's bottom line, but the core bank can stand on its own two feet.

Below we summarize Webster's recent financial performance. Despite a contracting NIM, over the past several years Webster has increased revenues by 3-4% per year and grown loans at 6-9% per year. While competitors have struggled with bloated expense bases, in July 2011 Webster set out an ambitious goal of improving its efficiency ratio – defined as non-interest expenses divided by revenue – to 60%; it hit this target right on schedule. Webster may owe some of its recent operating discipline to the four years it spent under Warburg Pincus's partial ownership after the private-equity firm bought a stake in the company in 2009. Regardless, Webster has proven itself to be adept at the basic blocking and tackling of banking.

Webster Financial: Recent Financial Performance	2009	2010	2011	2012	2013	2014
Net interest income	$495	$537	$564	$579	$597	$628
Core non-interest income[1]	196	185	175	189	198	198
Core operating revenues	$692	$723	$739	$768	$794	$826
% growth		*4%*	*2%*	***4%***	***3%***	***4%***
Less: Core operating expenses[2]	477	494	497	497	492	499
% growth		*4%*	*1%*	***0%***	***-1%***	***1%***
Core pre-provision net revenue	$215	$229	$242	$271	$302	$327
% growth		*7%*	*6%*	*12%*	*11%*	*8%*
Less: Net charge-offs	196	135	111	78	58	31
Core pre-tax income	$18	$94	$131	$193	$244	$296
Loans outstanding	$11,033	$11,018	$11,225	$12,029	$12,700	$13,900
% growth		*0%*	*2%*	***7%***	***6%***	***9%***
Net interest margin	3.14%	3.36%	3.47%	3.32%	3.26%	3.21%
Efficiency ratio[3]	66%	67%	65%	63%	60%	59%

Source: company filings, Kerrisdale analysis

1. As defined by WBS. Excludes gains and losses on securities (including the 2009 TruPS exchange).
2. As defined by WBS. Excludes foreclosed property expense and one-time charges.
3. As defined by WBS. Excludes e.g. intangible amortization. Based on FTE net interest income.

As shown below, Webster's balance sheet is plain vanilla. Its assets consist mainly of loans and liquid securities, with the loan portfolio split fairly evenly (56%/44%) between commercial and consumer borrowers. Its deposits come mainly from sticky transactional accounts, with a low average cost of just 0.29%.

Balance Sheet Statistics

Webster Financial: Balance-Sheet Summary

	Balance, 12/31/14	% of total
Loans	$13,900	*62%*
Securities	6,667	*30%*
Cash/deposits	394	*2%*
Other assets	1,572	*7%*
Total assets	$22,533	*100%*
Deposits	$15,652	*69%*
Borrowings	4,336	*19%*
Other liabilities	222	*1%*
Equity	2,323	*10%*
Total liabilities and equity	$22,533	*100%*

Source: company filings, Kerrisdale analysis

Webster Financial: Loan and Deposit Overview

	Balance, 12/31/14	% of total	Notes
Loans by type:			
Commercial	$3,893	*28%*	
Commercial real estate	2,795	*20%*	
Small business	1,154	*8%*	
Total business	$7,842	*56%*	
Residential mortgages	3,509	*25%*	51% jumbo, 48% conforming
Consumer	2,549	*18%*	97% home equity
Total retail	$6,058	*44%*	
Total loans	$13,900	*100%*	
Deposits by type:			
Checking[1]	$5,754	*37%*	
Savings[2]	5,801	*37%*	
Time deposits	2,272	*15%*	
Deposits excl. HSA	$13,827	*88%*	
HSA	1,825	*12%*	
Total deposits	$15,652	*100%*	

Source: company filings, Kerrisdale analysis

1. Demand and interest-bearing checking.

2. Money market and savings.

Like many other banks, Webster has benefited from improving credit performance and today boasts very low net charge-offs and nonperforming loans. Unlike some peers, however, Webster's earnings have not been recently inflated by non-recurring reserve releases; to the contrary, in 2014 it actually built reserves slightly as its loan portfolio grew. Thus, it does not face the problem of "replacing" short-term EPS bumps stemming from credit improvement.

Robust Credit Performance…

Webster Financial: Credit Performance

	2009	2010	2011	2012	2013	2014
Nonperforming loans	$ 373	$ 274	$ 188	$ 195	$ 163	$ 132
As % of total loans	3.38%	2.48%	1.68%	1.62%	1.28%	0.95%
Net charge-offs	193	135	111	78	58	31
As % of average loans	1.68%	1.23%	1.00%	0.68%	0.47%	0.23%
Provision for loan losses	303	115	23	22	34	37
Reserve build/(release)	110	(20)	(88)	(56)	(25)	7

Sources: WBS filings, Kerrisdale analysis

And as a result of its strong earnings, Webster has built up its capital ratios to robust levels; at 11.4%, its Tier 1 common equity ratio is 15% higher than its internal 10% target.

…and Stalwart Capital Positon

Webster Financial: Capital Position

	2009	2010	2011	2012	2013	2014*
Tier 1 common equity ratio	7.8%	9.9%	11.1%	10.8%	11.4%	11.4%
Tangible common equity ratio	5.6%	6.8%	7.0%	7.2%	7.5%	7.5%

Sources: WBS filings, Kerrisdale analysis

Internal Capital Targets per 2013 Investor Day

	2010	2011	2012	2Q13	Basel III Well-Capitalized	Internal Targets
Tier 1 Common/RWA	9.88%	11.08%	10.78%	11.24%	6.50%	10.00%
Tangible Common Equity	6.80%	7.03%	7.17%	7.27%	na	7.25%
Tangible Equity	7.02%	7.16%	7.92%	8.03%	na	8.00%
Leverage	8.31%	8.85%	8.72%	8.93%	5.00%	8.00%
Tier 1 Risk-Based	12.07%	13.05%	12.47%	12.93%	8.00%	11.00%
Total Risk-Based	13.94%	14.61%	13.73%	14.19%	10.00%	13.00%

Notwithstanding the solid performance of Webster's core Connecticut-area business and its unique nationwide HSA Bank unit, the stock market has not accorded the company a premium valuation. In fact, Webster trades in line with similarly sized banks based on 2014 and 2015 P/E multiples. This discount is unmerited: even without HSA Bank, Webster would deserve at least in-line multiples, while HSA Bank on its own warrants a multi-billion-dollar valuation.

Comparable Company Valuation

	Share Price	Mkt cap ($B)	P/E ratio 2014	P/E ratio 2015E	RoTBV 2015E
WBS	$ 34.53	$ 3.1	16.6x	15.3x	*12.5%*
Peer median		2.8	15.9x	15.2x	*10.8%*
% difference			***4%***	***1%***	
Peers:					
ASB	$ 18.64	$ 2.8	16.1x	15.2x	*10.0%*
BXS	22.39	2.2	17.8x	15.5x	*10.8%*
BOKF	59.00	4.1	13.5x	13.5x	*10.4%*
CYN	90.37	5.0	21.3x	20.2x	*12.1%*
CBSH	41.52	4.0	15.9x	16.0x	*12.3%*
CFR	67.80	4.3	15.6x	15.0x	*14.0%*
FNFG	8.86	3.1	12.6x	14.6x	*9.1%*
FULT	12.10	2.2	14.3x	14.1x	*10.5%*
HBHC	29.27	2.4	12.5x	12.6x	*10.9%*
PBCT	15.13	4.5	18.7x	17.8x	*10.1%*
SUSQ	13.41	2.4	17.4x	18.0x	*9.3%*
TCB	15.69	2.6	14.1x	13.1x	*12.1%*
VLY	9.60	2.2	16.7x	15.3x	*11.7%*

Source: Capital IQ, Kerrisdale analysis

Even before accounting for the upside of HSA Bank, Webster's desirable geographic footprint deserves a scarcity premium. For a regional bank, its local market share is unusually high, making it a logical acquisition candidate for any competitor looking to expand into Connecticut and surrounding areas. Citizens Financial (CFG), for example, the large New England-based based bank (with a balance sheet 6x larger than Webster's), would find Webster's footprint and business mix a natural fit. Another intriguing long-term path would be an acquisition by People's United (PBCT), a larger regional bank that trades at a 16% P/E premium to Webster and overlaps several of its major markets; such a transaction could create tremendous value via large cost synergies.

Connecticut Deposit Market Share

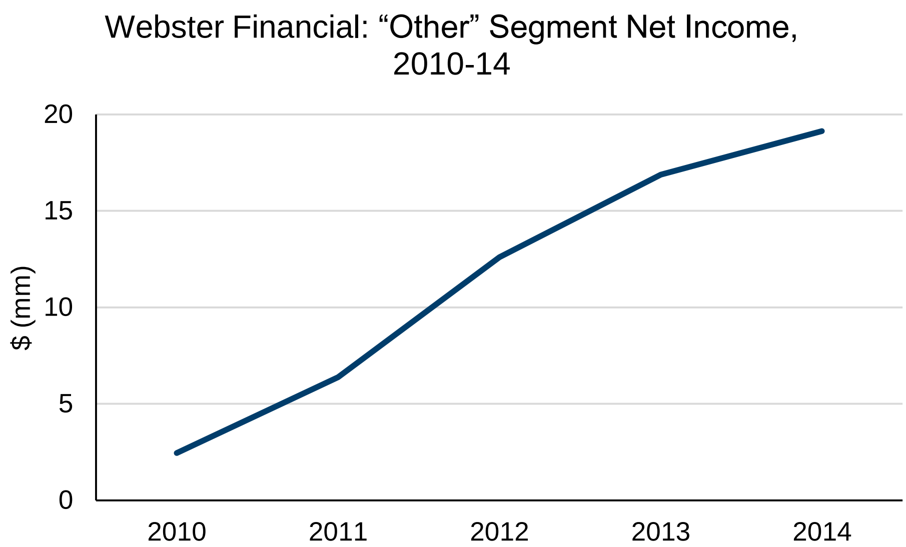
Rank	Company	Market share
1	Bank of America	26%
2	Webster	12%
3	People's United	11%
4	Wells Fargo	8%
5	TD Bank	6%
6	JPMorgan	4%
7	First Niagara	4%
8	Citibank	3%
9	Liberty Bank	3%
10	United	2%

Source: FDIC Summary of Deposits as of 6/30/14, Kerrisdale analysis

In sum, while Webster's core regional bank may not have the same staggering growth potential as its HSA Bank unit, it is solid, well-managed, and inexpensively valued – even without ascribing much value to its hidden gem.

V. Sum-of-the-Parts Analysis Justifies a $46 Price Target

There are dramatically different growth trajectories and revenue models for HSA Bank and Webster's core regional bank. As such, the most logical way to value the combined company is to assess each component separately. Unfortunately, as previously discussed, Webster has not disclosed segment results for HSA Bank itself; instead, it lumps this division in with its small private-banking unit in a segment labeled "Other." We believe that HSA Bank accounts for the vast majority of the "Other" segment's earnings, which have grown by a factor of eight from 2010 to 2014:



Source: company filings, Kerrisdale analysis
Note: 2014 figure represents annualized YTD 9/30/14 figure.

As previously discussed, more granular disclosures in Webster's 10-Ks support the belief that "Other" is dominated by HSA Bank. For example, in the 2013 10-K Webster explains, "Net interest income increased $7.7 million in 2013 compared to 2012. Of this amount, deposit growth, account growth and pricing initiatives in HSA resulted in an increase of $6.6 million for the year ended December 31, 2013, while higher loan and deposit balances in Private Banking resulted in growth of $1.1 million for the year ended December 31, 2013." Given these lopsided metrics, it's clear that the vast majority of Other net interest income comes from HSA Bank.

HSA Bank Historical Financials	2010	2011	2012	2013	
"Other" Revenue	$40.3	49.2	$62.7	$73.8	
"Other" PBT	2.9	8.9	18.0	24.1	
"Other" Net Income	2.4	6.4	12.6	16.9	
Other Net Interest Income	18.5	25.4	33.3	41.0	
Net int inc growth (HSA)	$5.8	6.1	$6.7	$6.6	MD&A
Net int inc growth (PB)	0.0	0.8	1.2	1.1	MD&A
** Note: Mgmt MD&A indicates that majority (~80%) of Other income is from HSA Bank*					
HSA Non-Interest Income		$14.3	$18.2	$22.0	Nov '14 Pres
HSA Non-Interest Expense		(18.4)	(19.5)	(22.9)	Nov '14 Pres
HSA Non-Interest Net Income		($4.1)	($1.3)	($0.9)	

In a November investor presentation, Webster provided some additional information, disclosing YTD 9/30/14 non-interest income and non-interest expense for HSA Bank specifically. Since the unit doesn't generate loan losses, the only missing line item is net interest income (i.e. the "float" revenue imputed to the HSA balances), which we estimate to be ~2% of average deposits. Using these assumptions, we estimate that the HSA Bank earned $21 million of net income in 2014, 11% of Webster's overall run-rate earnings:

Illustrative HSA Bank 2014 Earnings

HSA Bank Estimated Run-Rate Earnings

($ mm)	Total	HSA Bank	All other
Net interest income	$628	$34	$594
Core noninterest income	198	29	169
Total revenue	$826	$63	$763
Core noninterest expense	499	33	467
Core pre-provision net revenue	$327	$31	$296
Provision for loan losses	37	-	37
Pre-tax income	$290	$31	$259
Income tax expense	91	10	81
Net income	$199	$21	$178
Preferred stock dividends	11	-	11
Net income available to common	$188	$21	$167
Diluted shares	91	91	91
Diluted EPS	$2.07	**$0.23**	$1.84
% of total	*100%*	***11%***	*89%*
Average deposits (2014)		1,720	

Source: WBS filings, Kerrisdale analysis

However, this estimate doesn't include the earnings of JPMorgan's HSA business, which Webster acquired in January. Assuming that this business looks similar to HSA Bank with respect to fee income and expenses but generates lower float (since Webster must effectively invest all of the JPM deposits at once at today's low rates rather than benefit from prior years' securities purchases), we estimate that, pro forma for the acquisition, HSA Bank is generating almost $40 million of annual net income. (We do not deduct the non-cash intangible amortization expense associated with the cost of the JPM deal.)

Illustrative HSA Bank Pro Forma for JPM Acquisition

	HSA Bank	JPM	Pro forma
($mm)			
Total deposits	$1,825	$1,359	$3,184
As % of deposits:			
Net interest income	2.00%	1.75%	1.89%
Noninterest income	1.67%	1.67%	1.67%
Noninterest expense	1.89%	1.89%	1.89%
Net interest income	$37	$24	$60
Noninterest income	31	23	53
Total revenue	$67	$47	$114
Noninterest expense	35	26	60
Pre-tax income	$33	$21	$53
Income tax expense	10	7	17
Net income	$22	$14	**$37**

Source: WBS filings, Kerrisdale analysis

One simple sense check on this estimate is to compare the pro forma HSA Bank to two of its large competitors: Optum Bank, a subsidiary of UnitedHealth, and HealthEquity, a non-bank HSA custodian. Like other banks, Optum Bank files standalone quarterly financial statements with its regulators, available directly from the Federal Financial Institutions Examination Council or in more processed form from the FDIC. As of 9/30/14, these statements suggest that Optum is earning ~$65 million per year in net income, a 76% *premium* to our estimate for the pro forma HSA Bank despite a 21% *smaller* deposit base. While these standalone subsidiary financials can be difficult to interpret, Optum's results – generated from a business model very similar to HSA Bank's, in which HSA deposits are invested in low-risk securities to produce modest spread income – suggest that our estimate of HSA Bank's potential profitability is, if anything, conservative.

Meanwhile, HealthEquity generates far more revenue per dollar of deposits (despite sharing a portion of the spread with its partner banks) but incurs higher costs, resulting in net income of ~1% of average deposits, in line with our estimate for the larger-scale HSA Bank.

Pro Forma HSA Bank Compared to Optum Bank and HQY			
($mm)	Pro forma HSA Bank[1]	Optum Bank[2]	Health-Equity[3]
Ending deposits	$3,184	$2,569	$1,579
Average deposits	3,184	2,368	1,322
Net interest income	$60	$104	$19 [4]
Noninterest income	53	108	61
Total revenue	$114	$212	$80
Noninterest expense	60	75	59 [5]
Pre-tax income	$53	$137	$21
Income tax expense	17	50	8
Net income	$37	$86	$14
Revenue to deposits	3.6%	8.9%	6.1%
Net income to deposits	1.1%	3.6%	1.0%

1. As of 12/31/14.
2. As of 12/31/14. Expense shown includes provision.
3. As of 10/31/14 (YTD annualized).
4. Custodial fee revenue net of custodial costs.
5. Excludes amortization of acquired intangible assets.

Source: WBS filings, Optum Bank call reports, Kerrisdale analysis

With this information in hand, we can begin to value HSA Bank. A simple way to proceed is to compare the unit to its publicly traded competitor HealthEquity. Because of the attractive long-term growth prospects of the HSA sector, HealthEquity trades at premium multiples: almost 14x trailing revenue (based on our adjusted bank-like presentation of revenue, which nets out interest income and interest expense), 82x trailing earnings, and 53% of the value of its deposit base (held off balance sheet at its partner banks). Applying these multiples to the pro forma HSA Bank's metrics, we arrive at valuations ranging from $1.6 billion to $3.0 billion, with an average of $2.1 billion – thereby implying that the market is ascribing almost no value to Webster's strong, profitable, and growing core bank.

Illustrative HSA Bank Valuation: HQY as Comparable					
			HSA Bank Valuation Based on:		
($mm)	HQY	HSA Bank	Revenue	P/E	Deposits
Revenue	$80	$114	$114		
Market cap to revenue	*13.9x*		*13.9x*		
Net income	$14	$37		$37	
Market cap to net income	*81.5x*			*81.5x*	
Deposits	$2,100	$3,184			$3,184
Market cap to deposits	*0.5x*				*0.5x*
Market cap	$1,110		$1,576	$2,983	$1,683
Average of methodologies		**$2,081**			

Source: WBS filings, Capital IQ, Kerrisdale analysis

This comparable-based valuation is suggestive, but does it make economic sense? What if HealthEquity investors are too optimistic? To verify our view, we undertook a simple DCF analysis using widely cited industry growth figures combined with HSA Bank's current economics. The results confirm the validity of a multi-billion-dollar valuation for HSA Bank. We assumed the following:

- Aggregate HSA deposits grow in accord with standard industry forecasts of ~20% per year for the next ten years, then plateau at a modest 3% growth rate.
- HSA Bank retains its pro forma market share of ~15% of industry deposits.
- HSA Bank continues to earn a return on deposits of ~1.1%, with no benefit from rising short-term interest rates.
- Unlike a non-bank custodian like HealthEquity, HSA Bank must hold capital to support its deposit base. Since it will invest its deposits in low-risk securities without substantial capital charges, the binding constraint will be gross leverage, not risk-weighted capital ratios. We assume a 7% required tangible common equity ratio.
- While HSA Bank generates a healthy mid-teens return on equity under these assumptions, its 20%+ growth is even higher, implying a need for additional growth capital throughout the period. As a result, interim cash flows are negative (requiring either equity raises along the way or perhaps a larger infusion of initial equity to pre-fund expected growth), as HSA Bank steadily builds up to a >$20B deposit base, more than 6x larger than today.
- This conservative scenario doesn't give HSA Bank credit for potential benefits from increased scale. Non-interest income may eventually surpass non-interest expense if the existing infrastructure supports a larger fee-paying asset base.

<u>Using an 8% discount rate, these assumptions justify an HSA Bank valuation of $1.5 billion, or almost $17 per Webster share.</u>

Illustrative HSA Bank Valuation: Discounted Cash Flows

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Industry-wide HSA deposits ($B)[1]	$21.0	$25.5	$30.2	$35.3	$42.4	$50.8	$61.0	$73.2	$87.8	$105.4	$126.5
% growth	*25%*	*21%*	*18%*	*17%*	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*	*20%*
HSA Bank market share	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
HSA Bank deposits ($B)	$3.2	$3.9	$4.6	$5.4	$6.4	$7.7	$9.2	$11.1	$13.3	$16.0	$19.2
HSA Bank net inc. to avg deposits	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
HSA Bank net income ($mm)		**$41**	**$49**	**$57**	**$68**	**$81**	**$97**	**$117**	**$140**	**$168**	**$202**
Return on required equity		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
HSA Bank required equity ratio[2]	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%	7%
HSA Bank required equity	$240	$291	$345	$403	$483	$580	$696	$835	$1,002	$1,203	$1,443
Gross capital build required		$51	$54	$58	$81	$97	$116	$139	$167	$200	$241
Less: net income		41	49	57	68	81	97	117	140	168	202
Net capital build required		$11	$5	$1	$13	$15	$19	$22	$27	$32	$38
Free cash flow (Capital build)[3]		($11)	($5)	($1)	($13)	($15)	($19)	($22)	($27)	($32)	($38)
Terminal value		-	-	-	-	-	-	-	-	-	$3,545
Trailing P/E ratio											*17.5x*
P/TBV ratio											*2.5x*

Discount rate	*8.0%*
Terminal growth rate	*3.0%*
Present value of interim cash	$ (108)
Present value of terminal value	1,642
Total present value	**$1,534**
HSA Bank value per WBS share	**$16.90**

1. 2014-17 values from 2014 Year-End Devenir HSA Research Report; thereafter, 20% growth assumed through 2024.
2. Tangible common equity divided by tangible assets.
3. Net income less gross capital build required.

Source: WBS filings, 2014 Year-End Devenir HSA Research Report, Kerrisdale analysis

This analysis suggests that by 2024 total HSA deposit balances will equal $127 billion, up 6x from 2014. Dramatic as it is, this growth is not out of line with other projections. For example, the previously disclosed HSA white paper co-authored by two healthcare experts projects that *"50 million Americans will be covered by HSA Qualified plans by 1/1/2019 and that HSA account adoption will grow to 37 million in that time period"*; HealthEquity touts similar projections in its investor presentation (slide 6). Today, according to Devenir, HSA accounts hold average balances of less than $2,000, but older accounts hold $3,000-$6,000 and grow year after year. With 37 million accounts averaging $3,000 to $6,000, the projected total HSA deposit base would be $111 to $222 billion, roughly consistent with our assumptions.

What about Webster's core bank? Given its strong performance, it deserves at least as high a valuation as its mid-sized regional-bank peer group and could easily fetch a premium, especially if viewed as an acquisition candidate. (BB&T recently announced its acquisition of Susquehanna at 16.3x LTM EPS, while RBC is buying City National at 21.0x forward EPS.) Using our previous estimate of standalone core bank earnings of $1.84 and a median peer multiple of ~16x trailing earnings, we find Webster's core bank is worth ~$29 per share. Including ~$17 of value from HSA Bank derived via our DCF analysis, **<u>Webster overall is worth at least $46, *a 34% premium to its stock price today*</u>**.

Illustrative Sum-of-the-Parts Valuation			
Run-rate EPS	$ 1.84	$ 0.40	$ 2.25
Fair value ($mm)	$ 2,664	$ 1,534	$ 4,198
Fair value per share	$ 29.36	$ 16.90	**$ 46.26**
P/E ratio	*15.9x*	*41.9x*	*20.6x*
% upside			***<u>34%</u>***

Source: WBS filings, Capital IQ, Kerrisdale analysis

With a solid, well-managed core business and a unique, open-ended growth opportunity, Webster is clearly undervalued. Bank investors have failed to notice the tremendous value that the market ascribes to HSA growth at other companies and thus greatly underestimates the importance of HSA Bank – especially now that the JPM acquisition has made it the leader in its niche. We see significant upside in Webster's stock price.

VI. Conclusion

We believe that Webster is a classic “hidden asset” story, albeit with an asset hidden in plain view. Assembling the facts about HSA Bank takes some work, but at its core, HSA Bank is a simple business with a straightforward value proposition: helping consumers save for medical costs and enabling the nation to rein in unnecessary healthcare spending. As the number-one player in a market set to double or triple in size over a matter of years, HSA Bank clearly merits a premium valuation relative to cookie-cutter regional banks with no such growth prospects and wholly different end markets. But make no mistake: HSA Bank is not all Webster has going for it. Apart from this multi-billion-dollar business, Webster’s core regional bank has an attractive track record of solid execution in a difficult environment and should perform even better as the economy improves and rates rise. With such a strong foothold in its major geographic markets, Webster will remain a perennial acquisition candidate even as it flourishes as an independent. HSA Bank and Webster, each highly successful in its own right, have not been credited with the valuations they deserve, which we estimate to be at least $46 per share in total, 34% above the current stock price. To address this chronic undervaluation, we urge Webster’s board to explore spinning off HSA Bank.

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