STRATEGIC REPORT FOR
Zions Bancorporation

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EXECUTIVE SUMMARY

Zions Bancorp is a financial holding company that owns and operates either regional subsidiary banks in the west and southwest regions of the US. Zions is essentially a regional commercial bank that has a history tied to the Mormon Church. Zions has established a solid reputation and continues to lengthen its reach within the US. During its recent history, Zions has pursued a relatively straightforward growth policy that includes acquisitions and expansion into states that maintain relatively high rate of population and income growth. Zions has a strong footprint in the eight western and southwestern states in which it has been established and at the end of FY2005 entered the high growth Texas market through the acquisition of Amegy Corporation. The Company is in the midst of realizing the full efficiencies gained from this acquisition and recently finished the operations integration.

Zions decentralized management of the eight highly autonomous regional banks have created a local banking feel for the customers. In addition, the Company has been able to be more responsive to dynamic economic situations at the community level.

Zions has been a strong performer and is financially sound, recording consecutive increasing net interest income over the past few years. Zions has been able to grow both organically and inorganically, through acquisition in the past several years. Zions' stout financial management has also allowed the Company to avoid recent industry-wide deteriorations – including the fallout in the subprime mortgage market.

However, there certain areas of concern that will be the focus of Gotham Global's strategic analysis. While the core business of Zions have maintained high levels of success, there are specific subsidiaries that have been underperforming - resulting in decreased efficiency for Zions as a whole. There are also foreseeable problems that may arise due to Zions' regional scope. As an entirely domestic

bank, the Company may be overexposed to events that affect the US economy. Additionally, Zions may eventually run into margin and pricing pressures from larger banks that operate internationally and are thus able to diversify their risk, lower their capital requirements (under Basel II), afford competitive advantages of economies of scale that allow these banks to undercut Zions and eventually place it in a takeover scenario.

COMPANY BACKGROUND

Today, Zions Bancorporation is a major financial holding company, but its origins can be traced to the Mormon Church in Utah. Zion's Savings Bank and Trust Company was legally incorporated July 10, 1873 in the Utah Territory under the direction of Brigham Young, making it Utah's first chartered savings bank and trust company. The bank developed and grew steadily, surviving its only major threat – the depression caused by the crash of 1929. By 1957, the original establishment hand grown substantially and on December 31 of that same year, Zion's Savings Bank and Trust Company (1873), Utah Savings and Trust Company (1889) and First National Bank of Salt Lake City (1890) merged to form Zions First National Bank. The newly enlarged institution increased its total deposits to $109.5 million.

In 1960, authorities of the Church of Jesus Christ of Latter-day Saints, long-time equity-holder of Zions, decided to divest itself of its banking interests. The Church sold majority control of Zions First National Bank to Keystone Insurance and Investment Company. At the time of the sale, Keystone was owned by a group of businessmen headed by Leland B. Flint, Roy W. Simmons and Judson S. Sayre. At the time of the sale, the Bank had total deposits of just under $120 million.

On February 17, 1961, Zions First National Investment Company was incorporated in Nevada and became the majority owner of the bank stock controlled by the Keystone group. Four years later, the name of the investment company was officially changed to Zions Bancorporation. From there, a series of mergers and acquisitions led to the contemporary state of the Zions Bancorporation financial holding company. The most recent acquisition occurred in 2005, when Zions Bancorporation acquired Houston-based Amegy Bancorp and its 80-plus offices for $1.5 billion. Zions simultaneously launched a bank in Portland, Ore., called the Commerce Bank of Oregon.

The group's current banking businesses include: Zions First National Bank (Zions Bank) located in Utah and Idaho; California Bank & Trust (CB&T); recently acquired Amegy Corporation (Amegy) located in Texas; National Bank of Arizona (NBA); Nevada State Bank (NSB); Vectra Bank Colorado (Vectra); The Commerce Bank of Washington (TCBW); the newly opened Commerce Bank of Oregon (TCBO).

As it continues to expand, Zions still runs its businesses under eight independently operated subsidiaries—each with its own chief executive officer, charter and name. While this structure is intended to strengthen the local brands and decision-making process, it came with a legitimate challenge along the way: It was difficult to immediately assess the performance of the subsidiaries. In August 2004, Zions sought to dismantle this problem through implementation of business intelligence software, deciding on Planning for Financial Institutions produced by SRC Software. Since using the application, Zions reduced its corporate budgeting and reporting cycle by five months—from six months to just one. The company has also seen improvements in the consolidating and reporting of financial results, and according to executives within the company, it only takes a few hours each month instead of three days to consolidate margins.

Today, Zions Bancorporation operates full-service banking offices in eight western states – Arizona, California, Colorado, Idaho, Nevada, New Mexico, Utah and Washington – as well as Texas. The Company offers retail banking, small and medium-sized business lending, residential mortgage, home equity line of credit and investment activities – including wealth management services offered through one of its subsidiaries, Contango.

COMPETITIVE ANALYSIS

Zions Bancorp is a financial holding company that operates in the major industry defined as Finance and Insurance. This broad industry definition can be further broken down into subsets, and in this case Zions core business actions would place it under the Depository Institutions subset. The Company is also a holder of other financial institutions –such as its asset management subsidiary, Contango – that are classified under different subsets at the same level as depository institutions. However, for the purpose of analyzing the competitive landscape of the industry, we will restrict this broad group to the Commercial Banking category of the Depository Institution subset. Firms that fall into this category are: Bank of America Corporation, Golden West Financial Corporation, KeyCorp, Merrill Lynch & Co., Washington Mutual, Wells Fargo & Company, Comerica Bank and City National Corporation.

Following the passage of the Gramm-Leach-Bliley Act in 1999 – which allows banks to incorporate multiples types of finance and insurance activities under one holding company – financial companies have diversified their product and service offerings.[1] Consequently, firms such as WalMart, Home Depot and State Farm have expanded into the deposit and loan business[2]. This new breed of

[1] S&P 500 Industry Report
[2] The Economist, July 15, 2006, 73

financial institution must also be considered in the competitive analysis of the Commercial Banking category.

INTERNAL RIVALRY

The Commercial Banking Industry is characterized by fierce competition and a constant struggle to increase market share. Zions Bancorp must compete for consumer banking, commercial real estate, and business lending customers in an industry in which internal rivalry plays a prominent role. The main vehicle by which firms in the industry preserve market share is through competitive interest rates. While banks may compete by offering more ATM's, better services and more amenities, in the end the ultimate distinction of the final product is price. Thus, strong price competition will occur in two forms: interest rates on loans and interest rates on deposits. The deposit service is highly elastic and customers seek the highest rates of return on their deposits. A similar scenario exists in the loan market – customers seek the loans that offer the lowest rates.

Another factor pushing internal rivalry is the lack of new clientele from period to period. In order to grow, commercial banks are highly reliant on new clients. Due to its long history of existence, the Commercial Banking Industry possesses many firmly engrained relationships, pushing the incentive to capture new customers from other banks. As a result, competition for the few available *new* clients is strong. This can be witnessed in the market for college-aged students who are often offered deals such as free checking and low to no fees. College students are one of the larger, regenerating demographics of unattached clients for the commercial banking industry to capture each year.[3]

In addition to capturing clients, commercial banks rely on their ability to *maintain* key clients that provide large amounts of capital and whose repeat business is necessary to preserve a competitive market share. For instance, Zions Bank (subsidiary of Zions Bancorp) has maintained a strong hold on the farming

[3] DataMonitor Research Report 2007

loans market in Idaho and is the top provider of FSA loans to family-size farmers and ranchers. Zions' ranking in Idaho marks the third consecutive year that the bank has been the area's number one FSA lender. It is core client bases such as these that provide stability in capital flow for the bank and builds on the reputation as a leading provider of niche loans in specific regions.

Commercial banks are often forced to differentiate themselves from the competition through the use of extra services. The heavy use of the Internet reduces the cost of customers changing to a new provider because it reduces the time spent locating the most competitive rates and provides a relatively simple method of switching banks.

M&A is one common tool to fight against competition and expand when organic growth has halted. By becoming larger, banks can take advantage of economies of scale that apply to data collection, information technology, processing services and administration – thereby lowering marginal costs. With lower costs, the company can afford to offer more competitive prices in deposits and loans. Furthermore, inorganic growth can be achieved in a straightforward manner by acquiring new clients that are loyal to the target company and will be folded into the parent company's interest income portfolio. The Company's relatively small market cap makes it a potential acquisition target for one of the larger banks that wishes to expand its expertise into the Company's footprint. The Company may in fact stand to benefit from a take-over by maximizing its desirability now, receiving a suitable offer from a take over company, and avoiding future struggles against larger competitors. This option is discussed in the *Strategic Issues and Recommendations* section.

BARRIERS TO ENTRY

The commercial banking industry is a mature market and has previously experienced significant consolidation at the large firm level – including

aggressive mergers and acquisitions that involved banks such as Bank of America and Fleet Boston. The existing banks have committed significant resources on branding, effectively promoting the reliability and quality of their services. Because of this, the threat of entry by a new competitor is remote. A new entrant must overcome the benefits of incumbency and offer the same reliability of service (i.e. the bank will not go bankrupt) while beating existing banks on prices (interest rates and fees) in order to steal market share. The major companies in the industry are large and well established and have the advantage of significant economies of scale and scope in capital investment production, marketing, accessibility and serviceability, which exacerbates an entrant's inability to compete on price, quality or promotion. Potential entrants must also consider the predatory pricing. Large firms are able to comfortably reduce interest rates on loans or increase interest on deposits to certain customers who may be targeted by a new entrant and take short run losses to deter long term competition.

The relatively large start-up costs reflect the intense capital requirements of commercial banking. These capital requirements include the accumulation of deposits in order to provide various capital-based banking. The access to the inputs of production (i.e. depositors) is a significant factor of entry and can provide a significant barrier to potential entrants. Even if a new player enters the market, survival is based largely on the ability to capitalize on economies of scale in order to increase operating margins and maintain profitability.

While the brand equity of the larger banks provides adequate security, the intermediate size banks may be threatened to a small degree by the proliferation of fringe, internet-only banks. Because companies which focus on internet banking have relatively low capital requirements, they require smaller initial funding to start up. Thus, entry is possible for firms that wish to pursue a narrow service scope centered on internet banking. Despite the potential for internet banks, there is an inherent value and feeling of accountability that comes with being able to see an actual bank branch and interact with a teller, thus mitigating

the threat of internet banking on the traditional banks. While the prominence of the internet may lower some barriers to entry, reputation-building remains a significant obstacle to attracting the threshold quantity of customers. Entrants would have to face years of losses until their operational and administrative costs were spread thin enough over the interest income generated by their banking services to become profitable.

Another traditional factor that blocks entry to the industry is access to distribution. Commercial banks require numerous banking locations and ATM's as well as sophisticated online services. This creates a large fixed cost necessary for entry; the entrant must establish the banking infrastructure before effective services can be provided. IT systems can also be very sophisticated as well as expensive, thus implementation of effective internet services as well as data tracking and analysis may prove to be too costly for entrants to acquire.

Additionally, government policy and regulation limits the ability of fringe players to enter the market. These restrictions are in place to maintain the banks responsibility to depositors and to eliminate paper banks that are unable to perform the basic functions of a commercial bank. These barriers act as a deterrent to potential entrants.

As we discussed, the brand equity of established players in the industry plays a large role in determining possible entry. However, if a potential entrant is able to find a niche market that is not covered effectively by one of the large players, they may be able to develop a brand identity for providing a specific service.

SUBSTITUTES AND COMPLIMENTS

The threat of substitutes is significant within the commercial banking industry. The extreme internal competition forces firms in this industry to reduce operating margins by either lowering interest rates on loans or raising interest payments on deposits in order to attract clients. Consumers must evaluate the

trade off between quality (reliability) and price when choosing between firms in the commercial banking industry. Data shows that buyer's inclination to substitute in the market is primarily based on the competitiveness of rates.[4]

While the nearly homogenous product offering by most commercial banks allows for lubricated internal substitution, there are few external substitutes that provide lending services or safekeeping of capital. Savings and Loans practices provide the main external competition to commercial banks because they can offer better rates and fees due to fewer administrative costs and lower operating margins. Utah, in particular, has been a hotbed for Industrial-Loan Charters (ICL) that permit credit unions to liberally expand their membership rolls beyond original mandates and as well as a tax-exempt status, which allows them to offer better terms than commercial banks.[5]

In addition to the buy-side substitutes, there exist significant supplier substitutes in the market. The major supply product for the Commercial Banking industry is capital. Approximately 70% of capital comes from consumer deposits[6]. While most consumers do not have enough capital to place it in an entity that does not allow for immediate access, some wealthy consumers are not concerned with direct liquidity and thus have multiple options. Wealthy consumers can invest in real estate, gold, equity, and bonds as well as other investment instruments. Since those who have the luxury of investing in such instruments typically have sizeable capital holdings at their disposal, this presents a significant threat to the industry. Banks can counteract this threat to some extent by investing excess capital in real estate, equity and bonds themselves.

Compliments may include retail stores that offer bank-specific credit cards that provide discounts on items at the store. As popularity of the primary store

[4] S&P500 Industry Report
[5] "Zions Bancorp," *US Banker*, February 2007, 26.
[6] S&P Industry Survey: Banking

increase, the bank accumulates more clients and can earn increase their interest income from credit cards.

Supplier Power

In the Commercial Banking industry, the banks themselves are the suppliers of goods; however, 70% of that capital is generated through consumer deposits thus rendering the depositors the true suppliers in the industry. The depositors provide capital today and expect some return on the investment in the future. The supplier concentration competes amongst itself for the best rates available. There are vast numbers of individuals and groups – including mutual funds, hedge funds and institutional buyers of equity and debt financing – competing to provide capital. Subsequently, the capital suppliers do not pose a significant threat and maintain relatively low pricing power[7].

While the supplier power is generally low, there are certain externalities that can influence the potency of the suppliers at any given time. As we mentioned before, the presence of substitute inputs can either come from another bank or an alternative option, such as keeping cash in a safe, investing in commodities, the stock market or bonds. Hence, the performance of the stock market affects the supplier power in that when the stock market is performing well suppliers of capital have a higher opportunity cost of investing in the commercial bank (deposits, CD's, etc.). In the same sense, the performance of the US economy and the global economy in general affect the commercial banking industry as well.

There is an impact of inputs on cost if suppliers of capital demand a higher return on investment (e.g. deposits). This demand may require the bank to raise interest on loans thus losing out on product differentiation and losing a comparative advantage to competitors.

[7] S&P Industry Survey: Banking

The Federal Reserve's actions can also have a significant affect on supplier power. The Fed controls the overnight loan rates which directly influence the rates that commercial banks are able to offer. The Fed also influences the capital reserve requirements which directly affect the banks investing activities.

Buyer Power

Buyers in the industry are those who purchase the products of the commercial banks, in other words, the clients who borrow capital now and are obligated to pay interest on said loans in the future.

There are too many individual parties who are buyers, thus there is no one buyer that has a price-setting power.[8] Buyer volume is not significant enough for a single person to create bargaining leverage. Additionally, buyers do not work together, mitigating any potential buyer bloc power.

SWOT Analysis

Strengths

Decentralized management structure

The Company conducts its banking business through eight different regional banks. Each of these individual banks operates under a different name, charter, Chief Executive Officer and management team. This decentralized structure allows for decisions related to customers to be made at a local, more responsive level. Additionally, each bank directs its branding, market strategies, customer relationships, product pricing and credit decisions.[9] This "community bank" approach offers a higher quality service to its targeted customers, which encourages healthy business growth within the Company's footprint.

[8] S&P 500 Industry Survey: Banking
[9] DataMonitor Research Report, 18.

CENTRALIZED TECHNOLOGY AND OPERATIONS

The Company has been able to differentiate itself from smaller banks by using the combined scale of all of the 8 banking operations to create a broad product offering without the fragmentation of systems and operations that would typically drive up costs. This advantage was greatly enhanced after the implementation of new business intelligence software in August 2004. Before 2004, the Company relied on hundreds of disconnected, manually updated Excel spreadsheets to collect financial data from each of the subsidiaries. Company executives eventually turned to business intelligence software in order to reduce business risks, increase data quality and lower information-technology costs. By August 2004, the Company integrated SRC software with its existing Oracle general ledger platform to efficiently collect financial information from each bank and department cost center.[10]

Additionally, the Company is able to capitalize on certain economies of scale by either "manufacturing" the product centrally or outsourcing the task to a third party. Examples include cash management, credit card administration, mortgage servicing, and deposit operations.[11]

HEALTHY GROWTH FOOTPRINT

The Company has established a strong reputation and customer base within its footprint of the western and southwestern states, each of which have experienced relatively high levels of historical economic growth and each ranks among the top one-third of the fastest growing states as projected by the US Census Bureau.[12] The Company has positioned itself in regions with favorable demographic projections for the next 5 years, focusing on market segments that present excellent opportunities due to higher rates of growth, business formation, and expansion over other states.

[10] Bob Violino, "Disconnected No Longer," *Baseline* no. 66, 2006, 1.
[11] Zions Bancorp FY2006 10-k Report, 20.
[12] US Census Bureau, *Projected Population of the United States,* Table 1a.

FIGURE 1: DEMOGRAPHIC PROFILE BY STATE[13]

($ amounts in thousands)	Number of branches 12/31/2006	Deposits in market at 12/31/2006	Percent of Zions' deposit base	Estimated 2006 total population (1)	Estimated population % change 2000-2006 (1)	Projected population % change 2006-2011 (1)	Estimated median household income 2006 (1)	Estimated household income % change 2000-2006 (1)	Projected household income % change 2006-2011 (1)
Utah	112	$ 9,531,472	27.25%	2,551,534	14.26%	**12.43%**	$ 56.4	23.38%	**18.39%**
California	91	8,351,369	23.87	37,236,136	9.93	**8.00**	57.8	21.32	16.95
Texas	77	7,329,258	20.95	23,786,899	14.08	**10.96**	49.3	23.35	17.56
Arizona	53	3,675,458	10.51	6,135,872	19.59	**16.09**	51.3	26.44	**21.27**
Nevada	72	3,378,945	9.66	2,575,444	28.88	**22.95**	55.1	23.42	**18.06**
Colorado	38	1,665,988	4.76	4,821,136	12.09	**9.08**	58.5	23.82	**18.03**
Idaho	24	519,211	1.48	1,475,700	14.05	**11.75**	46.6	23.59	**17.88**
Washington	1	504,918	1.44	6,396,653	8.53	6.36	56.5	23.38	**18.35**
New Mexico	1	16,385	0.05	1,956,417	7.55	6.07	41.5	21.56	16.62
Oregon	1	8,742	0.03	3,694,335	7.98	6.28	50.1	22.23	17.56
Zions' w. avg					15.12	12.33	54.7	23.28	18.21
Aggregate nat				303,582,361	7.87	**6.66**	51.5	22.25	**17.77**

As seen in Figure 1, the Company has created a high growth footprint. The population growth rate in 7 of 10 states in the Company's footprint are projected to outpace the aggregate national population growth rate from 2006-2011.

FINANCIAL DISCIPLINE

The Company's financial strategy has been one of rational discipline and has allowed for continued growth while avoiding certain pitfalls of the commercial banking industry. An example includes the Company's strong hedging program which uses interest-rate swaps rather than mortgage-backed securities and has allowed the Company to ride out the flat yield curve better than most.

The Company was also able to avoid the recent sub-prime mortgage fall out as it does not deal in the sub-prime lending market. The Company aggressively reviews their portfolio each month to make sure everything is secure and enhance their understanding of the financial landscape to avoid negative externalities.[14]

ROBUST FINANCIAL GROWTH

[13] Data Source: SNL Financial Database

[14] US Banker, *Cover Story: Zions Bancorp,* February 2007, 27.

The financial performance in FY2006 is heavily affected by the acquisition and integration of Amegy Corporation; therefore, we will look at the financial status of fiscal 2005 in order to analyze the growth of the Company.

The Company has seen healthy financial performance due to organic and inorganic growth initiatives. The Company, as a whole, recorded revenues of $1,800.2 million during the fiscal year ended December 2005 – an increase of 12.9% over 2004.[15] The Company's revenues recorded a compound annual growth rate (CAGR) of 8.4% from 2002 to 2005. Driven by a 17% increase in its interest income, the Company's net interest margin increased to 4.6% as compared to 4.3% in the fiscal 2004.[16] Subsequently, by leveraging its strong financial performance, the Company should be able to power a sustained growth in the future and ensure improved investor confidence. Look to the *Financial Analysis* section of this report to see detailed analysis of the financial performance during fiscal 2006.

STABLE ASSET LIABILITY MANAGEMENT

In managing interest rate risk, the Company does not take positions based upon management's forecasts of interest rates, and instead maintains a position of slight "asset-sensitivity," meaning that its assets tend to re-price more quickly then its liabilities. The Company makes extensive use of interest rate swaps to hedge interest rate risk in order to achieve this desired position. This practice has enabled the Company to achieve a relatively stable net interest margin during periods of volatile interest rates.[17]

HEALTHY CORE BUSINESS

The Company's core business consists of providing community and regional banking services to both individuals and businesses at a higher quality level than its rivals. The Company has a "strong" footprint, as subsidiaries – such as Zions

[15] FY2006 10-k, 15.
[16] DataMonitor Research Report *2007*, 19.
[17] FY2006 10-k, 25.

Bank in Utah and Idaho – possess high levels of brand loyalty due to its reputation for quality service and training. The Company is among the top institutions in: SBA 7(a) loan origination, SBA 504 lending, software and cash management systems related to the electronic imaging of checks pursuant to the Check 21 Act, and the origination of farm mortgages sold to Farmer Mac.[18]

WEAKNESSES

DECENTRALIZED STRUCTURE

The decentralized nature of the eight relatively autonomous, regional banks provides some difficulty in implementing a dynamic, overall financial strategy. While this particular structure is intended to strengthen the local brands and decision-making process, it comes with a legitimate challenge: overall coordination of financial strategy.

The company did much to improve the consolidating and reporting of financial results, by implementing the SRC business intelligence software.

WEAK PERFORMANCE OF VECTRA

Since 2003, when the Company shifted the focus of Vectra Corporation (Colorado subsidiary bank) to small and mid-sized businesses, Vectra has not been able to offer the expected financial synergies and has remained unprofitable.

WEAK PERFORMANCE OF CONTANGO WEALTH MANAGEMENT

Contango has not been able to generate profits for the Company and is an extension outside of the commercial banking role in which the Company has excelled. This wealth management subsidiary is not a part of the core business services of the Company and may be superfluous to the service strategy that has brought the Company much of its success.

[18] FY2006 10-k, 20.

Over-reliance on the US

The Company's operations are concentrated within the US which increases the risk of negative financial impact from events that affect the US economy. For FY2006, almost all revenues were generated within the US. The domestic scope of the Company not only increases its exposure to local factors but also deprives the company of higher revenues from growth markets in Asia and Latin American countries.

Opportunities

Strategic acquisitions – Amegy and Commerce Bank of Oregon

The Company entered two new states in fiscal 2005 after acquiring Amegy Bancorporation of Texas and opening the Commerce Bank of Oregon in Portland. Amegy, which was acquired in July 2005, was the third largest independent banking company in Texas – with approximately $7.7 billion of total assets. Amegy will continue to operate under its own brand name with its local management to preserve the customer relationships that had been forged prior to the acquisition. Amegy will give the Company a strong presence in the world's eighth largest economy and rapidly growing Texas market. In addition, Amegy provides enhanced treasury management capabilities.[19]

In October 2005, the Company opened The Commerce Bank of Oregon in Portland after acquiring the charter of a specialty credit card bank in liquidation. Successful inorganic growth initiatives are expected to boost the company's top-line by allowing it the access to diversified and expanded customer base in new markets.[20]

Expected growth in banking industry

[19] FY2006 10-k, 21.
[20] DataMonitor Research Report, 20.

The global banking industry recorded a CAGR of 4.9% from 2001 to 2005 and is projected to continue a CAGR of approximately 5% in the next five years due to a general global economic upturn.[21] Various Asian and Latin American countries are currently experiencing vast financial transformations and will likely provide significant opportunities for US banks.

Increasing home ownership

The homeownership rate in the Western US is expected to rise from 64.6% to approximately 70% by 2013 due to the recent movement of immigrants into homeownership and continued growth of baby boomers aging into their peak home owning years.[22] In the long term, growing demand for homes could provide excellent mortgage business opportunities.

NetDeposit

NetDeposit is the Company's remote capture technology system that allows for the efficient processing and clearing of checks. NetDeposit is a valuable, proprietary asset to the Company and should be further developed in the future.

Threats

Basel II

The Basel II Accord aims to ensure that capital allocation is more risk sensitive, and in doing so, separates operational risk from credit risk in its approach for setting capital standards. Basel II uses a three pillar concept that involves – (1) minimum capital requirements, (2) supervisory review and (3) market discipline – to promote greater stability in the global financial system. The Basel II Capital Accord requires banks to assess risk in each area of their business and set aside adequate regulatory capital. Essentially, Basel II better aligns regulatory capital

[21] S&P500 Industry Report
[22] "Housing Vacancies and Homeownership," *US Census Bureau*

of a bank with its risk profile.[23] Complying with Basel II qualification standards requires a significant history of consistent, accurate and granular data within the credit management information systems. The costs of complying with Basel II is a heavy burden on small to medium sized banks and adherence to the stringent regulations of the Accord may result in higher compliance costs, thus reducing the margins of the Company.

Basel II will potentially increase the capital requirement advantages afforded to large, international banks that maintain diversified portfolios and possess broader-based risk. These lower capital requirements will allow for enhanced sustainable growth:

FIGURE 3: EFFECT OF CAPITAL RESERVE REQUIREMENTS

	Year 1	Year 2	Capital Growth
High reserve requirement (a)			
Asset	100	120	2/110 = 1.80
Capital	10	12	unsustainable
High reserve requirement (b)			
Asset	100	110	1/105 = 0.97
Capital	10	11	sustainable with slower growth
Low reserve requirement			
Asset	100	120	1/110 = 0.90
Capital	5	6	sustainable

The bank with the lower capital reserve requirement is able to sustain higher levels of growth.

INDUSTRIAL LOAN CHARTERS (ICL) AND CREDIT UNIONS – UTAH

Utah is a hotbed for ICL's that permit credit unions to liberally expand their fields of membership. Credit unions control 40% of consumer deposits in Utah – a high market share that may be attributable to laws that have allowed credit unions to expand membership rolls beyond original mandates and the lack of

[23] DataMonitor, 21.

taxation. These favorable regulations allow for credit unions to offer better terms to customers and place commercial banks at a disadvantage.

HIGH INTEREST RATES

Since the start of 2004, the US Federal reserve and other Central Banks have imposed steadily increasing interest rates in order to check inflation and the over heating of regional economies. The June 2006 rate increase to 5.25% marked the 17th consecutive rise in the federal fund rate. Relatively high interest rates would potentially drive down demand for borrowing, including consumer and corporate credit which would lower the Company's interest income – inherently reducing the Company's bottom line in the future.

CONSOLIDATION IN THE BANKING INDUSTRY

A significant number of large commercial banks, insurance companies and other broad-based financial services firms have merged with other financial institutions to diversify their offerings and reduce their corresponding business risks. There were a number of major mergers in the financial sector that took place in the mid-1990s. Citibank merged with Travelers Group, an insurance company, and in 1997 formed the conglomerate Citigroup, a corporation combining banking and insurance underwriting services. Additional consolidation included Smith-Barney, Shearson, Primerica and Travelers Insurance Corporation. These combinations had violated the Glass-Steagall Act by combining insurance and securities companies; however, the passage of the Gramm-Leach-Bliley Act in 1999 legalized these prior mergers and paved the way for future consolidation in the financial industry.[24] Due to their enhanced size and competitive position, these institutions aim to increase their market share and utilize economies of scale, which could potentially result in pricing and margin pressure for the Company in some product markets.

[24] S&P500 Industry Report

The consolidation within the commercial banking industry creates significant long-term dilemmas that deal with Zions' inability to compete with global banking giants for a number of reasons. These banking powerhouses possess a wide range of competitive advantages that involve: economies of scale, expanded market reach via sophisticated internet-based services, benefits to risk management stemming from the diversity of international portfolios, expansive budgets and resources, ability to sustain predatory pricing, international brand equity, expansive service scope, superior operational and technology systems. The Company derives the majority of its businesses upon its ability to retain its market share across segments in the US market. Ongoing consolidation is creating larger rivals with diversified businesses who could potentially steal market share from the Company's footprint and lead to financial woes.

FINANCIAL ANALYSIS

FY2006 FINANCIAL RECAP

Over the past few years Zions Bancorp's has been in excellent financial condition and has recorded steady growth while avoiding certain industry-wide deteriorations, including the sub-prime mortgage fallout. The Company's financial stance was once again very strong in FY2006. The Company reported record earnings for FY2006 of $579.3 million or $5.36 per diluted common share. This was up from $480.1 million and $5.16 in FY2005 and $406.0 million and $4.47 in FY2004.

The key drivers of the Company's robust financial performance in FY2006 included improvements in the average net loans and leases (+35%), average total deposits (+32%), and the net interest margin (+5bp). Net interest income, the main driver of revenue and free cash flows in the commercial banking industry, increased by 30% to $1.7 bill from 2005. After tax net income also increase by

21% over 2005 – all indicators of healthy loan growth and overall financial well-being.

There was a modest increase in the efficiency ratio (expenses/revenue); however, this increase was primarily due to the Amegy acquisition, and declined throughout the year as integration efficiencies were attained. We expect to see a continued decrease in the efficiency ratio as the Company reaches full integration with Amegy within the next year. The return on average assets and return on average equity performance ratios declined mildly as well, mainly due to the acquisition of Amegy, which increased the amount of equity and assets within the Company thus lowering the proportional returns. This should not be seen as a signal of diminishing returns but understood as an adjustment that occurred due to a shift in the capital structure due to the large acquisition.

The Company's capital position has strengthened significantly over the past several years. As of December 2006, the Company's total risk-based and Tier 1 risk-based capital ratios of 12.3% and 8.0% respectively, compared with the minimum statutory ratios of 8% and 4%. These solvency ratios convey the presence of a relatively strong asset liability management system, which invokes a sense of trust amongst depositors and shareholders.

The Company was also able to handle the pressures of a dynamic market in 2006. Declining rates of residential housing development and construction in the West resulted in significantly slower rates of loan growth in its CB&T, NBA and NSB subsidiaries in the latter half of the year. This resulted in a mix shift away from commercial real estate and towards commercial lending sectors in new loan originations. The Company was able to handle the market shift because of its diversified service capacity.

During FY2006, the Company was able to avoid an industry wide deterioration in sub-prime mortgage market. The Company does not participate in the sub-prime

market and holds a relatively small portion of Alt-A mortgages, thus remained relatively sheltered from the downturn.

FINANCIAL CONDITION

While the Company has witness robust financial performance over the past few years, it is always important to compare the Company with the status of its leading competitors to gauge its place in the commercial banking industry. With the prominence of the internet, it becomes important to not only analyze the regional competitors (UnionBanCal Corp) but also the international players that are able to encroach on the Company's footprint even without a physical presence.

FIGURE 3: MARKET COMPARISONS

	Zions Bancorp	Bank of America	Washington Mutual Inc.	Wells Fargo Corp	UnionBanCal Corp
Market Cap (billions)	$9.32	$228.7	$35.63	$118.8	$8.7
P/E	15.89	11.15	11.19	14.28	12.02
EPS	5.362	4.593	3.64	2.487	5.238
Stock Price (Apr. 16)	85.19	51.23	40.73	35.51	62.98
Return on avg. assets	1.32%	1.48%	1.02%	1.76%	1.50%
Return on avg. com equity	12.89%	16.28%	13.52%	19.60%	16.73%
Efficiency ratio	56.85%	46.86%	60.75%	58.10%	62.67%
Net interest margin	4.63%	2.82%	2.58%	4.83%	4.09%
Operating Margins	53.65%	57.89%	51.08%	56.43%	45.12%
Profit Margins	25.99%	31.28%	25.71%	25.34%	27.67%

As we can see from Figure 3, the Company has a relatively high P/E ratio, which may be largely due to the unrealized earnings potential of the newly acquired Amegy. Many of the expected efficiencies and economies of scale have yet to be realized, thus suppressing the earnings numbers on the books and creating an artificially high P/E.

The net interest margins are difficult to compare as each of the banks participates in a heterogeneous set of interest bearing practices in a wide range of volumes – thus distorting the average margins. However, some of the other financial metrics tell an interesting story of the industry landscape. When compared with

the large banks, the return on average common equity, efficiency ratio, operating margins are relatively weak and indicate some economies of scale that are being utilized by the large banks that have escaped the Company. We will discuss the low return on average common equity – the efficiency ratio and operating margins are more of a long-term concern to the Company. The efficiency ratio and operating margins are two useful indicators of profitability and provide significant evidence for economies of scale in banking. Clearly the megabanks (+$100bil market cap) have found a way to maximize efficiency and generate healthy cash flows through operation and are highly profitable as a result.

As mentioned earlier, the Company's return on average common equity is relatively low – especially when compared to bank's larger competitors. However, this may not necessarily mean that the Company is struggling to earn competitive levels of return. Figure 4 decomposes the return on equity metric.

FIGURE 4: DUPONT ANALYSIS OF RETURN ON EQUITY

DuPont Model	Zions Bancorp	Bank of America
Profit Margin	25.18%	28.94%
Asset Turnover	0.05	0.05
Financial Leverage	9.42	11.30
ROE	11.69%	16.28%
Net Income	583.1	21133
Sales (or revenue)	2315.9	73023
Average Total Assets	46970	1466681
Average Shareholders' Equity	4987	129773

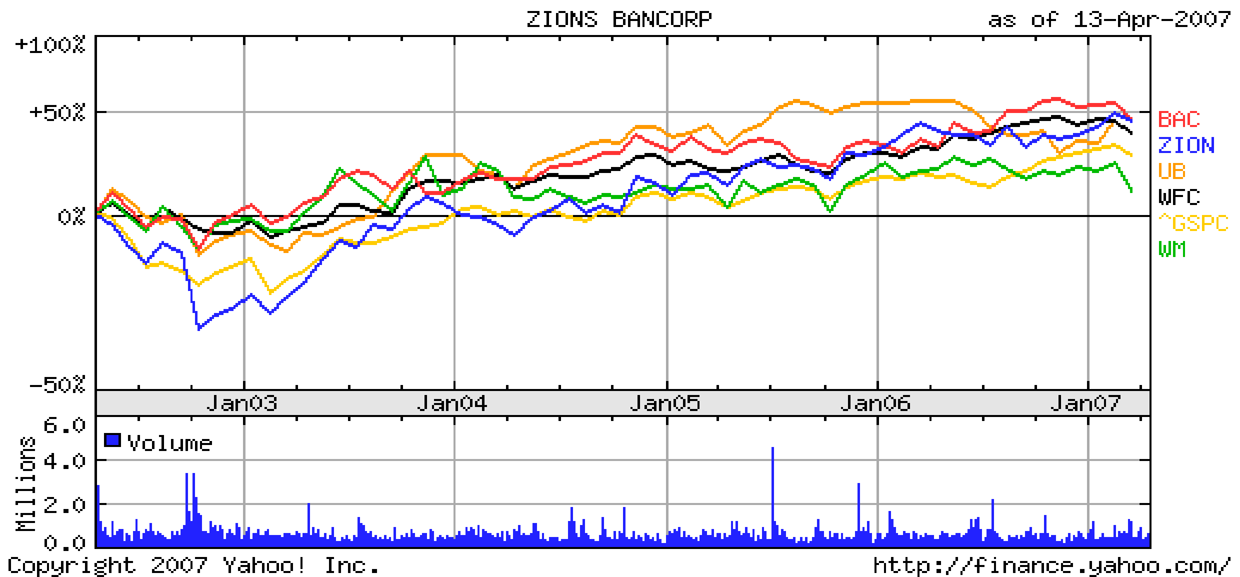
The Company's return on equity (ROE), an important indicator of financial health, is slightly lower than its competitors. However, this should not cause alarm as it is mainly due to the fact that Zions is not as highly levered as competitors, such as Wells Fargo who maintain relatively less equity and more debt. The DuPont model breaks down the calculation of ROE into its key parts, which are profit margin (net income/sales), asset turnover (net sales/average

total assets) and financial leverage (assets/equity) – these components are multiplied to reach the 'return on equity' metric. While Zions is relatively on par with Bank of America in terms of asset turnover and profit margin, it maintains a higher proportion of shareholders' equity. This analysis suggests that Zions' low ROE is primarily the result of financial leverage. The financial leverage ratio is a proxy for how much of the company is financed with debt. For Zions, this metric is contributing significantly less to ROE than Bank of America, thus reducing the relative returns to shareholder equity. The banking industry is very heavily "debt financed" because the capital that is generated by the business is acquired in the form of deposits. Zions is 89.3% debt financed (including short term liabilities – in this case, deposits – and long term debt) while Bank of America and other large banks are around 92%. This is due to a number of factors, including the fact that the larger banks have more steady cash flows and can make interest payments thus are less likely to go bankrupt, allowing them to take on more debt. Capital standards also favor banks that are larger, have more diversified risk and are more immune to negative externalities. As we discussed earlier, lower capital requirements allow for a competitive advantage in growth. While Zions' ROE is relatively low, the company remains highly profitable and we are not highly concerned. We are also confident that the Company will increase its ROE once the full potential of the Amegy integration is achieved.

STOCK PERFORMANCE

Looking at the Company's stock performance over the past several periods, we find that stock has performed exceedingly well over the past two years and has outperformed the market (S&P500) since January 2005. When compared with both its megabank competitors as well as one significant regional competitor, it is clear to see that the market holds elevated expectations for the Company.

FIGURE 5: FIVE YEAR RELATIVE STOCK PERFORMANCE



Part of the strong stock performance may be due to the Company's strong cash flows and stout financial discipline, leaving investors confident in the Company's ability to remain profitable in the future. Additionally, the inorganic growth strategy – which includes the Amegy acquisition – boosts investor confidence in management's motivation to continue to grow in the future. It is important to keep the stock price up in the event of an eventual take over in order to maximize shareholder value.

The value of the Company's stock, and any stock for that matter, is ultimately determined by the discounted present value of the free cash flows. Looking at the Company's free cash flows we find:

FIGURE 6: FREE CASH FLOWS

Zions Bancorp	2004	2005	2006
Cash Flow from Operations	662.4	754.2	1046.9
Capital Expenditures	(72.3)	(68.0)	(122.4)
Free Cash Flow (FCF)	590.1	686.2	924.5
Growth Rate of FCF		0.16	0.35

Clearly, continued growth is crucial to the present value of the Company. Over the past few fiscal years, the Company's free cash flows have been steadily increasing primarily as a result of increases in net interest income. Using a variation of the Gordon Growth Model, we find the valuation implied growth rate of the Company's free cash flows. For FY2006, free cash flows increased dramatically due to the acquisition of Amegy – for the sake of this analysis we will use the free cash flows from FY2005 as a proxy of cash flows in "normal" year. The valuation implied growth rate indicates the market's prediction of how fast Zions' cash flows will grow in perpetuity. Using a required rate of return of 5.73% (using WACC), we find:

FIGURE 7: IMPLIED GROWTH RATE

Gordon Growth Model	Zions Bancorp FY2006 (millions)
Market Cap	9,370
Plus Debt	6,160
Minus Cash and Equivalents	2,270
Total Enterprise Value	13,260
Normalized FCF FY2005	686
Required Rate of Return	5.73%
Price Per Share (Apr. 16)	$85.19
Valuation Implied Growth Rate of FCF	0.58%

The analysis suggests that the market believes that the Company's cash flows will only grow on average by 0.58% per year in perpetuity. This may be a reflection of investor speculation that the Company's long-term growth will eventually slow down or plateau at some point. On the other hand, this may also be a signal that the company is currently undervalued – if one would expect a high growth rate in the future.

FINANCIAL CONCERNS

Zions Bancorp as a whole has recorded robust financial growth over the past few years; however not every component has been profitable. Vectra Corporation, the subsidiary bank in Colorado, has struggled since 2003 when the Company shifted its focus to small and mid-sized businesses. Vectra has not been able to offer the expected financial synergies and it shows in the performance ratios:

FIGURE 8: FINANCIAL PERFORMANCE RATIOS[25]

ZIONS BANCORP	2004	2005	2006
Return on average assets	**1.31%**	**1.43%**	**1.32%**
Return on average common equity	**15.27%**	**15.86%**	**12.89%**
Efficiency ratio	**57.22%**	**55.67%**	**56.85%**
Net interest margin	4.27%	4.58%	4.63%
VECTRA BANK OF COLORADO			
Return on average assets	**0.80%**	**0.76%**	**0.87%**
Return on average common equity	**5.45%**	**5.68%**	**6.63%**
Efficiency ratio	**75.80%**	**74.72%**	**69.99%**
Net interest margin	4.51%	4.57%	4.73%

Vectra's efficiency ratio (non-interest expense to total taxable-equivalent revenue) is a dismal 69.99% as compared to the Company's combined efficiency ratio of 56.85% in 2006. The weak overall performance of Vectra, which accounts for 7% of the Company's total revenues, may place the Company at a competitive disadvantage in some geographical locations and pull down its overall financial performance.[26]

STRATEGIC ISSUES AND RECOMMENDATIONS

The strategic situation can be broken down into two distinct components. The long term outlook directly influences the decisions and goals of the immediate future.

[25] FY2006 10-k, Schedule 23, 64.
[26] FY2006 10-k, 64.

LONG TERM OUTLOOK

The first issue deals with the Company's ability to deal with increasing pressures from larger competitors, specifically banks that maintain an international scope. There are a number of factors that make competition with large scale banks difficult. The megabanks possess the resources to develop superior technical and operational systems. One crucial result of the advanced technical systems has been the ability to penetrate the Company's market footprint regardless of physical presence via comprehensive internet services. Traditionally, these same larger competitors have operated under fewer regulatory constraints and lower cost structures. The larger banks benefit from various economies of scale and are able to spread their administrative and other fixed costs thinner.

The Company, as a regional bank, is less shielded from external market forces, such as a change in the property market or slower new business generation in particular regions within the US. In 2007, many analysts expect the housing market to tumble, which would mean a significant increase in the Company's credit risk, as three of the Company's regional banks – CB&T, NBA and NSB – are heavily involved in the housing development and construction loan market. The Company is not as diversified as a global organization would be and is thus more susceptible to the effects of various externalities.

In addition to the current competitive advantages expressed by the larger banking organizations, there are potential changes to capital standards that will enhance the already numerous benefits of consolidation in the near future. Currently, the U.S. federal bank regulatory agencies' risk-based capital guidelines are based upon the 1988 capital accord ("Basel I") of the Basel Committee on Banking Supervision (the "BCSB"). The BCBS is a committee of central bank supervisors and regulators from the major industrialized countries that develop broad policy guidelines that each country's supervisors can use to determine the policies they implement. The BCBS has been working on revisions to Basel I, and

in June 2004 released the final version – open for updates – of its proposed new capital framework, Basel II.[27] Basel II aims to ensure that capital allocation is more risk sensitive, and in doing so, separates operational risk from credit risk in its approach for setting capital standards. Basel II uses a three pillar concept that involves – (1) minimum capital requirements, (2) supervisory review and (3) market discipline – to promote greater stability in the global financial system. Basel II in the US would directly apply to internationally active banking organizations with consolidated total assets of $250 billion or more, or consolidated on-balance sheet foreign exposures of $10 billion or more. However, other U.S. banking organizations could opt to apply given the organization was capable of effectively complying.[28] There is one alternative European method, 'Basel Lite,' which would ideally take all the most effective portions from Basel II and ditch the rest. However, the current situation necessitates the Company to expect Basel II.

Currently, the Company does not possess the data collection and analytical capabilities necessary to adopt Basel II. This poses a serious threat for the Company, as Basel II will allow banks to operate with lower levels of capital for certain lines of business. Subsequently, analysts believe that there will be significant competitive advantages afforded to companies that are able to adopt the Basel II framework. If the Company plans to be a competitive, regional player in the future, the Company may need to form a financial syndicate of other regional banks to purchase the services of an IT consulting firm in order to develop the sophisticated systems and data that are required to adopt Basel II standards.

Once the larger banks are able to increase their competitive advantage under the guidelines of Basel II, they will enhance their ability to provide the most competitive rates. The increasing prominence of the internet is another significant component that favors the megabanks. Eventually, we believe that

[27] S&P500 Industry Report.
[28] Bank for International Settlements, *Basel II: Revised International Capital Framework*,

internet banking will replace store fronts in an effort to dramatically reduce administrative costs as well as the large capital expenditures that go into the physical properties. The banks that will be successful in the internet banking industry will likely be the banks that possess the best brand equity because it takes slightly more trust when face-to-face interactions are taken out of the equation. This is especially true for the vastly growing international market; banks that maintain a strong reputation outside the US and possess the resources to develop sophisticated internet services to people will attract customers anywhere, anytime. The internet allows people to search for the best rates, and lowers the switching costs of customers. No matter where they are, customers do not have to search very far for the most competitive rates and as long as they know Bank of America or Wells Fargo by name and recognize their magnitude, they will be confident in doing business with these megabanks – more so then they would with a company that has no presence or recognition globally, like Zions.

In addition to missing out on the high growth foreign markets, the strength of the Company's footprint will eventually wane with the expansion of internet services offered by the megabanks – who can offer lower rates due to the high volume involved and globally diversified risk. User numbers become the name of the game because the globe is shrinking and the reach of the large banks is growing. Many of the international competitors will be able to capitalize on the growth markets of Asia and Latin America. As the number of customers dramatically increases, the margin pressures will separate the banks that can sustain themselves on sheer volume and the banks that cannot – hence the affinity towards consolidation of the commercial banking industry. There may be a tipping point in which the megabanks are able to create significant margin pressures on the regional banks in the long-term. The sheer volume with which these banks deal in may be enough to sustain a constant predatory pricing environment for the smaller banks that require larger margins to remain profitable. Efficiency ratios will continue to fall as companies become more efficient in their internet banking services. Physical assets and storefronts will

become less and less important and the environment will shift; the companies who have figured out how to minimize their efficiency ratios now will likely be the leaders in the internet service battles of the future – battles for customers far outside of the Company's reach.

IMMEDIATE FUTURE GOALS

The second strategic analysis contains recommendations for the Company's present growth strategy. The Company must pursue a narrow service strategy and focus solely on developing the successful core businesses. As evidence throughout this report, the Company has performed exceedingly well in its core business and must continue this success in order to sustain net interest income growth. This leaves open the possibility of divesting potentially unprofitable subsidiaries while bolstering the Company in the areas that already exhibit a competitive advantage.

Hence the Company's growth strategy can be broken down into four main objectives: (1) expansion in high growth markets, (2) maintenance of a local banking experience, (3) centralization of technology and operations and (4) a narrowed focus on the successful areas of business.

The Company must continue expanding their services in states with high levels of projected population and income growth (Utah, Nevada, California and Arizona). This will allow the Company to increase internally generated deposits in order to facilitate the growth of loan balances while avoiding liquidity risk. This presence must be elevated by improving awareness, accessibility and quality of service offered to its customers. To do this, the Company must increase the number of branches and ATM's in these regions as well as using the internet to target potential customers of these high population growth areas.

The Company holds eight very different banks that each possess high levels of autonomy, which allows each regional bank to adapt quickly to the environment

in which it exists – a clear advantage in the commercial banking industry. Each subsidiary bank should maintain its local feel, as opposed to the “mass market” or “vertical” product silos offered by the Company’s larger competitors. While maintaining a local level of management, the Company should ‘manufacture’ products affected by economies of scale – such as cash management, credit card administration, and deposit operations – centrally. Recently, the Company has been making significant efforts to centralize its technology and streamline its operations. The acquisition of Amegy enhanced the Company’s technology and operations practices after the major systems platform merger was completed in 2006. The Company must continue to locate cost cutting mechanisms gained from centralize production and processing, while maintaining a local responsiveness in its management approach.

The Company must focus on its strongest businesses and sell off unprofitable assets. Contango, a wealth management subsidiary, has proven to be unprofitable thus far and may need to be spun off. Additionally, the Colorado banking subsidiary, Vectra, has been a poor performer over the past few years and must be dealt with soon. Vectra has consistently recorded poor efficiency ratios, as well as low deposit and loan growth. Colorado is also a state that does not fit in with the high growth footprint scheme, as it is projected to have a relatively low population growth rate from 2006-2011. If the Company cannot make headway with Vectra, it must look to divest the unprofitable subsidiary.

The Company should enhance the areas in which it is already above average and provide excellent service, accessibility and reliability while maintaining excellent credit quality. Once the Company re-focuses on its core business of commercial banking, specifically SBA 7(a) and SBA 504 loans, it will capitalize on the extensive relationships it has worked to hard to develop with small to mid-market businesses. In 2006, residential housing developments declined, which created slower loan growth and a shift from commercial real estate to commercial lending for the Company. The future of the housing market is far from certain, reinforcing the need to diversify its risk by improving its business lending service,

which is already strong and is often inversely correlated to residential housing developments.

The two main issues discussed above lead to a very straightforward long-term strategic stance. The Company must pursue a narrow service strategy while maintaining profitability in preparation for an eventual takeover. In the long-run, the Company cannot compete with the economies of scale achieved by the consolidated banks of the world. Along with superior resources, extended market presence, and exclusive technology systems, international banks will also soon enjoy the benefit from the changes in capital standards produced by Basel II. Hence the only long-term outcome appears to be a take-over from an international bank that would like to increase its presence in a certain niche. This is why the Company must do everything it can to be noticed as a bank that excels in its niche, producing slightly higher quality in its core business services. We have presented a number of measures the Company should pursue in order to maximize its value during a potential take-over scenario. The Company does not determine when or if a take-over will happen, thus it must continue to make improvements in the mean time. The Company should be a very attractive target due to its strong reputation, history of financial discipline, slightly higher quality of service, regional responsiveness, strong growth footprint and firmly established relationships with businesses within it footprint. The Company must continue to make itself lean and profitable – an attractive buy for a larger bank with a specific need to fill.