BRYAN CAVE

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Bryan Cave LLP
One Metropolitan Square
211 North Broadway
Suite 3600
St. Louis, MO 63102-2750
Tel (314) 259-2000
Fax (314) 259-2020
www.bryancave.com

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To our Clients and Friends in the
Financial Institutions Industry:

Walt Moeling and Jim McAlpin spoke at the recent Acquire or Be Acquired Conference sponsored by Bank Director Magazine. Their topic was "The Path to Full Profitability by 2013." In advance of their talk at the conference, Walt and Jim sought input from a group of industry observers on what they foresee as likely developments over the next few years. We thought you would be interested in what we heard in response to these questions, and the following is an excerpt from Walt and Jim's presentation at the AOBA Conference:

Background

- There are more than 6500 commercial banks in the U.S. Only 500 of these banks have assets of more than $1 billion, and only 110 have assets of more than $10 billion. In other words, over 90% of U.S. banks have assets of less than $1 billion. Also of significance to this discussion, one third of U.S. banks have less than $100 million in assets.

- In connection with this presentation we sent a survey to a number of our contacts at investment banking firms and also to a group of bank consultants. We asked them to look forward over the next few years and project what the landscape will look like in community banking. We received responses from over 30 industry observers from across the country, and our respondents have allowed us to share their comments either with attribution or anonymously.

"What will the ideal community bank look like by year end 2013?"

- **Adam Aspes of Sterne Agee** provided an answer that sums up most of what we heard in response to this question: *"The ideal community bank will either: (i) have a dominant market share in a rural slow growth market, or (ii) if located in an urban market, have enough scale and product offering to compete for deposits with the larger banks."*

- **Jennifer Demba of SunTrust Robinson Humphrey** responded: *"Investors will value concentrated market share community banks, not fragmented networks."*

- One community bank consultant wrote in response *"$1 billion in asset size will not be a large bank by 2013."* We consistently heard in response to this question that, in all but rural markets, a minimum necessary asset size will be $500 million.

- **Chris Marinac of FIG Partners** wrote: *"While not universally applicable, in general we think the regulatory costs of operating a bank have increased such that it is difficult to produce adequate long-term returns for a bank below $500 million in assets. There are exceptions, and some private bank investors find a single-digit Return on Equity to be acceptable. However, we think the demands for 11% to 14% ROEs create a $ billion+ size threshold for surviving banks."*

- Another investment banker told us that his firm has modeled the impact of increased compliance costs on smaller community banks: *"If you assume an increase of [direct and indirect] compliance costs of $100,000, and then factor in growth of only 5% to 8% per year, it is hard for a smaller bank to get to 1% ROA, much less double digit ROE."*

"What changes should be expected in profitability for community banks and in pricing multiples?"

- **Geri Forehand of Sheshunoff** sent us a copy of their most recent industry overview. In it were listed the September 30, 2010 national averages for Return on Equity and Return on Assets, showing national ROE averaged 3.88% and ROA was 0.44%. This was an increase from the September 30, 2009 national averages of 0.57% for ROE and 0.06% for ROA.

- Our survey respondents were asked to look forward to year end 2013 and provide their predictions of Return on Equity and Return on Assets for banks of certain asset sizes. We also asked them for their thoughts on what acquisition multiples will be at that time, and why.

  The feedback we received with regard to profitability expectations was interesting, and reinforced the view that size and scale will increasingly matter in the world of community banks.

- For banks under $500 million in assets, our survey respondents predicted 2013 expectations for ROA in a range of 50 bps to 85 bps. ROE for this group of banks was predicted to fall between 6% and 8% in that same time period.

  As **Bill Herrell of Morgan Keegan/Burke Capital** put it, *"This group of banks will see gradual improvements in credit quality but the average return will continue to be weighted down by those banks that are hampered by real estate loan concentrations. These banks may have difficulty in diversifying their revenue streams which will limit top-line revenue, and increased capital requirements will limit leverage and hold down ROE."*

- For banks between $500 million and $1 billion in assets, our survey respondents predicted 2013 expectations for ROA in a range of 70 bps to 100 bps. ROE for this group of banks was predicted to be between 8% and 10% in that same time period.

- For banks between $1 billion and $10 billion there was more optimism reflected by our survey respondents. 2013 expectations for ROA were in a range of 100 bps to 125 bps, with ROE between 12% and 15%.

  Related comments received from survey respondents reflected a view that credit issues are now largely behind this group of banks, or are actively being resolved since they raised sufficient capital to absorb the impact. Revenue streams are also more diverse for this group of banks.

- For banks over $10 billion in assets our survey respondents predicted 2013 ROA in the range of 1.25% to 1.30%, and ROE of around 15%.

"What about merger and acquisition multiples by 2013?"

- The feedback we received might be a little sobering for those looking for a complete rebound in M&A pricing.

- **Curtis Carpenter of Sheshunoff**. **Curtis** wrote *"Acquisition multiples are (and will be) directly attributable to bank earnings and growth. When we could project 12% asset growth and 1.75 ROA's (after integration), the multiples were justifiably 3 x book. [Today,] with most bankers not even comfortable with 5% growth [predictions] and great uncertainty about future earnings, it is no wonder multiples are low."*

- Another of our survey respondents pointed out that, particularly over the last two decades, value for community bank shareholders has been received not from dividends or increased trading value of their stock, but at the back end when the bank was sold for 2 x book or higher.

- In looking toward the future, the consensus among our survey respondents was that even by 2013 banks with less than $500 million in assets will be fortunate to get as much as 1 x tangible common equity, or "book," and 10 x price to earnings. Our respondents felt that banks between $500 million and $1 billion in assets that are performing well should see 1.25 x book and 10 x to 12 x price to earnings by 2013.

- There was also a view shared by several of our survey respondents that the greatest likelihood for premium pricing will be with banks between $1 billion and $10 billion in asset size. But even here, the definition of "premium" was muted from how it would have been described a few years ago. Our survey respondents predicted price to tangible common equity for banks of this size to be in the range of 1.25 x to 1.50 x, with the possibility of 1.75 x to 2.00 x book for the very strongest of these banks. Price to earnings was predicted to fall within a range of 10 x to 12 x.

- **Peyton Green of Sterne Agee** wrote: *"1.5 x book will be the new 2.5 x book value of a few years ago. Sellers should be focused on relative value of the pro forma company rather than the headline in the newspaper article. This has always been the most difficult concept to get across to a board, but it is necessary in creating a good stock and good returns, prospectively."*

- For banks of greater than $10 billion in asset size, our survey respondents predicted a range in 2013 of 1.5 x to 2.0 x book and 12 x to 15 x earnings.

- As has always been the case, size of acquisition multiples correlate with bank earnings, growth prospects and the quality of management. As **Sal Inserra of Crowe Horwath** commented in response to our survey *"You get paid on net income no matter how you make it, as long as it is recurring."*

"What will be the most significant factors in achieving consistent profitability over the next several years?"

The responses we received were thoughtful and insightful, and we would like to share a brief summary with you:

◊ As you might expect, most of the respondents viewed "deposit mix" as being of great importance in achieving consistent profitability. Consistent, reliable low cost funding is critical. Core deposits will be the key.

◊ **Stephen Curry of Everett Advisory Partners** wrote: *"It's all about NIM – consistent, reliable low cost funding is critical, as is a higher percentage of earning assets."*

◊ We found interesting what was listed next as being most important by a number of our survey respondents. A few years ago we could have expected "growth" to be the predominant answer, and many of our respondents still listed "growth." However, a strong minority, particularly among the bank consultants, listed "risk management" as now being more important.

◊ "Product mix and innovation" were frequently listed among the key factors for achieving consistent profitability. As one respondent said *"banks need to diversify creatively*." This effort at diversification will of course result in challenges in staffing and in underwriting. Many community banks will need to take a hard look at their current staffs as they assess the viability of pursuing new areas of lending or new product lines in a search for non-asset based income.

◊ With respect to what is important for some of the larger community banks we found a comment by one of the investment bankers to be insightful: *"Too many franchises have distribution systems that don't work given the deleveraging of commercial customers and consumers. [The importance of] resizing the franchise has been underestimated by almost all of the companies that I cover."*

For these larger community banks, achieving greater size to allow for ever improved efficiency will be very important, and that's good news for the service providers.

◊ As mentioned by **Curtis Carpenter of Sheshunoff** in his response to our survey: *"Considerable effort will be made by all banks to achieve economies of scale. With the menu of products shrinking and price controls coming in on fee income, the only escape hatch to restoring profits is lowering expenses though size and scale."*

◊ Several of the consultants who completed our survey said that, with regard to expense controls, they are beginning to see an evolution of smaller banks outsourcing and pooling compliance and operational resources to share regulatory and operational costs.

◊ **Mark Ross of Stifel Nicolaus** specifically emphasized what he referred to as *"the increased importance of a rationale branch structure."* As Mark put it, *"there is no longer value in chasing out of market demographic opportunities."* Mark's advice is to *"build out what you have to its maximum potential."*

◊ Not to be overlooked is the need to make a commitment to new technologies as they become available and affordable. The members of Generation X and Generation Y are not using traditional banking channels as much as the older generations of bank customers. Community banks of all sizes cannot afford to fall behind the technological advances being offered by the large banks to their customers.

◊ In summary, as described by **Angela Holguin of Integrated Banking Solutions**: *"For the next few years, capital support, a strong low cost deposit mix, and improved diversification and performance metrics of the loan portfolio will be key to improved profitability."*

What is the Bryan Cave perspective?

- In a de-leveraging market and industry, organic growth will come much more slowly.

- Slower growth will result in a significant shift in focus toward profitability.
- Enhanced profitability will require ever tightening expense controls.
- Core deposits and core customers will be very significant drivers of value.
- "Excess capital" will once again be a non-sequitur. Capital is again king.
- Community banks that are well capitalized and well managed will have the ability to thrive in a rapidly changing environment. Agility will be a valuable trait.
- There will continue to be consolidation, but viable communities will always recognize the need for a "local" bank.

We recognize that the data reflected in our survey presents a much different world from what many bank Boards have come to expect and probably still assume. Unless Boards fully understand just how much things have changed, they are likely to continue to expect growth models of 12% - 15% in assets and income. We hope this piece has triggered some thoughts and reactions, and we would welcome an opportunity to discuss these points with your management team or Board. Please feel free to contact any member of the Bryan Cave Financial Institutions Group.

Walt Moeling
(404) 572-6629

Jim McAlpin
(404) 572-6630

Kathryn Knudson
(404) 572-6952

Jerry Blanchard
(404) 572-6804

Judith Rinearson
(212) 541-1135

Katherine Koops
(404) 572-6819

B. T. Atkinson
(704) 749-8954

Beth Lanier
(404) 572-4571

John ReVeal
(202) 508-6395

Lyn Schroeder
(404) 572-6904

Linda Odom
(202) 508-6331

Margo Strahlberg
(312) 602-5094

Rob Klingler
(404) 572-6810

Lauren Brown
(404) 572-6769

Jonathan Hightower
(404) 572-6669

Kristine Andreassen
(202) 508-6117

Amber Hall
(404) 572-6829

Ken Achenbach
(404) 572-6808

Mike Shumaker
(404) 572-5908

Andy Brummel
(816) 374-3352

Dustin Hall
(404) 572-4573

Barry Hester
(404) 572-6711