Acquire or Be Acquired

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Charting Your Strategic Course in a Challenging Environment

Walter G. Moeling, IV
James J. McAlpin, Jr.
Bryan Cave LLP

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A Broader Perspective℠

The Current Environment

- 6,522 banks (91% of all U.S. banks) have assets of less than $1 billion, 551 banks have assets between $1 billion and $10 billion, and only 108 institutions have assets greater than $10 billion.
- 2,287 banks (32% of all U.S. banks) have assets less than $100 million.
- In the past seven quarters, only three new charters were granted (all to absorb or liquidate failed banks).

The Current Environment

- Failure activity nationwide has decreased for 5 straight quarters – only 7 failures in 4th Quarter 2012.
- Southeast continues as hardest hit region, with over 50% of all failures in 2012.
- However, bank stocks outperformed the broader market for 2012, with Southeast banks leading the way (up 65% for the year*).

*Source - The Hovde Group

The Current Environment

- Gradual rebound for banking industry as credit quality improves, but thin loan demand, narrowing of spreads and higher expenses now a concern.
- New capital generally limited to banks with scale (+$1 billion assets), track record of superior profitability and a compelling growth story.*

*Source – Carson Medlin

The Current Environment

- Deal activity reached 225 announced transactions in 2012 – the highest level since 2007.
- Open-bank merger pricing still hovering close to sellers' book value.
- Asset quality of selling bank strongly influencing pricing – median of 125% price to tangible book for sellers with TX ratio less than 25%, but 89% price to tangible book for sellers with TX ratio between 50% and 75%.*

*Source – SNL Financial

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2013 Bryan Cave Survey

We surveyed 50 industry thought leaders and observers, including bank consultants and advisers, investment bankers and partners at private equity firms. Our goal was to obtain their observations and insights on a number of industry and economic factors considered by bankers and boards of directors when conducting strategic planning. We received responses from across the country, as well as data and industry overviews from some of the participants. Some of the participants in the survey authorized use of quotations from their responses.

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2013 Bryan Cave Survey Results

Industry Consolidation:

How many banks will we have in the U.S. by 2020?

All our respondents agreed that the bank population will shrink over the next 7 years, with most estimates ranging between a total of 5,000 and 6,000 banks at 2020. A total of 5,000 banks assumes a reduction of approx. 300 banks per year.

"Consolidation will occur where the seller has something to offer . . .I suspect there will remain a fair number of banks that should go away, but nobody will want them."
Jim Stokes, SunTrust

2013 Bryan Cave Survey Results

Industry Consolidation:

How many banks will we have in the U.S. by 2020?

"I don't think a specific number is the right approach. I think consolidation in the top 100 markets in the country will certainly occur, especially in the sub $500 million asset size banks. It will be difficult for the small banks in rural America to effect significant consolidation."
Geri Forehand, Sheshunoff

2013 Bryan Cave Survey Results

Industry Consolidation:

What will be the top 3 drivers of bank consolidation?

"Tired boards, regulatory environment, loan growth."
Nick Barbarine, Hovde

"Aging boards and management teams. The lower returns in a typical illiquid community bank investment do not compare favorably to other investments. Increased benefits of scale."
Jon Winick, Clark Street Capital

"1) Insufficient capital to support asset growth / NIM to cover cost of compliance. 2) Board fatigue. 3) Return on investment not comparable with investment with similar risk characteristics. . . . Lack of succession planning."
Sal Inserra, Crowe Horwath

2013 Bryan Cave Survey Results

Industry Consolidation:

What will be the top 3 drivers of bank consolidation?

"1) Lack of access to capital, 2) Inability to generate returns for shareholders, and 3) Management succession / board fatigue."
John Schramm, FIG Partners

"Normal life events for owners and management who have no management succession plan; Distressed banks without sources of new capital – those who can't make it; community banks with low profits and fatigue – those who don't want to make it."
Curtis Carpenter, Sheshunoff

2013 Bryan Cave Survey Results

Industry Consolidation:

What will be the top 3 impediments to bank consolidation?

"Seller expectations, pride and access to capital."
Bill Wagner, Raymond James

"1) Bid/Ask spreads with Sellers believing the near term and intermediate future undervalues their institution. 2) Accounting marks and impact on pro forma capital. 3) Lack of acquisition financing options for lower tier acquirers."
Mark Ross, Stifel

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2013 Bryan Cave Survey Results

Industry Consolidation:

What will be the top 3 impediments to bank consolidation?

"1) With the credit cycle and drop in valuations, significant equity has evaporated, especially after taking into account fair value accounting and mark to market of loan portfolios. This has made CEOs totally unwilling to consider selling because all they have is W-2 income left to hold onto. 2) Lack of attentiveness or strategic vision at the Board level. 3) Regulatory pressure has been inconsistent and irregular. Also, far less than expected given the degree of credit quality issues."
Peyton Green, Sterne Agee

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2013 Bryan Cave Survey Results

Prospects for Community Banks:

Is there a minimum asset size that even smaller, true community banks should be targeting to better ensure their survival and earnings potential?

"No."
A Sandler O'Neill + Partners Investment Banker

"No – it's time to get away from focusing on arbitrary asset numbers that ibankers, like me, make up. Boils down to a bank's ability to achieve a return on equity that exceeds their cost of capital (or an ROE which their shareholders/board will accept – many times this ROE threshold is less than a bank's true cost of capital)."
Jeff Brand

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2013 Bryan Cave Survey Results

Prospects for Community Banks:

Is there a minimum asset size that even smaller, true community banks should be targeting to better ensure their survival and earnings potential?

"I find that most of my clients under $200 million feel they probably need to do something in the way of selling in the next several years. Above that size many feel they are a survivor as is and many fee they should be a buyer."
Wes Brown, St. Charles Capital

"I don't know of many banks that don't think they need to be larger. However, I know of a few small banks that do just fine. It's all about the margin. Without a strong margin, everything is tougher."
Bill Wagner, Raymond James

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2013 Bryan Cave Survey Results

Prospects for Community Banks:

Is there a minimum asset size that even smaller, true community banks should be targeting to better ensure their survival and earnings potential?

"Like real estate, it comes down to location, location, location. If you are a rural bank with adequate capital, relatively little competition and stable base, a small bank of $100 mm or even less can make it even in the face of a higher level of compliance cost . . . Move that bank to where the competition is fierce and the cost of operations is high, a $100 mm bank is toast."
Sal Inserra, Crowe Horwath

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2013 Bryan Cave Survey Results

Prospects for Community Banks:

Is there a minimum asset size that even smaller, true community banks should be targeting to better ensure their survival and earnings potential?

"Absolute minimum is $500 million. In addition to being relevant, it's very difficult to generate an acceptable ROAA and comply with all regs with smaller size institution"
John Schramm, FIG Partners

"It's not $1 billion yet, but every year marches closer."
Mark Ross, Stifel

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2013 Bryan Cave Survey Results

Prospects for Community Banks:

During a recent strategic planning session for a mid-sized bank, a board member and long-time bank investor commented: "The community banking model is dead." What is your reaction to that statement?

While a small number of respondents agreed with the statement, many more did not, though they recognized the need to redefine the model in order to adapt.

2013 Bryan Cave Survey Results

Prospects for Community Banks:

"I don't think it is completely dead, but investors need to re-adjust their expectations. I think the days of running a mediocre bank and selling for 2X+ of book are gone, but a profitable, dividend paying bank with growth opportunities will remain attractive, especially in desirable markets."
Bill Wagner, Raymond James

"I disagree. It is working just fine in places that have a reasonable amount of loan demand; although it is hard to deal with the regulatory pressures. If rates stay this low for years, then I think many others will conclude it is dead; however, rising rates would breath much life back into the industry. The value of community bank deposits (primarily the noninterest bearing deposits) has little value now, but will have substantial value in a rising rate environment."
Curtis Carpenter, Sheshunoff

2013 Bryan Cave Survey Results

Prospects for Community Banks:

"Maybe community banking is dead, but customer relationship banking is alive and well. I constantly meet people that hate dealing with the consumer oriented, mass-market banks. Competition has increased over the past decade, not decreased, and bankers are going to have to gain comfort in making lower spreads."
Peyton Green, Sterne Agee

"Community bankers need to be better than they were because the market (environment and competition) is tougher."
A Sandler O'Neill + Partners Investment Banker

2013 Bryan Cave Survey Results

Prospects for Community Banks:

". . . The community bank is not dead, but it must adapt. As capital requirements and regulations change, so does the way community banks operate. The community bank of the future will be larger, well-capitalized, and much more efficient."
John Schramm, FIG Partners

"The 'all things to all people' concept has been long gone. In the future segmentation will be the way to go. Crafting a total customer solution for a segmented customer base will be the strategic path to ensure relevance."
Geri Forehand, Sheshunoff

2013 Bryan Cave Survey Results

Bank Management:

What effect has this economic downturn had on development and retention of the next generation of bank management?

"Clearly damaged."
Robert Covington, Stephens Group

"There has been a serious negative impact on the ability to attract and retain young talent to the banking industry, but the offset is that those people trained in this environment will have better first hand experience of working through problems and a permanent mental imprint of the damage that bad credit decisions can cause."
Mark Ross, Stifel

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2013 Bryan Cave Survey Results

Bank Management:

What effect has this economic downturn had on development and retention of the next generation of bank management?

"Actually, I think the downturn has been wonderful in developing the next generation of bank management. Bankers learned how their clients acted in the worst of times and have learned so much about risk management, and problem asset resolution."
Jon Winick, Clark St. Capital

"Fewer folks want to be bankers; however, probably good that bankers have been through a difficult period as their skills/range is likely greater."
A Sandler O'Neill + Partners Investment Banker

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2013 Bryan Cave Survey Results

Bank Management:

What are the top 3 technological developments that will have the greatest impact on bank operations or customer interaction in the coming years?

Mobile banking was included in almost every response, recognized as a game changer.

"Cell-phone transactions (payments/deposits); social networking sites; pre-paid cards."
Jeff Brand

"Continued advances in online banking and digital payments – your credit card is your bank."
Robert Covington, Stephens Group

2013 Bryan Cave Survey Results

Bank Management:

What are the top 3 technological developments that will have the greatest impact on bank operations or customer interaction in the coming years?

"*Mobile banking, intrusion of retailers directly into the payments business, continuation of trend to outsourcing of entire technology core processes."*
Wes Brown, St. Charles Capital

". . The advent of mobile technology and banking through devices has changed the way people do their banking. It will be more important to be creative about developing relationships as customers will spend less and less time in branches."
David Wood, PKM

2013 Bryan Cave Survey Results

Bank Management:

What areas of risk management would you suggest that bank boards pay closer attention to?

"—Operational risk – ensuring loan operations have kept pace with evolving legal and regulatory standards;
—Technology risk – internet threats and mobile device vulnerabilities need proactive management. Once the hackers shift their focus from large banks to smaller ones, the threat will have a significant impact on community banking;
—Regulatory risk – the rapidly changing regulator landscape is reshaping the banking industry; smaller banks can't afford to be caught behind the evolution as "catch up" will be difficult and expensive."

Stephen Curry, Everett Advisory

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2013 Bryan Cave Survey Results

Bank Management:

What areas of risk management would you suggest that bank boards pay closer attention to?

"ALCO. We may have just witnessed the end of a 30 year secular decline in yields, from a peak of over 10% on the ten year treasury in the early 1980's to 1.4% in mid 2012. With all the challenges, there is a risk of reaching for basis points, but the benefits may be quickly erased at the first signs of higher yield expectations. Variable rate loans can offset bond portfolio losses and it may be a net positive from an ALCO perspective, but companies need to carefully consider their positioning in what will likely be a very different environment when the Fed begins to reverse course on both targets as well as purchase programs."

Mark Ross, Stifel

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2013 Bryan Cave Survey Results

Bank Management:

What areas of risk management would you suggest that bank boards pay closer attention to?

"One area that has only recently come into focus is the risk of cyber-attacks. Since banking is becoming more dependent on computers, that could be the biggest risk banks face. I also think that bank fraud perpetrators will become more sophisticated, making it necessary for banks to develop sophisticated systems to detect fraud."
John Schramm, FIG Partners

". . . Succession planning and technical depth below the "C" level executives."
John Poelker

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Bank Management:

What are the banks and/or bankers you have most admired over the past year?

We received many suggestions for "most admired banker of the year." The descriptions of these bankers had several common characteristics, including:

-- Sound fundamentals enforced consistently;

-- Tough on cost, focused on leading with innovation and talent

-- Embracing the downturn as an opportunity for acquisitions that are not just financially rewarding, but add to the franchise value;

-- Recognition that mistakes were made, and communication of the resulting wisdom down the line as knowledge for the next generation.

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Bank Management:

What levels of ROE do you expect to see by 2015 in the top performing quartile of banks under $2 B in assets, and what P/E and P/B multiples would you anticipate will be implied by that ROE?

Survey respondents predicted ROE for such top performing banks to be between 12% and 14% by 2015, with P/E and P/B in sale transactions of 12X to 14X earnings and 1.5X to l.75X tangible book.

Charting Your Strategic Course

- "It is a false assumption that bank investors think like portfolio managers. With the right ownership, a bank generating poor or mediocre returns can survive in perpetuity."
- "Bigger, Strong, Prettier – the only way to go."
- "Consolidation will occur where the seller has something to offer."
- "Hope is not a strategic plan."

All quotes are from responses to the 2013 Bryan Cave Survey.

Charting Your Strategic Course

- Much of what passes for “strategic planning” in banks is actually operational planning and budgeting.
- The passive nature of many bank boards, coupled with mis-alignment of financial incentives for many bank CEOs, hinders effective strategic planning.
- Bank boards need to become more proactive in charting the strategic course of their institutions.

Charting Your Strategic Course

- Every strategic planning session should answer the foundational question of “Buy, Sell or Hold?”
- Without clarity of overall strategic direction, detailed planning is irrelevant.
- The responsibility of board members can be summarized in one goal – maximizing long-term value for shareholders.

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Charting Your Strategic Course

Questions for Discussion

What are the characteristics of a meaningful strategic planning process, and what are some best practices?

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Questions for Discussion

Can a long term hold and build strategy be in the best interests of shareholders?

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Questions for Discussion

What dynamics most influence a board's decision to pursue a sale of a bank?

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Questions for Discussion

To what extent should management succession be a topic for discussion in strategic planning, and what is the best approach to this topic?

Charting Your Strategic Course

Concluding thoughts and observations –

"the more things change the more they stay the same."

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Our Financial Institutions Practice—Community Based, Nationally Recognized

Over the past decade, our financial institutions practice has become recognized as one of the top banking practices in the nation. Our two dozen core banking attorneys focus on mergers and acquisitions, regulatory, corporate, operational and securities matters for more than 400 financial institution clients.

More than 50 other Bryan Cave attorneys regularly provide significant litigation, lending, work-out, bankruptcy, employment law, employee benefit, intellectual property, tax, fiduciary law (including personal estate planning for bankers), real estate and similar legal specialty work for our financial institution clients.

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Our Financial Institutions Practice

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We enjoy being able to say that whatever issue a banker may have, we have a lawyer who has worked on a similar issue for a banker!

The members of our financial institutions group offer clients across the United States a broad spectrum of practical experience and legal knowledge of the governance, structure and regulation of financial institutions. We emphasize hands-on experience. Our team includes numerous 25-year+ veterans of banking law, and many of us have prior real world experience as investment bankers, regulators, bank officers and CPA's who formerly audited banks.

Our broad experience, coupled with our innovative solutions and our long standing relationships with regulators, trade associations and service providers, make us an invaluable asset to our clients.

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For further information:

Walter G. Moeling, IV | Walt.Moeling@bryancave.com
James J. McAlpin, Jr. | James.McAlpin@bryancave.com

www.bankbryancave.com
www.bryancave.com

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