

# ACQUIRE OR BE ACQUIRED

EXPLORING YOUR GROWTH OPTIONS

## Capital Planning Strategies for Acquirers and Survivors

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Sunday, January 30, 2011  
8:30 a.m. – 10:30 a.m.

# Presenters

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# *Capital Planning Strategies for Acquirers and Survivors*

*...alternative title slide*

***“HAVE’s and HAVE NOT’s”***

- ***Big Banks (and Strong Banks)***
- ***Small Banks***

# *Capital Planning Strategies for Acquirers and Survivors*

**or...**

**“NOT WITHOUT PAIN”**

- ***Fifth Third Bancorp (FITB)***
- ***Huntington Bancshares (HBAN)***

# “NOT WITHOUT PAIN”

	Fifth Third Bancorp \$111 billion		Huntington Bancshares \$54 billion	
	2006	2010	2006	2010
Tangible Common Equity (mils)	\$7,654	\$9,101	\$2,384	\$4,025
Common Shares (mils)	556	910	236	863
Tangible BVPS	\$13.76	\$10.34	\$10.12	\$4.66
December 31 Market Price	\$40.93	\$14.68	\$23.75	\$6.87
<b>Ownership Dilution</b>		<b>39%</b>		<b>73%</b>
<b>Tangible BVPS Reduction</b>		<b>25%</b>		<b>54%</b>
<b>Market Price Decline</b>		<b>64%</b>		<b>71%</b>

Note: FITB 2010 data includes effect of common stock offering and TARP repayment  
 HBAN issued common stock and repaid TARP in December 2010

# *Capital Planning Strategies for Acquirers and Survivors*

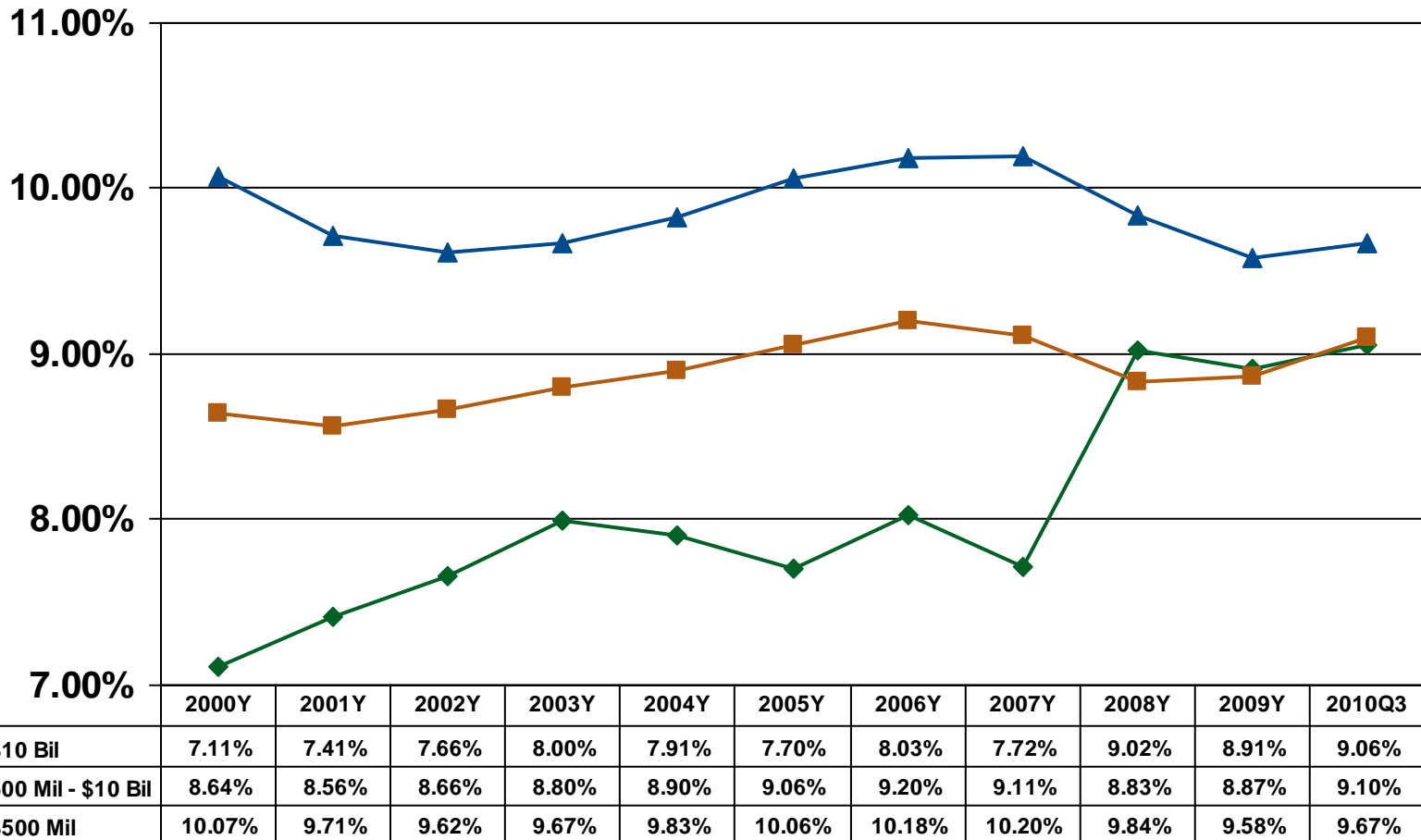
- Industry update
- Legal perspectives on the state of the capital markets
- Capital planning for “troubled” banks
- Capital strategies for stronger institutions
- Case studies

# Industry Update

- Capital
- Asset Quality
- Earnings
- Problem banks
- Bank equity markets
- M&A

# Capital Levels

## Median Tier 1 Leverage Ratio



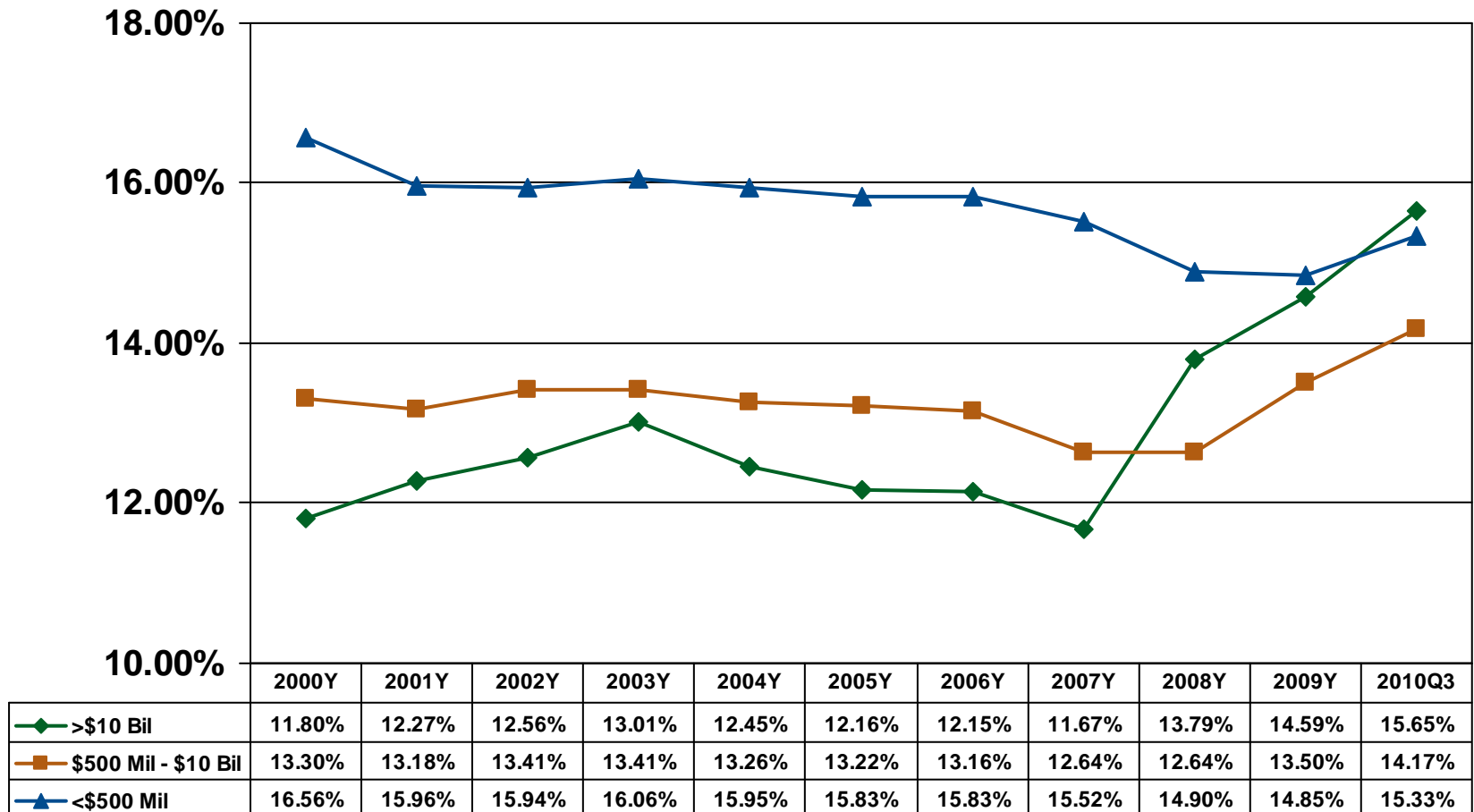
Note: Median results of all bank holding companies, commercial banks & savings banks (top-tier consolidated only).

Includes operating & acquired/defunct companies having reported 09/30/10 assets.

Source: SNL Financial

# Capital Levels

## Median Total Risk-Based Ratio



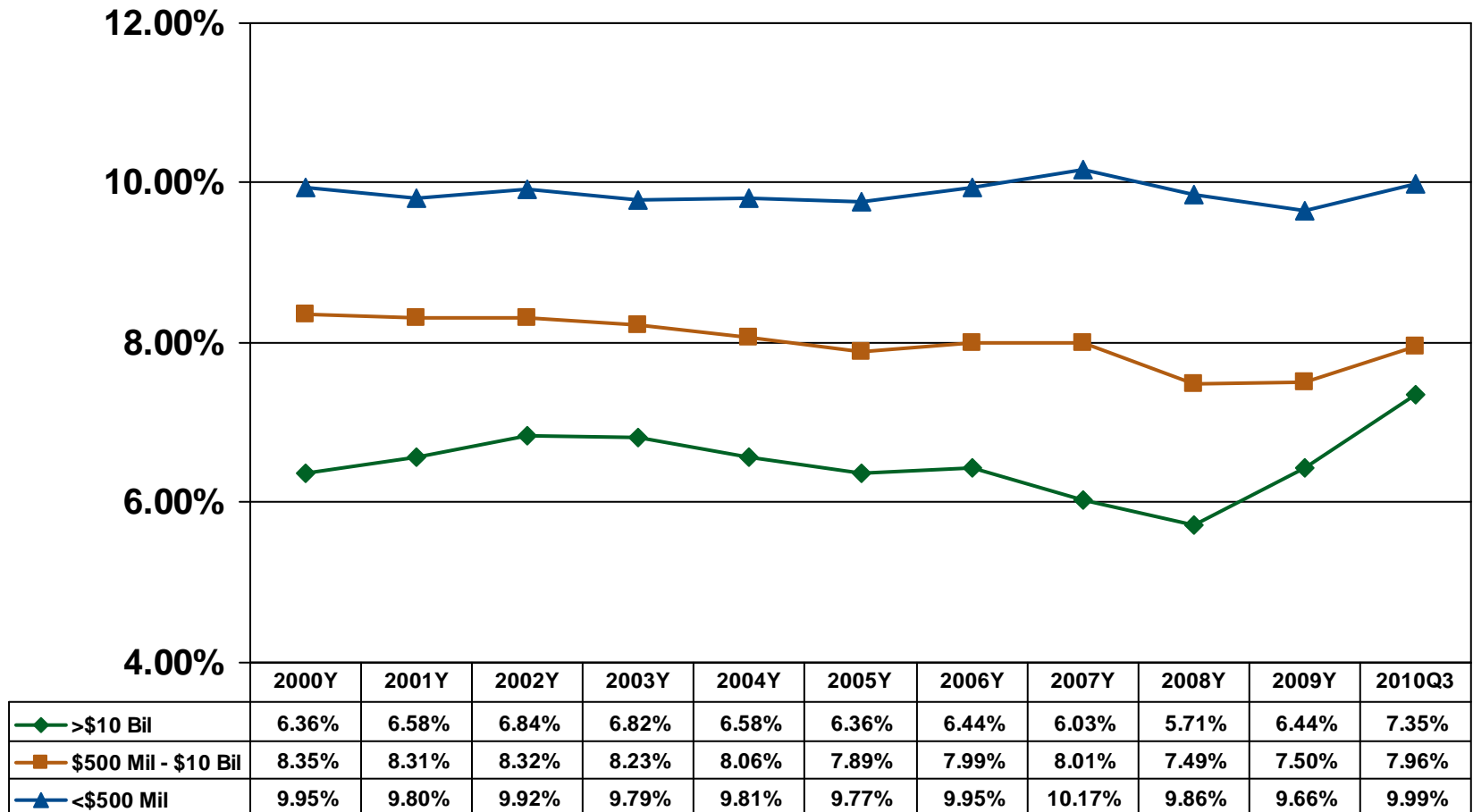
Note: Median results of all bank holding companies, commercial banks & savings banks (top-tier consolidated only).

Includes operating & acquired/defunct companies having reported 09/30/10 assets.

Source: SNL Financial

# Capital Levels

## Median Tangible Common Equity / Tangible Assets



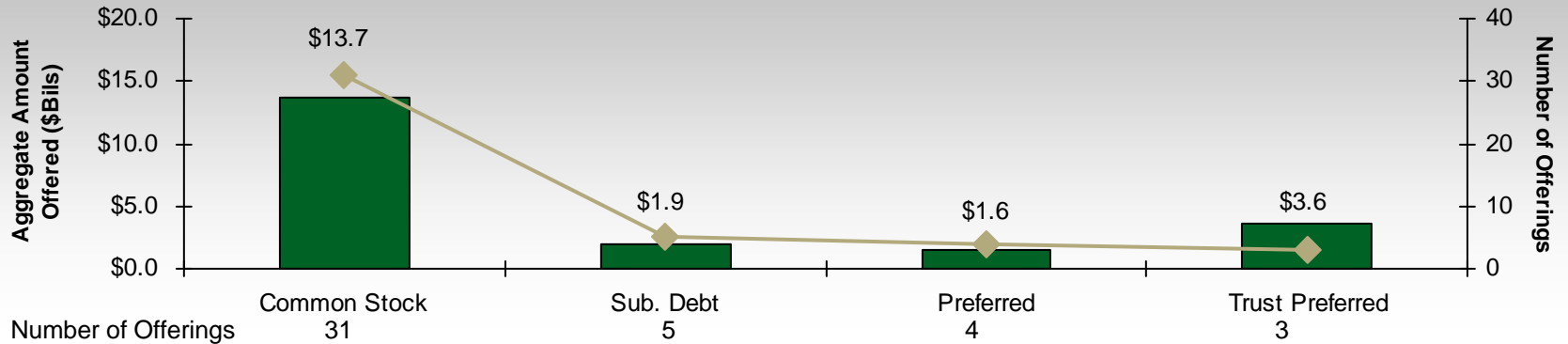
Note: Median results of all bank holding companies, commercial banks & savings banks (top-tier consolidated only).

Includes operating & acquired/defunct companies having reported 09/30/10 assets.

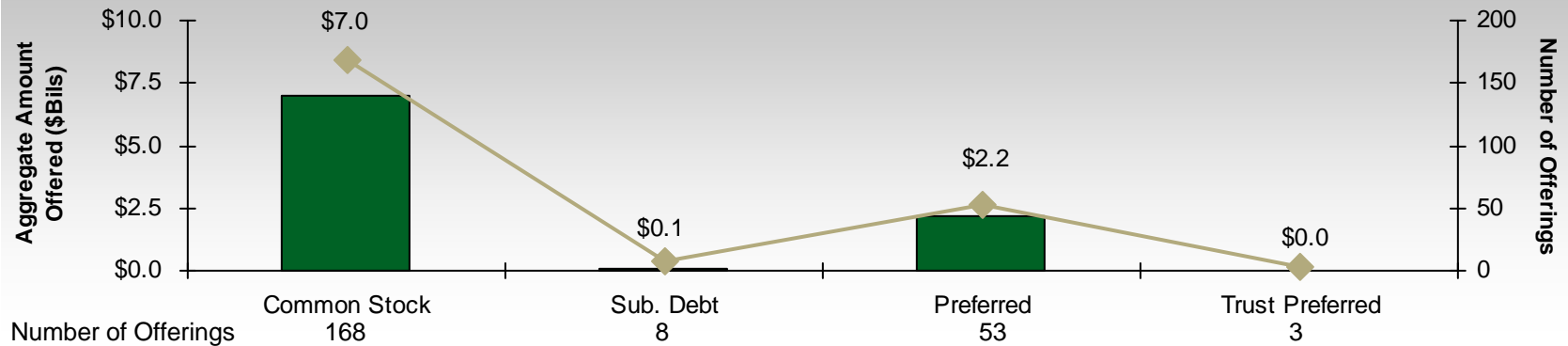
Source: SNL Financial

# 2010 Bank & Thrift Capital Issuances

## Issuers' Assets >\$10 Billion



## Issuers' Assets <\$10 Billion



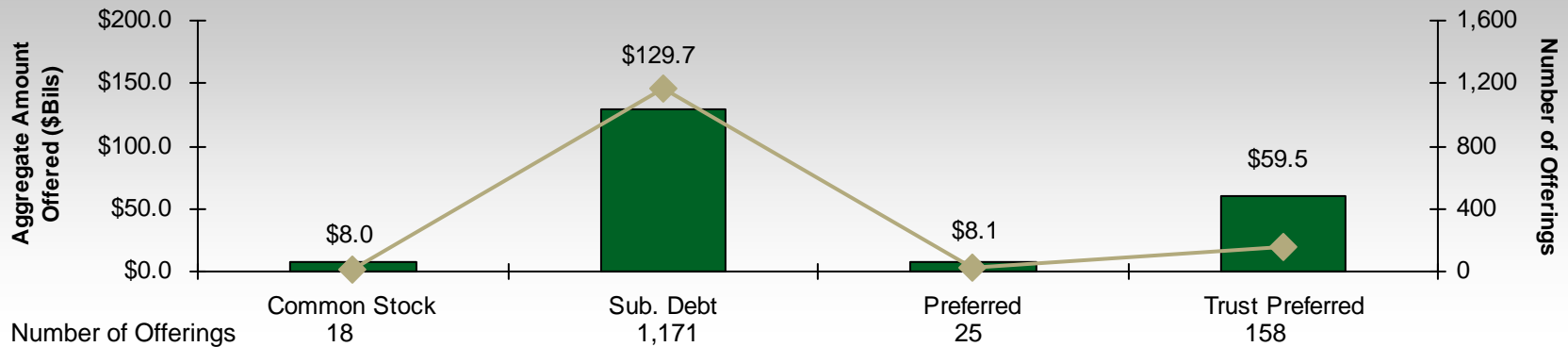
Note: Excludes secondary offerings, terminated offerings, offerings issued under TARP, and exchange offerings.

Number of offerings only included those in which a gross amount offered was available. Includes offerings in USD only.

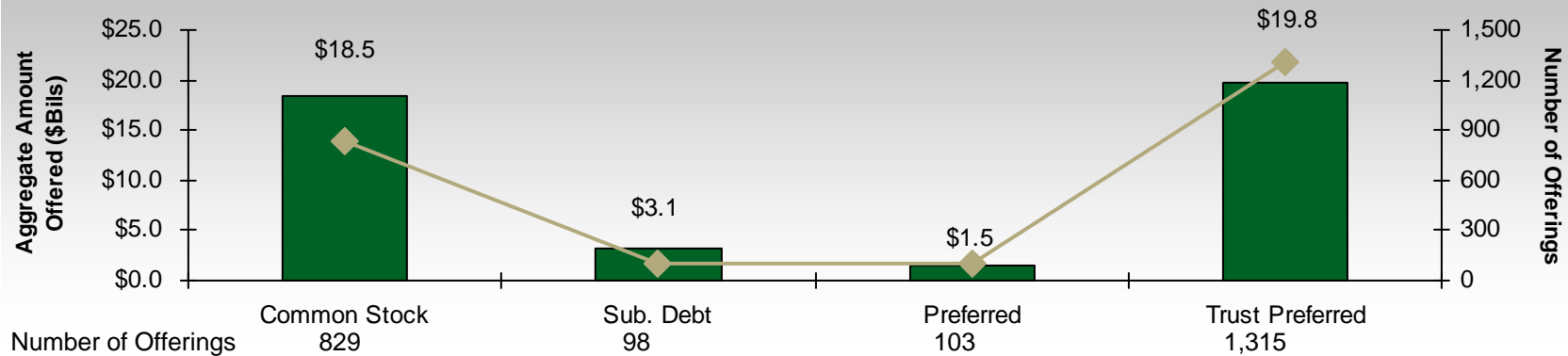
Source: SNL Financial

# Bank & Thrift Capital Issuances 2001 - 2006

### Issuers' Assets >\$10 Billion



### Issuers' Assets <\$10 Billion



Note: Excludes secondary offerings, terminated offerings, offerings issued under TARP, and exchange offerings.

Number of offerings only included those in which a gross amount offered was available. Includes offerings in USD only.

Source: SNL Financial

# Regulatory Capital Requirements BASEL III

- Quality, consistency and transparency of the capital base will be raised
- Tighter definition of “Common Equity”
- Introduction of “Leverage Ratio” as back-stop to risk-based requirements
- G-20 Seoul Summit proposed framework (November 2010)
  - \* Common equity/RWA increased from 2.0% to 4.5% by 2015
  - \* 2.5% capital conservation buffer phase-in 2016-19
  - \* Common equity/RWA minimum standard will be 7.0% by 2019
  - \* Tier 1/RWA raised from 4.0% to 6.0% by 2015
  - \* Tier 1/RWA minimum standard will be 8.5% by 2019 after buffer
  - \* Total capital/RWA 8.0% now will increase to 10.5% by 2019
- All major G-20 financial centers commit to adopt by 12/31/2011
- Target date for implementation by 12/31/2012

# *Dodd-Frank Impact*

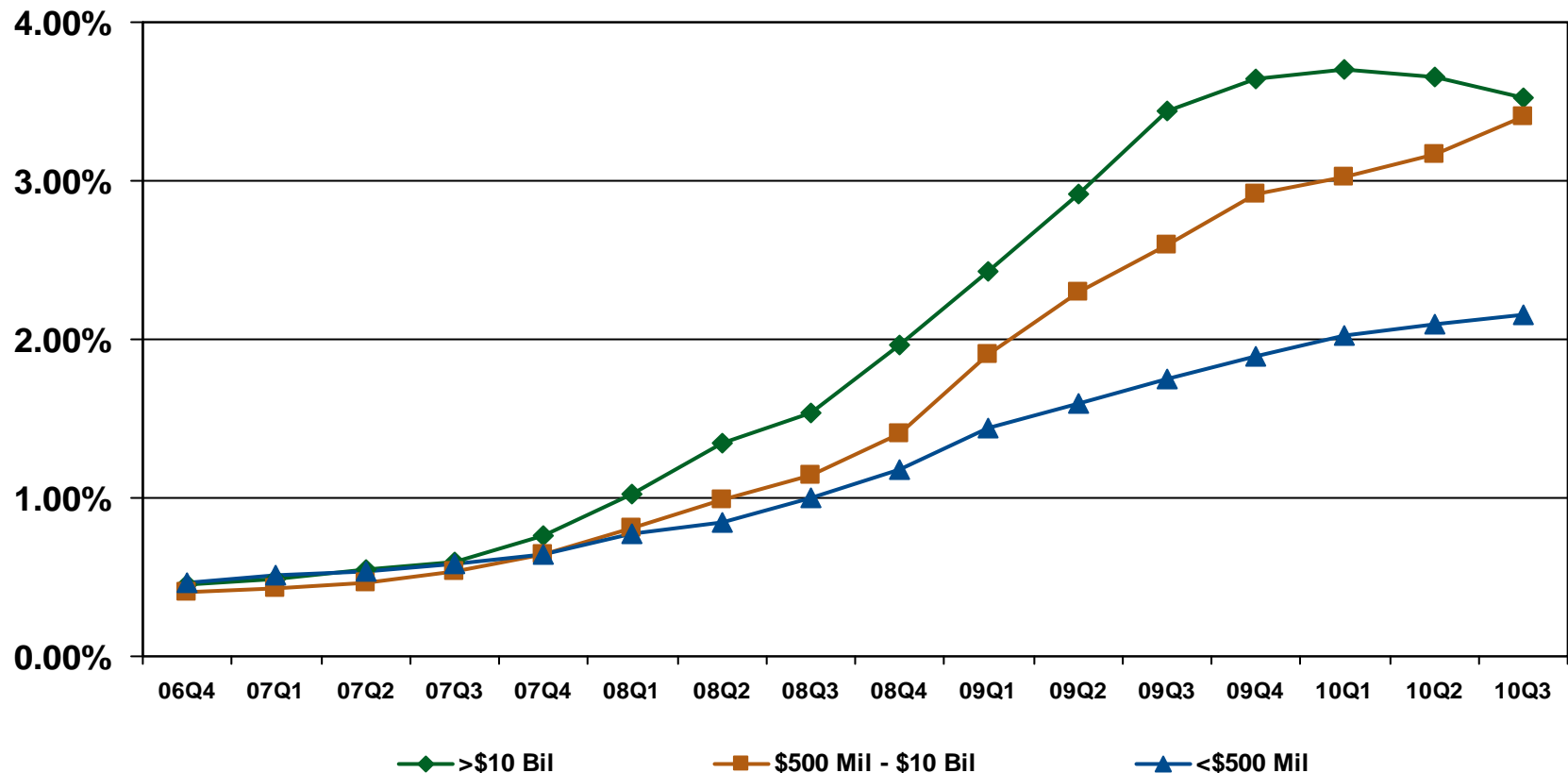
- Collins Amendment designed to ensure that banks “hold sufficient capital to absorb losses during future periods of financial distress”
- Directs regulators to establish minimum leverage and risk-based capital requirements on a consolidated basis for banks, thrifts AND their holding companies – at not lower than existing standards for banks
- Small bank holding company exemption (\$500 million)
- Trust Preferred Securities (and other hybrid instruments) no longer included in Tier 1 capital after phase-in period -- 2013-2016
- Trust Preferred Securities issued before 5/19/10 grandfathered
- Common Equity will be the predominant form of Tier 1 capital
- Non-cumulative Perpetual Preferred Stock (“NCPPS”) will remain Tier 1 capital, subject to limits

# *Regulatory Capital Requirements Impact to Community Banks*

- US Regulators will translate the international standards
- US Regulators will develop new rules
- US Banks will be required to hold more capital
- How much more?
- Expecting at least 8.0% Tier 1 leverage ratio
- Expecting at least 12.0% Total Risk-Based ratio

# Asset Quality Trends

## Median Nonperforming Loans / Total Loans

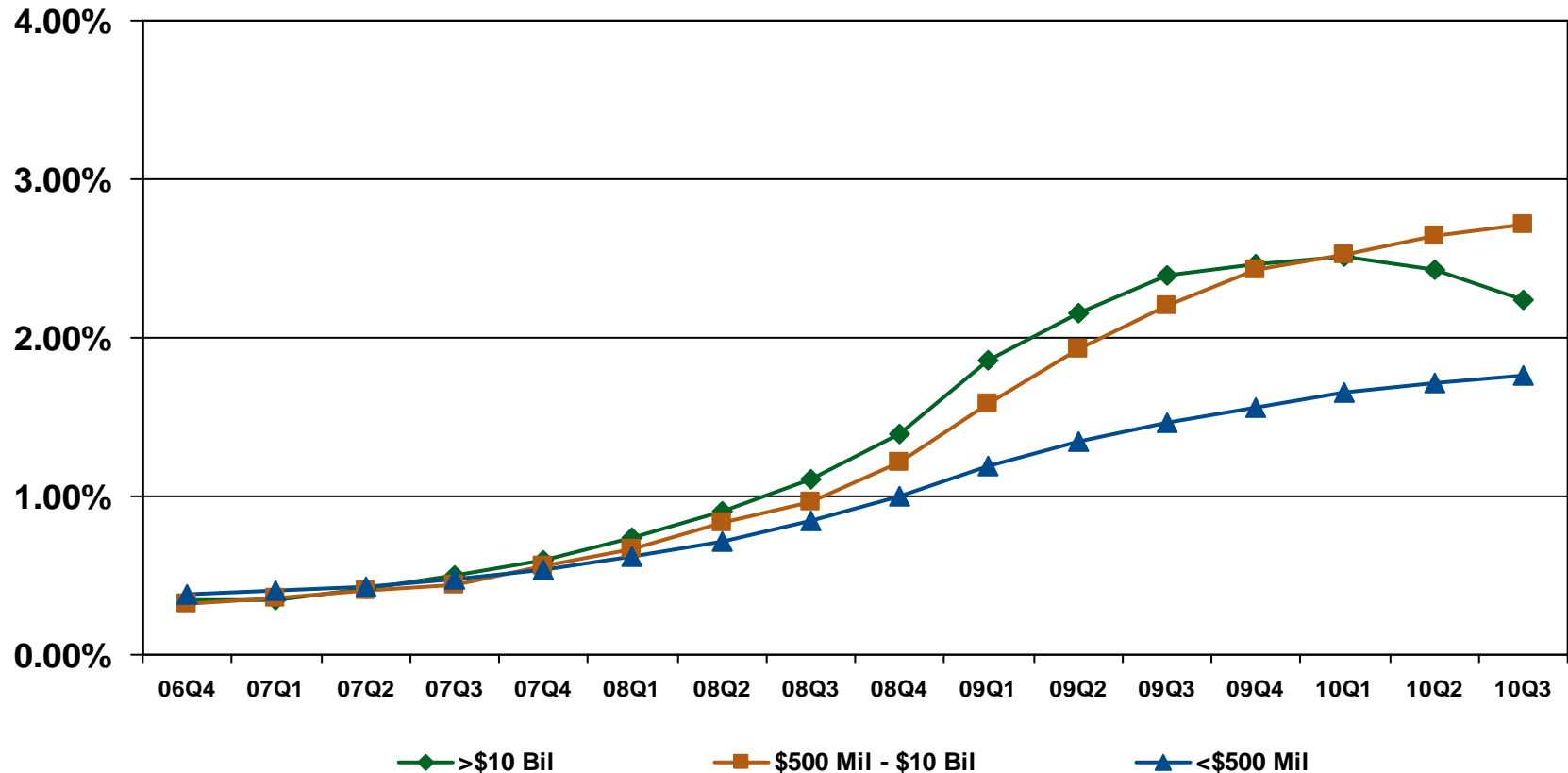


Note: Nonperforming Loans ("NPLs") equal to the sum of loans 90+ days past due, nonaccrual loans, and restructured loans less the guaranteed portion of 90+ days past due loans and nonaccrual loans wholly or partially guaranteed by the U.S. government. Based on the median results of all commercial banks, savings banks & savings institutions reporting 09/30/10 assets.

Source: SNL Financial

# Asset Quality Trends

## Median Nonperforming Assets / Total Assets

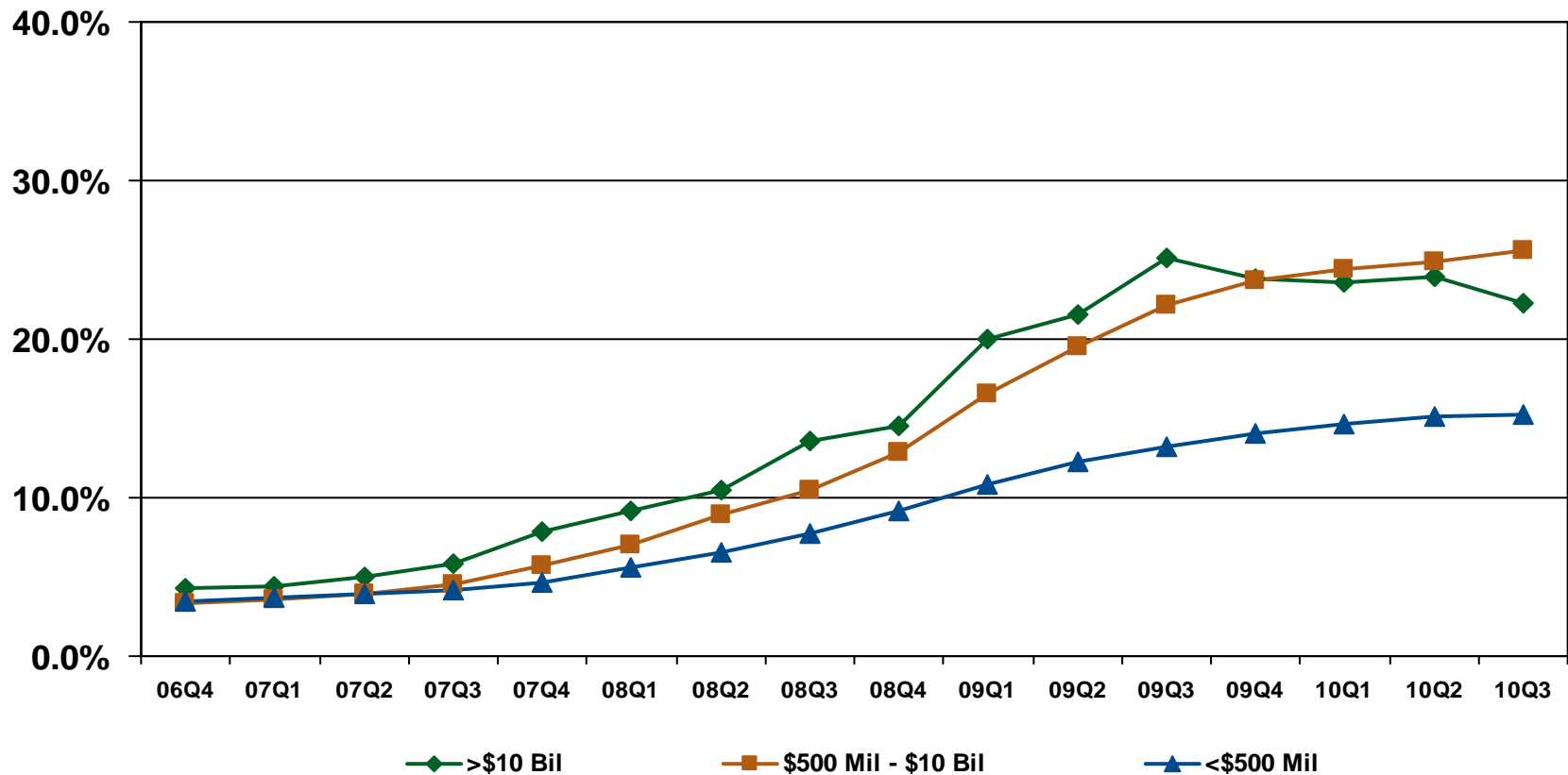


Note: Nonperforming Assets ("NPAs") equal to the sum of loans 90+ days past due, nonaccrual loans, debt securities and other assets, and restructured loans less the guaranteed portion of 90+ days past due loans and nonaccrual loans wholly or partially guaranteed by the U.S. government and other real estate owned covered by loss-sharing agreements with the FDIC. Based on the median results of all commercial banks, savings banks & savings institutions reporting 09/30/10 assets.

Source: SNL Financial

# Asset Quality Trends

## Median Texas Ratio



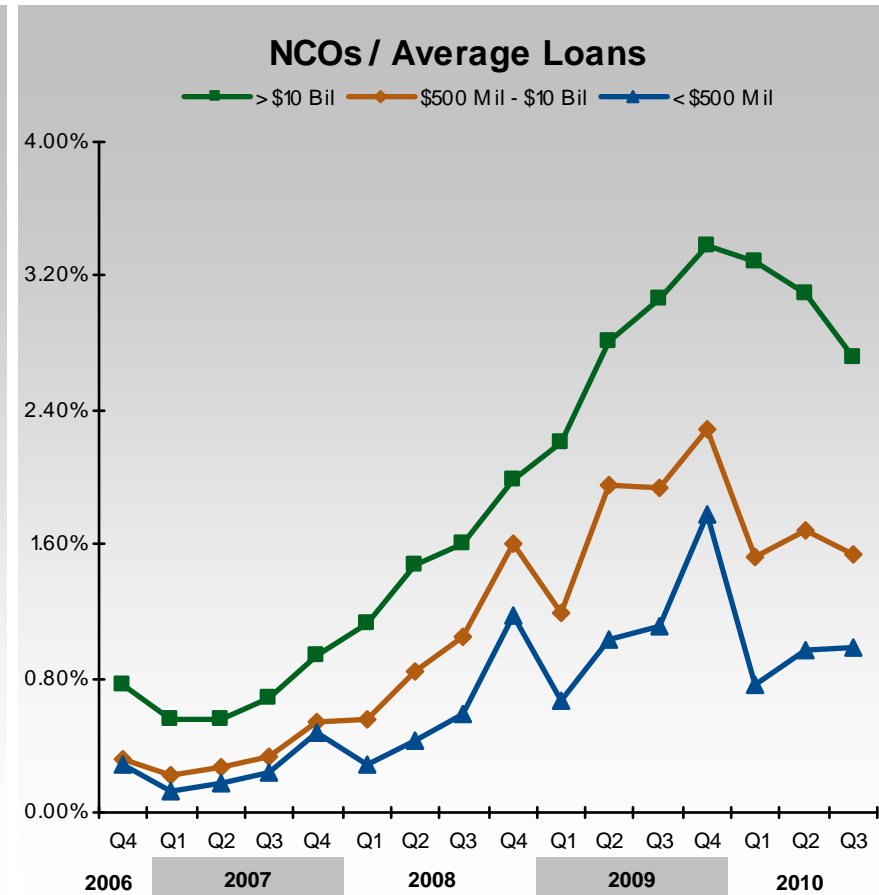
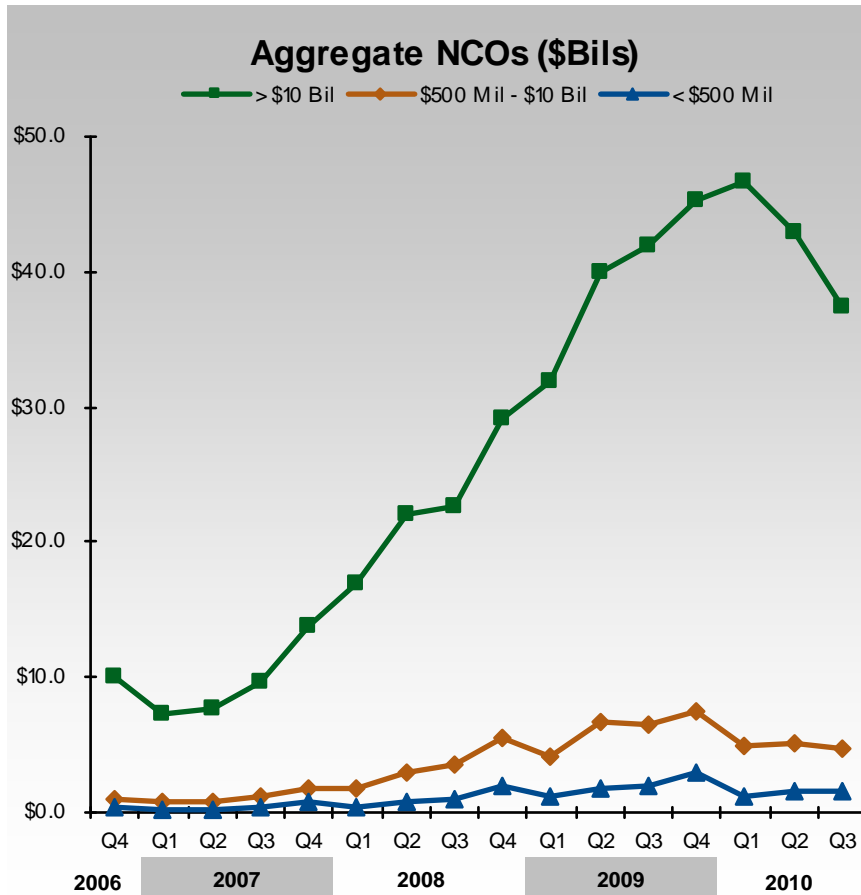
Note: Texas Ratio = NPAs / (Tangible Equity + Loan Loss Reserve)

Based on the median results of all commercial banks, savings banks & savings institutions reporting 09/30/10 assets.

Source: SNL Financial

# Asset Quality Trends

## Aggregate Net Charge-Offs

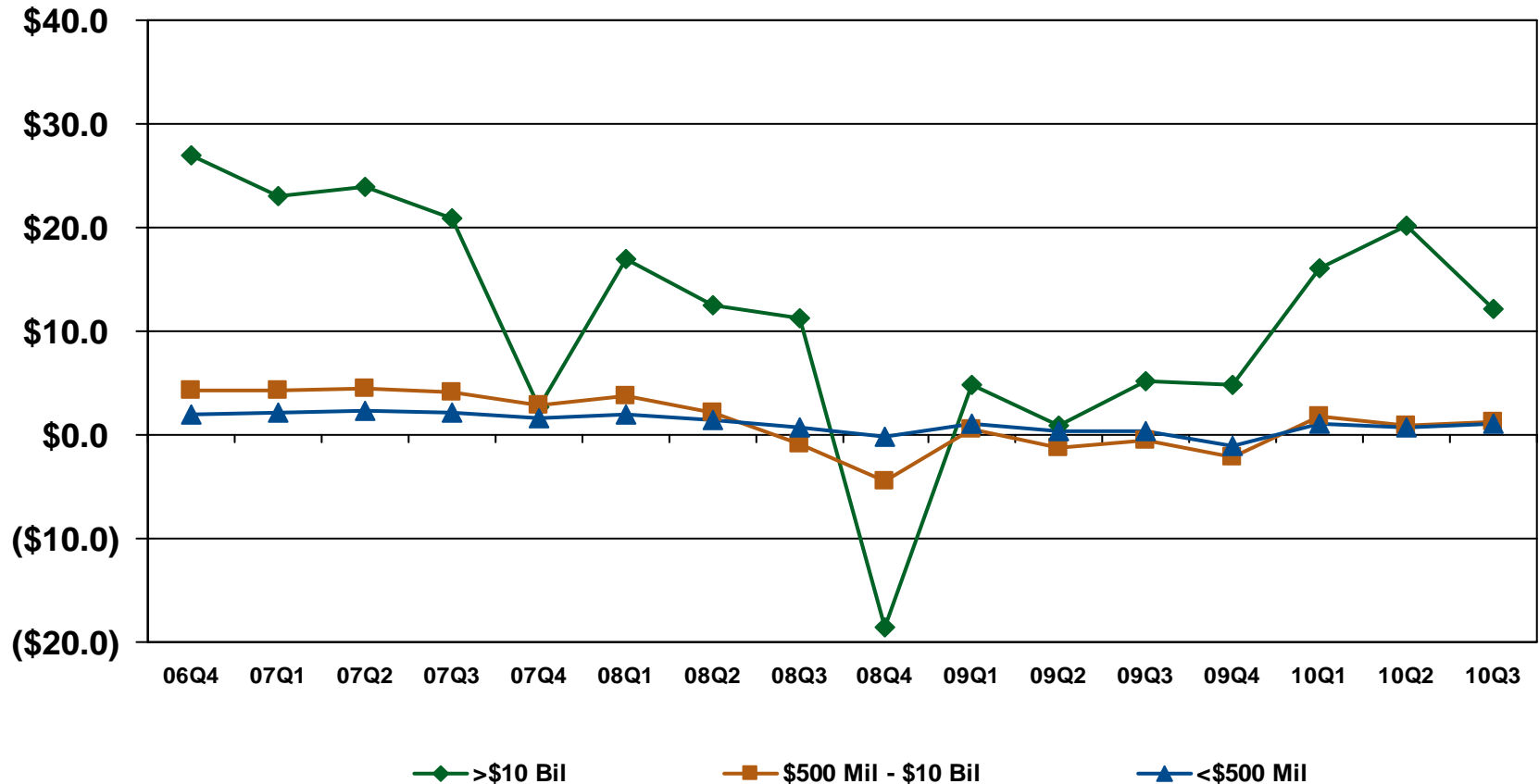


Note: Based on the aggregate results of all commercial banks, savings banks & savings institutions (including those acquired/defunct). During 2010Q1, there was a significant increase in the balance of loans outstanding. This increase was due entirely to a change in accounting rules. As a result, during 2010Q1 NCOs / Average Loans decreased for banks greater than \$10 Billion despite aggregate NCOs increasing.

Source: SNL Financial

# Earnings & Profitability

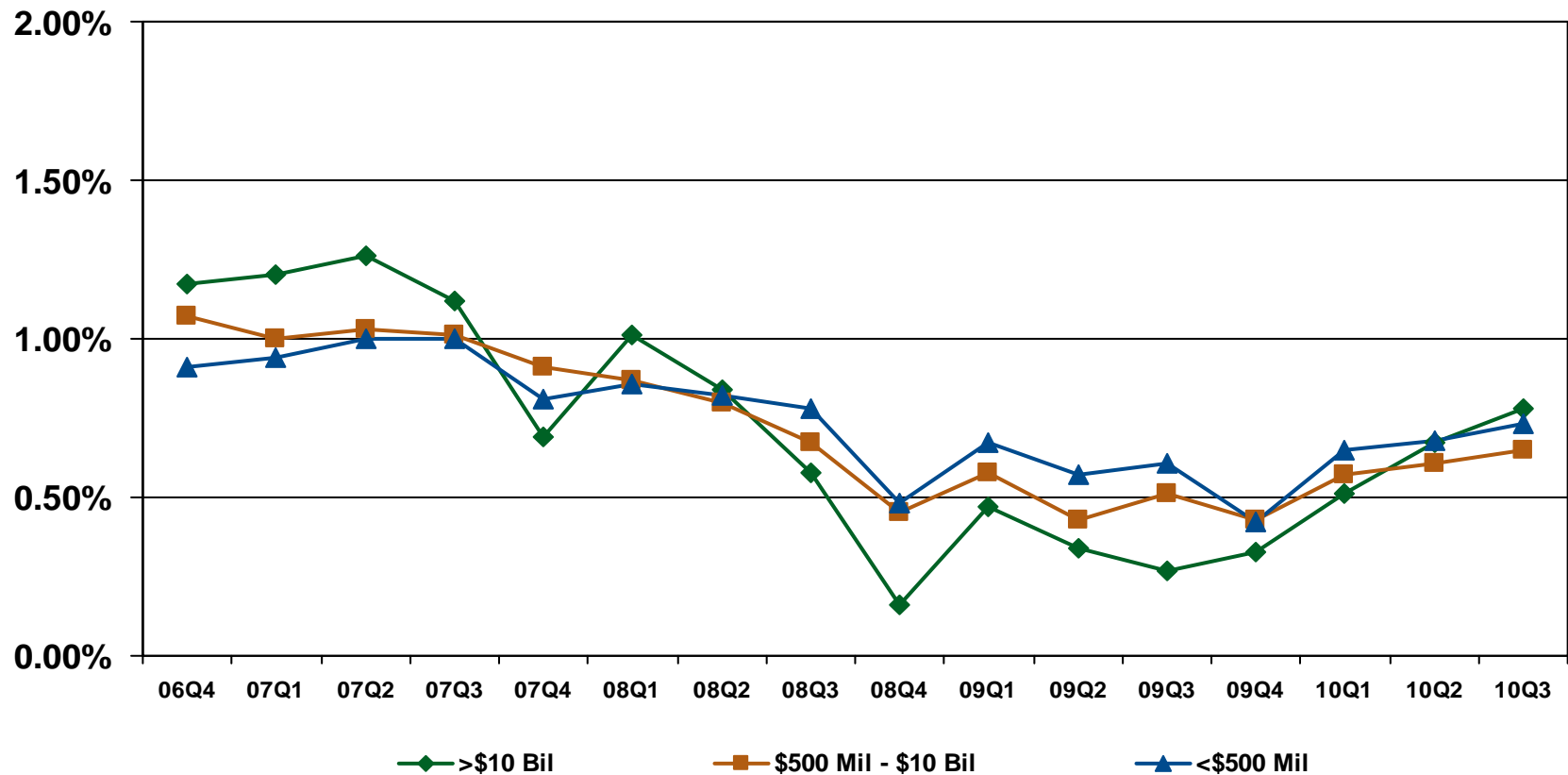
## Aggregate Net Income (\$ Billions)



Note: Based on the aggregate net income of all commercial banks, savings banks & savings institutions reporting 09/30/10 assets.  
Source: SNL Financial

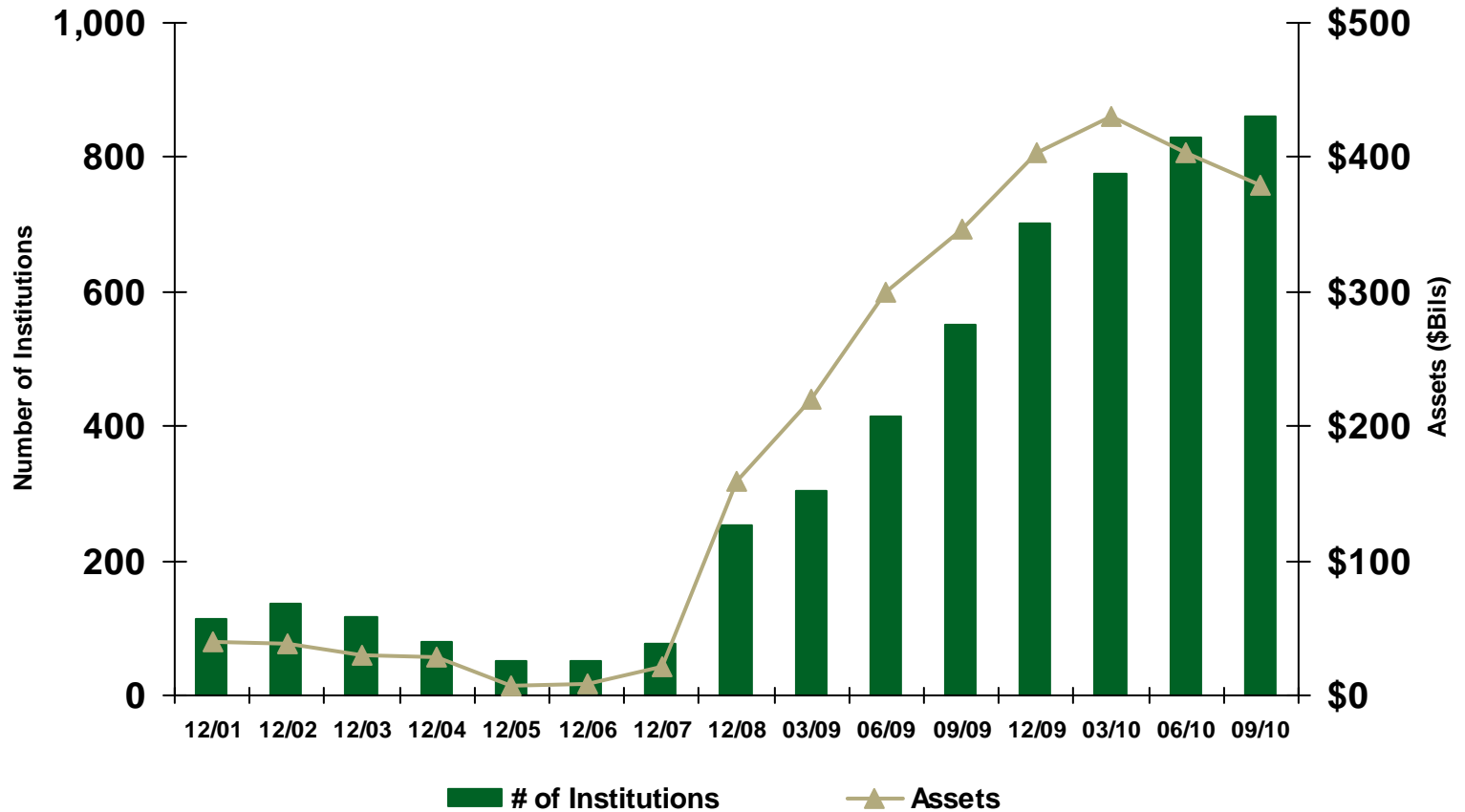
# Earnings & Profitability

## Median Return on Average Assets



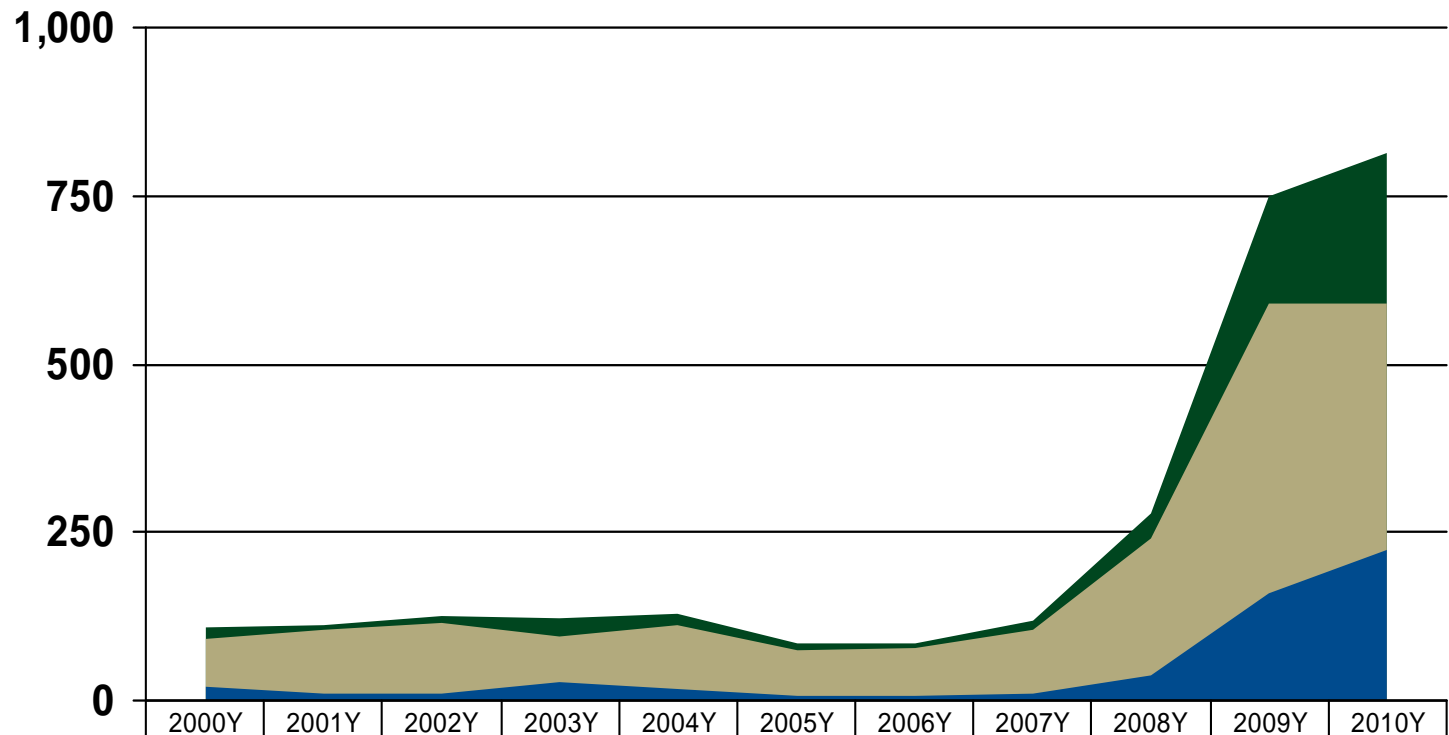
Note: Based on the median results of all commercial banks, savings banks & savings institutions reporting 09/30/10 assets.  
Source: SNL Financial

# Number of Problem Institutions



Source: FDIC.gov

# Regulatory Enforcement Actions



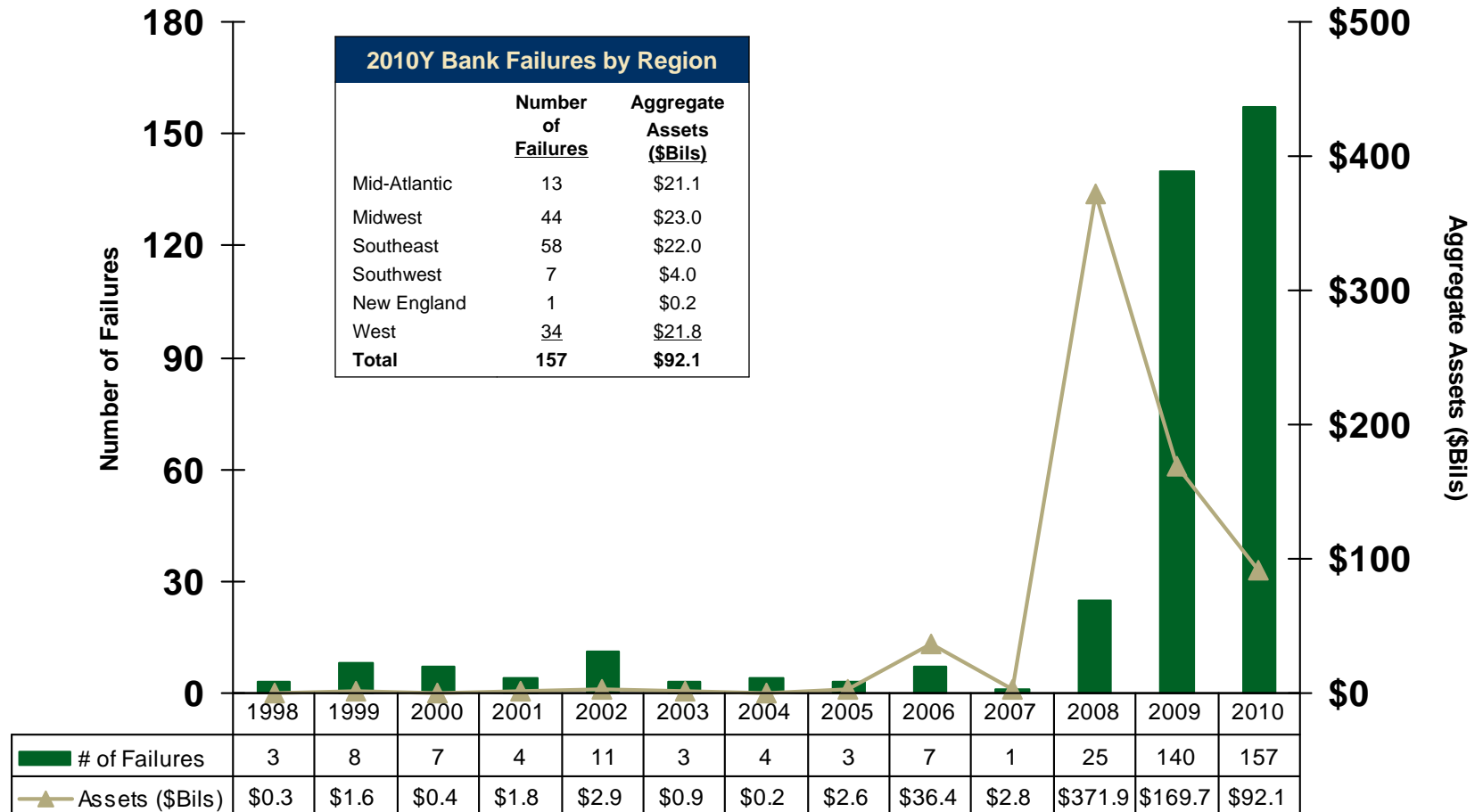
	2000Y	2001Y	2002Y	2003Y	2004Y	2005Y	2006Y	2007Y	2008Y	2009Y	2010Y
■ Total	109	113	124	121	128	84	84	117	278	749	813
■ C&Ds (FDIC, OCC, OTS)	90	104	115	95	111	76	77	106	240	589	590
■ Written Agr (Fed Reserve)	19	9	9	26	17	8	7	11	38	160	223

Note: Total number of orders issued in each period. Total may include modified orders.

For the FDIC, OCC and OTC, only Formal Agreements/Consent Orders and Cease & Desist Orders are included. (Source: SNL Financial)

Written Agreements are from the Federal Reserve's website – [www.federalreserve.gov](http://www.federalreserve.gov).

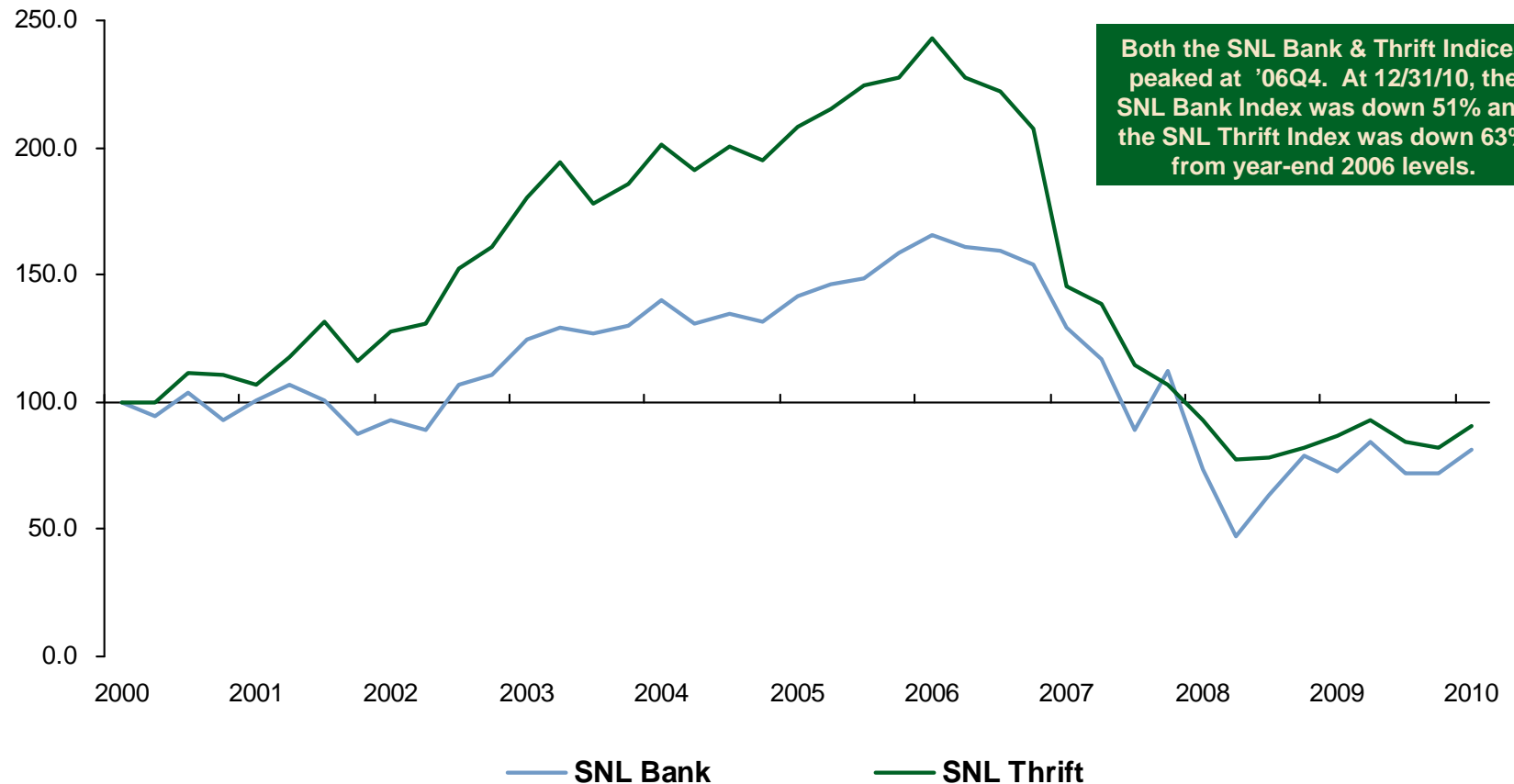
# Failed Bank Data



Source: FDIC

Note: Top 5 States by Number of Failures: Florida (29), Georgia (21), Illinois (16), California (12), and Washington (11)

# Equity Market Returns

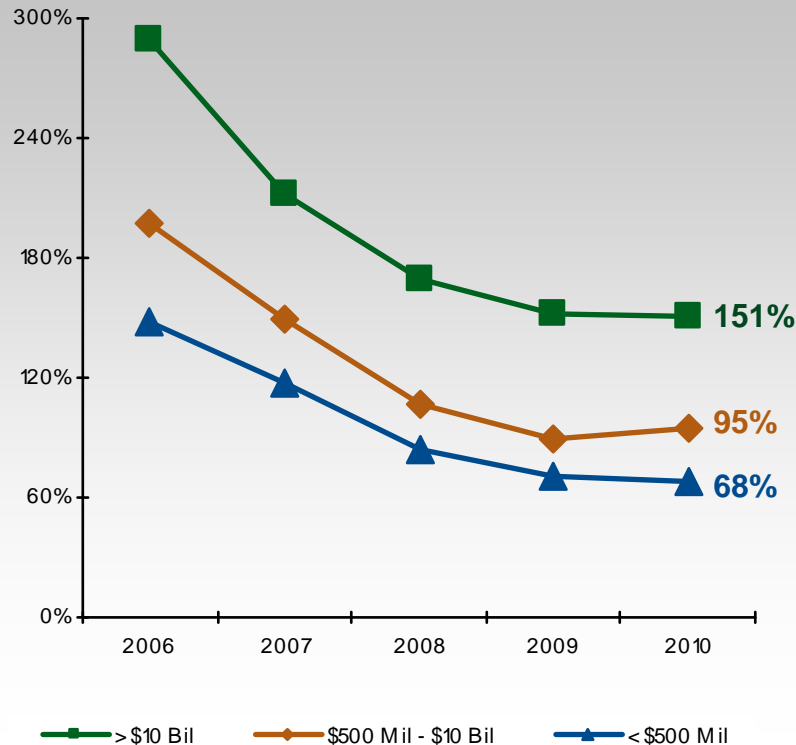


Source: SNL Financial

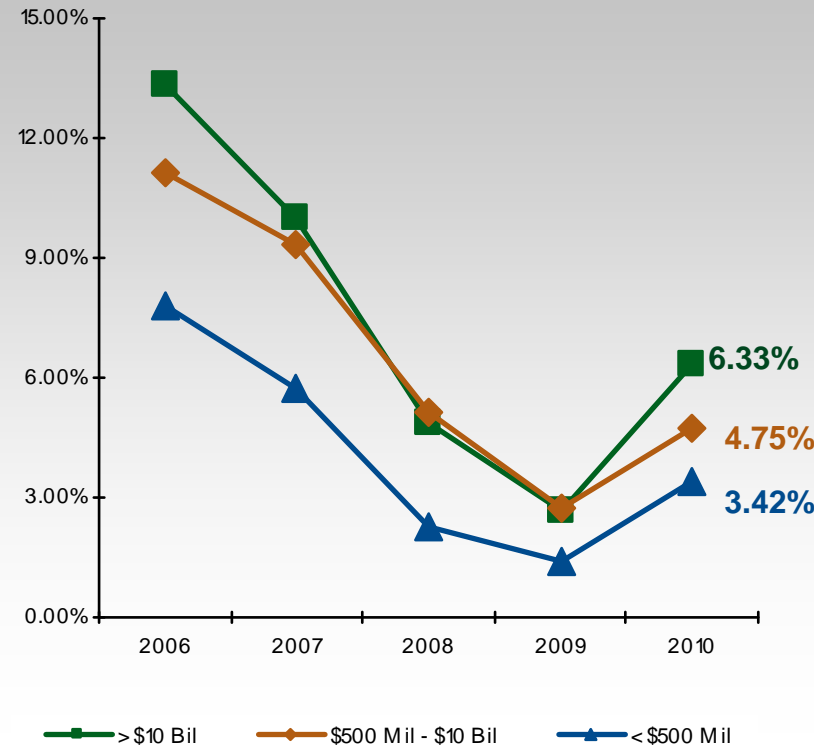
Note: Graph uses 12/31/00 index values for purposes of establishing indices for the SNL Bank Index and the SNL Thrift Index. Index values include historical returns.

# Price / Tangible Book Value Trends

## Price / Tangible Book Value



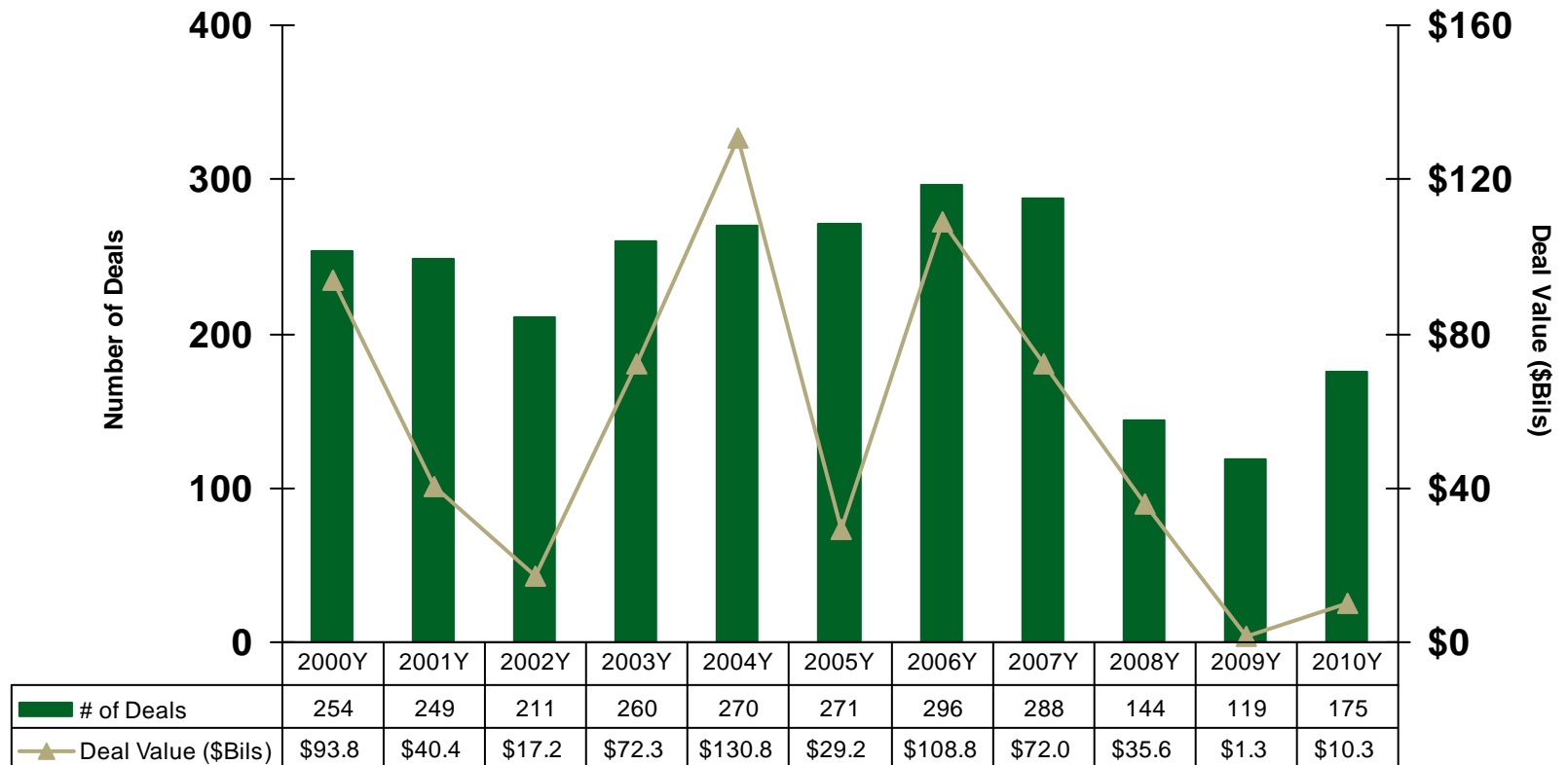
## Return on Average Equity



Source: SNL Financial

Note: Median statistics for publicly traded banks & thrifts. Excludes M&A targets. ROAE for 2010 based on YTD 09/10.

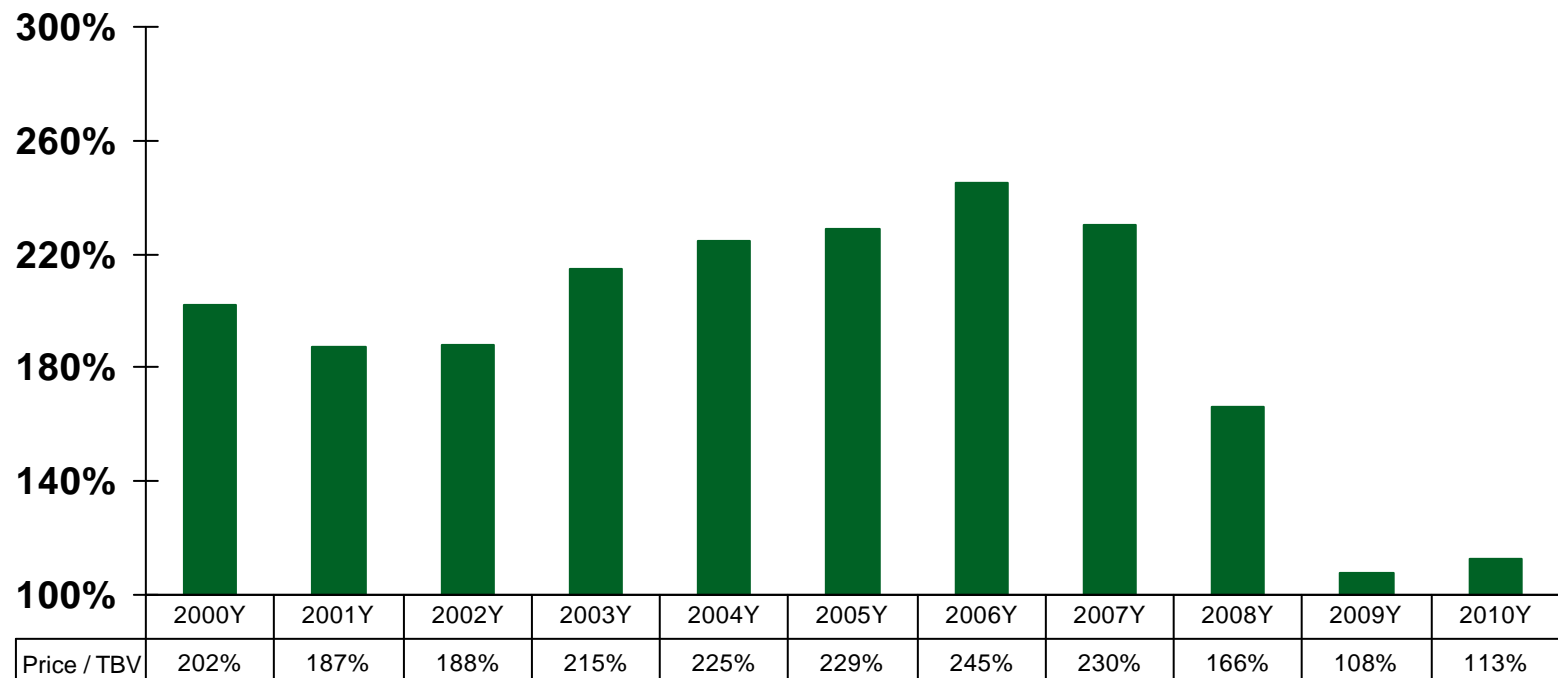
# Bank & Thrift M&A Activity



Source: SNL Financial

# Bank & Thrift M&A Pricing Trends

Average Price / Tangible Book Value



Source: SNL Financial

# Top 5 M&A Deals of 2010

## Based on Seller's Asset Size

Seller Financial Statistics									Announced Deal Statistics					
Buyer	Seller	ST	Total Assets (\$Bils)	Tangible CE / Tangible Assets	YTD ROAA	YTD ROAE	LTM Effic. Ratio	NPAs/ Assets	Texas Ratio	Announce Date	Deal Value (\$Bil)	Stock or Cash	Price/ Tg. Book	Prem/ Core Deposits
1 BMO Financial Group	Marshall & Ilsley Corp.	WI	\$51.9	8.19%	-0.98%	-7.87%	60.9%	4.87%	34.9%	12/17/10	\$4.1	Stock	98%	-5.4%
2 Toronto-Dominion Bank	South Fncl. Group	SC	\$12.4	2.90%	-2.70%	-32.91%	86.0%	4.56%	53.3%	05/16/10	\$0.2	Mixed	17%	-6.0%
3 Hancock Holding Co.	Whitney Holding Corp.	LA	\$11.5	8.10%	-0.61%	-4.24%	78.6%	4.73%	38.5%	12/21/10	\$1.5	Stock	164%	3.6%
4 M&T Bank Corp.	Wilmington Trust Corp.	DE	\$10.4	7.28%	-6.36%	-46.11%	76.7%	10.52%	92.0%	10/31/10	\$0.7	Mixed	47%	NA
5 Investor group (1)	Sterling Financial Corp.	WA	\$9.7	-1.25%	-2.65%	-108.81%	74.0%	10.61%	235.6%	04/26/10		See Note Below		
<b>Average</b>			<b>\$19.2</b>	<b>5.04%</b>	<b>-2.66%</b>	<b>-39.99%</b>	<b>75.2%</b>	<b>7.06%</b>	<b>90.8%</b>				<b>81%</b>	<b>-2.6%</b>

(1) Sterling Financial Corp. was recapitalized with \$730 million of new capital including the conversion of U.S. Treasury Preferred Stock for common stock.

Source: All data from SNL Financial. (Based on price-to-core earnings multiple if available).

# Industry Update Highlights

- Capital isn't "King"...it's "King Kong"
- Large banks were more proactive in addressing asset quality and capital issues – with support not available to the smaller community banks!
- Asset quality issues will persist for community banks
- Community banks have fewer alternatives, and troubled banks will have to slug it out
- About "half-way" through the bank failure cycle
- Equity markets have improved and will increase further
- Starting to see signs of life in M&A

# *Legal Perspectives on Raising Capital*

- Capital more important than earnings for buyers?
- Hard Capital (common stock) best?
- Raising capital is difficult without an “event”
- 9 of 10 capital raises fail if purpose is to comply with capital level directives in regulatory order

# *Hurdles to Raising Capital*

- Passing hat among directors not working (worn out or drained)
- Change in definition of accredited investors – limits investor pool in community
- Required write-downs by regulators
- Increased funding of ALLL
- Stress testing requirements of whole bank

# *Hurdles to Raising Capital*

- Asset Quality
- Determining size of capital raise (“size of hole in doughnut”)
- Economy
- Fair valuing loan portfolio
- CAMELS composite rating
- Public orders (everybody thinks the bank is at risk)

# *Hurdles to Raising Capital*

- FRB commitments for 5%-9.9% equity investors
- 500 shareholder rule (do you really want to be a registered company?)
- When do we get dividends?
- When do we get our money back?
- Size (will it be important in future?)

# *Hurdles to Raising Capital*

- Board gives up the fight
- Let 'er fail
- Lack of faith in management
- Current owners abhor dilution or do not get that they are in trouble
- Bank's overall risk profile is suspect
- Holding company saddled with Trust Preferred, TARP and bank stock loan – where is new capital to be deployed?

# *Sign Me Up – I am a buyer*

- Easier to raise money capital if there is an “event”
- Buy failed bank
- Buy a clean/slightly trouble institution
- Buy a clean stripped-down bank
- Return of funds if one or more of above not accomplished in a time certain

# *Sign Me Up – I am a buyer*

- Plan to go public
- Faith in management and bank's strategic plan
- Build a fund for roll-ups
- Bank with plenty of capital and good CAMELS composite rating

# Sources of Capital

- Private Equity Investors
- Other Holding Companies (non-control investment)
- Private investors buying a stripped clean bank since formation of *de novos* generally not possible today
- Regional combinations
- Current and new shareholders
- Small Business Loan Fund (to be discussed in detail later)

# Capital Strategies for Community Banks

## ➤ Pass the Hat

- Board members, insiders, large shareholders should be the first line of attack
- Limited success but will be less dilutive than other options

## ➤ Find the Investor(s) before Pricing/Structuring the Deal

- Sophisticated investors negotiate their own deal
- Structure the instrument and price to meet the investor(s) needs
- The success rate of pre-priced PPMs is very low

# Capital Strategies for Community Banks

## ➤ Keep it Simple

- Regulators want more COMMON EQUITY
- Preferred stock, sub debt and convertible instruments may be used in certain situations
- Trust Preferred is essentially dead
- Holding company loans to small BHCs will come back
- Small Business Lending Fund may be an effective capital tool for some banks

# Recap Example

- Michigan based bank - CAMELS 5; significantly undercapitalized
- Recapped with about \$10 million of capital – all common
- Existing shareholders participated and maintained control to preserve NOL (52%/48% ownership split)
- New investor bought in at 30% discount to price paid by existing shareholders (two-pricing tiers)
- Price approximated 115% of pro forma book value per share (company had negative equity pre-transaction)
- Bank will be well-capitalized following deal

# *Distressed Sale Example*

- Florida based bank - CAMELS 4; adequately capitalized
- New investor group is purchaser and will use target as a platform bank
- Bank's footprint is highly attractive
- Existing shareholders potentially get 50% of TBV in cash
  - 30% of TBV paid at closing
  - 20% of TBV paid on an earn-out basis over two years

# *Growth Oriented Capital Raise Example*

- Chicago area bank; healthy and well-capitalized
- Interested in FDIC and distressed transactions
- Private placement to raise up to \$10 million
- Mostly sold to existing shareholders
- Priced at approximately 135% of TBV

# *TRUPs and TARP Restructuring*

## **Independent Bank Corporation (IBPC)**

- Adopted a Capital Restoration Plan January 2010
- Established target capital ratios of 8.0% Leverage and 11.0% Total Risk Based
- Primary Initiatives:
  - Exchange common stock for TRUPs
  - Exchange common stock for TARP
  - Raise common equity in a public offering

# *TRUPs and TARP Restructuring (continued)*

## **Independent Bank Corporation (IBPC)**

- Treasury to exchange Series A Preferred for Series B Convertible Preferred under substantially similar terms with exception of the conversion feature
- Series B Preferred is mandatorily convertible into common shares at 7th anniversary at 100% of liquidation value and at the market price of IBPC at that time
- Treasury can convert Series B to common at any time at a fixed Conversion Rate based on 75% of liquidation value
- Company can compel conversion (at the Conversion Rate) if at least \$40 mil of TRUPs converts to common and \$100 million of common stock is raised

# *TRUPs and TARP Restructuring (continued)*

## **Independent Bank Corporation (IBPC)**

- In April 2010 the Treasury exchanged \$72 mil in TARP for Series B Convertible Preferred Stock
- In June 2010, \$41.4 mil of \$92.9 mil TRUPs exchanged for common
- Current ownership dilution to common stockholders is approximately 85%
- Additional share issuance could dilute original common ownership by more than 95%

# *Small Business Lending Fund (“SBLF”)*

- Overview: Not a part of TARP so TARP-like provisions do not apply (compensation, dividends, warrants, etc.); Treasury will purchase senior perpetual non-cumulative preferred stock
- Use of Funds: At least 90% of funds must be contributed from holding company to financial institution; SBLF funds may be used to refinance TARP
- Eligibility: Insured depository institutions with assets less than \$10 billion; current terms do not apply to mutuals or S-Corps;
- Ineligible: Institutions on the FDIC problem bank list (CAMELS 4-5); CAMELS 3 case-by-case

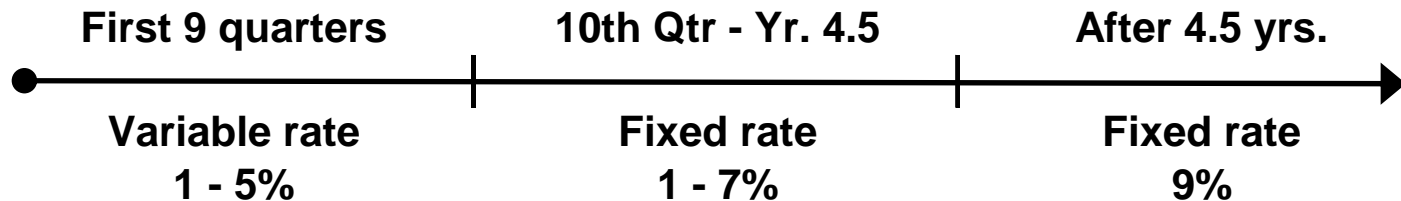
# *Small Business Lending Fund (“SBLF”)*

- Funding Amount: Up to 5% of RWA for assets < \$1 billion  
Up to 3% of RWA for assets \$1-10 billion
- Qualified SBL: Loans of \$10 mil or less to businesses of less than \$50 mil in revenue in the following categories: C&I; owner occupied CRE; ag production loans; ag land loans  
Note: SBA and other government-guaranteed loans excluded
- Dividend Rates: Adjusted quarterly off Baseline level of SBL (four quarters ending June 30, 2010); rates apply to dollar amounts of SBL that exceed the amount of SBLF funds received

*See Dividend Timeline and Rate Schedule on next slide*

# Small Business Lending Fund (“SBLF”)

## Dividend Timeline and Rate Schedule



Increase in Lending over Baseline	First 9 quarters	10 <sup>th</sup> Qtr. – Yr. 4.5	After 4.5 yrs.
0% or less	5%	7%	9%
More than 0%, but less than 2.5%	5%	5%	9%
At least 2.5%, but less than 5%	4%	4%	9%
At least 5%, but less than 7.5%	3%	3%	9%
At least 7.5%, but less than 10.0%	2%	2%	9%
At least 10.0%	1%	1%	9%

# *Small Business Lending Fund (“SBLF”)*

- Submit Application by March 31, 2011
- Provide a ***Small Business Lending Plan*** to primary federal regulator and state regulator, if applicable; the Plan is considered confidential supervisory information
- SBLF may be repaid at anytime without penalty; including partial redemptions of at least 25% of original funding
- Full amount repaid at the end of ten years
- During participation in SBLF, dividends or repurchases may not result in more than a 10% decrease in Tier 1 Capital

# SBLF – Sample Analytics

## Key Assumptions

Assets	\$400,000	
RW Assets	\$300,000	
Common Equity Capital	\$28,000	7.0% Ratio
Net Income (Year 1)	\$2,000	
Growth Rate of Net Income	0.0%	
Cash Dividends	\$0	
Shares	1,000	
BVPS	\$28.00	
Current Market Price	\$22.40	80% of BV
Projected Market Price Year 5	100% of BV	
Amount of SBLF (Max)	\$15,000	5% of RWA

# SBLF – Sample Analytics

## Alternative Capital Analysis

<b><u>Additional Assumptions</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
Minimum Dividend Rate	1.00%	1.00%	1.00%	1.00%	5.00%
Maximum Dividend Rate	5.00%	5.00%	6.50%	7.00%	8.00%
Earnings Rate on Funds (A-T)	1.50%	1.50%	1.50%	1.50%	1.50%

	<b><u>Common</u></b>	<b><u>SBLF Funding (2)</u></b>	
<b><u>Book Value Analysis</u></b>	<b><u>Issuance (1)</u></b>	<b><u>Min. Rate</u></b>	<b><u>Max. Rate</u></b>
Year 5 Book Value Per Share	\$32.42	\$37.78	\$34.40
Book Value Enhancement		16.5%	6.1%

(1) Assumes capital raise of common shares issued at current market price (80% of book)

(2) Assumes capital raise in five years at 100% of projected book value

# SBLF – Sample Analytics

## Growth/Leverage Analysis

<u>Additional Assumptions</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Avg. Loan Volume	\$15,000	\$30,000	\$45,000	\$60,000	\$75,000
Net Spread	3.00%	3.00%	3.00%	3.00%	3.00%

<u>Cumulative Earnings Analysis</u>	<u>SBLF Funding (1)</u>	
	<u>Min. Rate</u>	<u>Max. Rate</u>
Five Year Earnings Accretion	\$4,013	\$638
% of Beginning Equity Capital	14.3%	2.3%
% of SBLF Funding	26.8%	4.3%

(1) Does not consider impact of potential capital raise to exit SBLF

# *Subordinated Debentures with Warrants*

- Midwestern Bank, \$2 billion in assets
- Has remained profitable through recession; common stock trades at discount to peers
- \$10 million Private Placement
- 10% Coupon, 5 year fixed, then floating
- 10 year maturity
- 20% Warrant coverage, Strike @ Market plus 20%, five year expiration
- Projected IRR of 12% to 13% for 5-year holding period
- Preparing to market in 1Q2011

# Convertible Non-Cumulative Perpetual Preferred Stock

- Midwestern Bank, \$3 billion in assets
- Reported net loss in 2009; return to marginal profitability in 2010; NPAs continue to “creep” higher
- \$25 million Private Placement
- 8% Annual Dividend, payable quarterly
- Conversion price equal to tangible book value per share at the last quarter prior to conversion
- Board/Management opportunity to invest at same terms
- Projected IRR of 15.7% for 5-year holding period
- Preparing to market in 1Q2011

# Capital Planning for Banks under Regulatory Enforcement Actions

➤ **Typical Language:**

“Within 60 days from the date of this Order, the Bank shall prepare a written capital plan”

or

“During the life of the Order, the Bank shall maintain a Tier 1 leverage ratio equal to or exceeding 8.0% and a total risk-based capital ratio equal to or exceeding 12.0%, in addition to a fully funded ALLL”

➤ **Case Study** – Bank with \$800 million in assets adopted Capital Plan in December 2009

# Capital Plan Case Study

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1. Executive Summary
2. Regulatory Capital Guidelines and Current Capital Position
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8. Planned and Strategic Growth
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# Capital Plan Case Study

## Executive Summary

- Establish board policies and directives related to capital
- Key observations: capital ratios, asset quality and earnings
- IMCR (“Individual Minimum Capital Ratio”):
  - 8.25% Tier 1 leverage and 11.00% Total RBC ratio
- Current capital deficiency of \$4 million
- Capital Stress test shows no capital shortfall

### **Action Items:**

- ✓ Issue \$12 million in Subordinated Debentures; \$10 million down streamed to Bank
- ✓ Balance sheet reduction target of \$75 million
- ✓ Increase ALLL from \$9 million to \$17 million
- ✓ No dividends until return to acceptable performance

# Capital Plan Case Study

## Current Capital Position

- Calculate current capital ratios
- Calculate surplus/deficiency relative to “well capitalized” and IMCR requirements
- Bank had \$4 million deficiency relative to Tier 1 IMCR
- Bank had \$10 million surplus relative to Total RBC ratio IMCR

# Capital Plan Case Study

## Financial Condition and Performance

- Concentrations in construction and CRE
- NPAs increased from \$5 to \$45 million from 2007-09
- NCOs of \$10 million in 2008-09
- Large provision expense to build ALLL
- Net loss of \$10 plus million in 2009
- Efficiency ratio of 65%
- Pre-tax Pre-provision (“PTPP”) earnings rate of \$10 million, or 1.25% of average assets
- Summarized asset quality initiatives
- Peer comparisons indicated low capital, high NPAs, and peer “average” efficiency ratio

# *Capital Plan Case Study*

## *Parent Company Review*

- No cash prior to Sub Debt issuance
- No debt prior to Sub Debt issuance
- No operations other than ownership of the Bank

# Capital Plan Case Study

## Bank-level Financial Projections

- \$10 million capital infusion from parent
- Balance sheet reduction of \$75 million in 2010; assume flat balance sheet in 2011 and 2012
- Large public funds deposit business; with sufficient liquidity
- Reduce concentrations in construction and CRE
- Conservative underwriting; Slow loan originations
- 2010 net income forecast at \$1 million with elevated loan loss provision expense and charge-off assumptions
- 2011-2012 Core operating profitability flat; improving GAAP net income driven by decline in NPAs and charge-offs
- Dividends reinstated in 2011 to assist in servicing parent debt

# Capital Plan Case Study

## Parent Company Cash Flow Projections

- Sub Debt fixed interest rate of 8.00% for three years; then variable at 2 year Treasury plus 6.25%; 5 year maturity
- \$2 million beginning cash balance at Parent
- Parent expenses approximately \$1 million per year
- No Bank dividends to Parent in 2010
- Complete projections, including bank performance, debt service, parent level income statement and balance sheet, reconciliation of equity and cash

# Capital Plan Case Study

## Capital Stress Test

- Followed the Supervisory Capital Assessment Program (“SCAP”) framework – the Big Bank Stress Test
- Conservative, 2-year forward looking model designed to provide capital buffer against higher than expected losses
- “Base” case of \$18 million in NCOs; “More Adverse” scenario of \$27 million in NCOs

### **Basic SCAP Model:**

1. Equity **plus** “Excess” ALLL **plus** 2-year PTPP earnings
2. Less 2-year estimated NCOs
3. Projected “Asset” and “Risk Weighted Asset” levels critical to the calculation
4. Calculate estimated capital ratios; and surplus/deficiency vs. IMCR
5. Analysis demonstrated surplus of \$2.6 million under “More Adverse” scenario

# *Capital Plan Case Study*

## *Planned and Strategic Growth*

- Affirmative statement regarding anticipated balance sheet growth during the planning period
- Would include organic growth, or growth as a result of planned or opportunistic branching or acquisitions
- Concise summary so there is no confusion among management, the board of directors and the bank's regulator

# Capital Plan Case Study

## Capital Contingency Plan

- What happens if projections are not achieved?

### Contingency Plans:

1. Holding company to raise capital (form and priority)
2. Sell assets to generate gains
3. Further balance sheet deleveraging
4. Change balance sheet mix to lower risk weighted assets
5. Sell the Bank/Company

# Capital Plan Case Study

## Dividends

- Affirmative statement that dividends have been suspended
- Note the importance of holding company debt service and shareholder dividends
- Set the stage for the circumstances under which dividends could be reinstated
  - \* Core earnings
  - \* GAAP earnings
  - \* Achievement of plan projections
  - \* Reduction in NPAs
  - \* Credit, Interest rate and Liquidity risk profile
- Make dividend reinstatement part of the “plan”

# Capital Plan Case Study

## Levels and Trends in Problem Assets

- Acknowledge the direct correlation between Problem Assets and “adequacy” of Capital
- Review both NPA and Classified asset metrics
- Review specific asset quality improvement initiatives
  - \* independent loan review workout firm
  - \* more aggressive loan collection strategies
  - \* enhanced credit administration processes
  - \* increased staffing
- Targeted Non-accrual and OREO balances included in financial projections

# *Capital Plan Case Study*

## *Monitor Results*

- Management to prepare quarterly report comparing actual performance to plan
- Board shall review and note in minutes
- Plan may be modified based on material variance

# *Case Study: Purchase of a Troubled Bank*

- Target - \$50 million in assets
- \$10 million of loans substandard and Buyer does not want them
- Target has \$2 million of capital (4% Tier 1 capital ratio)
- Target's parent has a bank stock loan
- Buyer willing to buy bank stock (at a discount)

# Case Study: *Purchase of a Troubled Bank*

- Buyer will pay bank stock lender a discounted amount on the bank stock loan in exchange for release of bank stock (primary negotiations between bank stock lender and Buyer not with Target)
- Buyer will cause the Target to dividend to parent the \$10 million of questionable loans at closing
- Buyer pays nothing to Target's parent for Target stock

# Case Study: *Purchase of a Troubled Bank*

- Buyer acquires a \$40 million clean bank by injecting \$2 million into Bank (bank capital now \$4 million [10%] – regulators may require more)
- Shareholders of Target's parent will receive collections from \$10 million pool – likely not much – for their shares

# Case Study: *Purchase of a Troubled Bank*

- Buyer needs to be careful as to the collectability of the \$40 million of loans and have money in reserve to inject into the Bank for growth and losses
- Best approach to acquire a platform for future growth?
- Regulatory approval needed for transaction to be closed

# *Purchase of a TROUBLED Bank*

- Many variations to example discussed
- Buyer must locate right target with footprint that fits
- Target shareholders must recognize - better to get out (maybe for nothing) than to let target fail
- Model will not fit all troubled bank situation as the hole may be too big
- Indemnity not worth anything
- Escrow of loans/funds/securities

# *Purchase of a FAILED Bank*

- We covered the process last year
- Many new structures
- Equity kickers
- Purchasing good only assets – let FDIC retain NPAs, OREO, Quick Rate, FHLB Advances
- Loss share in 3 level
- Loss share 60%-80%

# *Purchase of a FAILED Bank*

- Know what you are buying (loss share assets and excluded assets)
- Many strange events will arise after the closing (i.e., litigation from asset related issues, written off assets, assets taken back by FDIC, etc.)
- Bank property purchases
- Little bank buys big bank

# *Purchase of a FAILED Bank*

- Excluded assets (non-performing loans, OREO, quick rate, FHLB advances, litigation)
- Puts of assets to receiver (3.4)
- Assets not purchased (3.5)
- Correction of errors (8.2)
- Claims and suits (9.3)

# *Purchase of a CLEAN Bank*

- Many on drawing board
- Will “real acquisitions” be coming in large numbers – everyone predicting yes
- Problem – premiums low now (1.10-1.25 times TBV)
- Many owners want out (tired of regulators and rise in compliance costs)

# *Purchase of a CLEAN Bank*

- Asset quality viewed skeptically
- Liability side of balance sheet is important
- Reserves important
- Footprint important
- Building size important for future marketability

# *Purchase of a CLEAN Bank*

- Haves and have nots
- Learning to drive a stick shift
- Time to become active buyers is here
- Good luck and be careful

# *Capital Planning for Acquirers*

## *Regulatory Requirements*

- Regulators will direct banks to higher capital levels...8%/12% for “healthy” banks
- Regulators don’t like to see capital dilution from M&A
- In distressed or recap deals, generally regulators want at least 2x capital to classified assets at closing
- Common equity will be the dominant form of capital

# Capital - Accounting Impact in M&A

- FAS 141R changed the methodology for accounting for loans and reserves
- Market conditions have made the fair value marks of the loan portfolio critical
- Marks should be reasonably determined during due diligence
- Public companies are under more scrutiny to be aggressive on FV marks (i.e., greater FV discounts)

# The Real Price of Current M&A Deals

## Seller Financials at Completion

Buyer	Seller	ST	Closing Date	MRQ Total Assets (\$Mil)	BV of Loans Acquired (\$Mil)	MRQ LLR (\$Mil)	Net Loans (\$Mil)	LLR/Loans	MRQ NPAs/Assets
Bryn Mawr	First Keystone	PA	07/01/10	\$488.5	\$289.2	\$6.7	\$282.5	2.31%	1.56%
Chemical Financial	O.A.K. Financial	MI	04/30/10	\$821.8	\$683.2	\$15.3	\$667.9	2.23%	1.68%
First Niagara Finl	Harleysville National	PA	04/09/10	\$5,187.8	\$3,383.2	\$66.6	\$3,316.6	1.97%	2.58%

## Closing Deal Info.

Buyer	Seller	Deal Value (\$Mil)	Tang. Common Equity (\$Mil)	Prem/Discount (\$Mil)	Price/TBV
Bryn Mawr	First Keystone	\$31.3	\$30.6	\$0.7	102%
Chemical	O.A.K.	\$83.7	\$69.6	\$14.1	120%
First Niagara	Harleysville	\$299.9	\$220.5	\$79.4	136%

## Post Closing Deal Info.

Fair Value of Loans (\$Mil)	Trans. Goodwill (\$Mil)	Net Assets Acquired (\$Mil)	Deal Value/Net Assets Acquired	Net Assets Acquired/Assets
\$274.8	\$10.4	\$20.9	150%	4.3%
\$630.6	\$39.2	\$44.5	188%	5.4%
\$3,057.0	\$130.9	\$169.0	177%	3.3%

Source: SNL Financial, LLC and/or Buyer's 10-Q filings.

# Q & A

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