

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss
DATE: February 28, 2011
SUBJECT: Community Bank Investing: The Private Equity Perspective

Of the nearly 7,800 banks in the US, approximately 80%, or about 6,300, could be considered community banks (based on total assets). According to a recent analysis from Howe Barnes Hoefler & Arnett, of those banks, approximately 2,400 need to raise capital. This number assumes a 20% loss is incurred on all past due assets (including those identified as non-performing assets). The capital is needed to pay off TARP, bring capital ratios to a minimum of 7% Tangible Common Equity, 8% Leverage Capital and 12% Total Risked Based Capital (three common capital measurements used by investors and regulators), and establish a loan loss reserve of 1.50%. To that list, we would add the regulatory push for higher capital, opportunities for acquisitions, and growth opportunities in disrupted markets.

What this means is bank investors will have plenty of opportunity to deploy funds to bolster bank equity capital in the next two years. But along with this opportunity come pitfalls. Investors need to exercise care to ensure their investment is not just a good bank, but a good bank with the ability to grow value.

First and foremost, the investment needs to be a good bank. The risk of ignoring the fundamental quality of the bank investment is simply too high. In the current environment, three things come to the forefront in assessing the quality of a bank investment: financial performance, asset quality, and strategy and business model.

The financial performance of a bank is one of the most important management report cards. An analysis of historical performance and company projections guides investors in ascertaining growth and profitability dynamics. This will include an in-depth assessment of a bank's net interest margin, asset and funding mix, sources and trends for non-interest income, adequacy of loan loss reserves, and non-interest expense. Additionally, investors will need to evaluate how well a bank's management weathered the recent financial storm.

Given the depth of the recent recession and the accompanying damage to bank balance sheets, investors must also take care to completely understand a bank's asset quality. While most banks have finally confronted their credit problems, many banks dragged their feet. Therefore, it's necessary to analyze trends of past due and non-performing loans and to understand the risk in a bank's investment portfolio. To complete the picture of a bank's risk profile, investors will also need to analyze the bank's credit concentrations, loan underwriting and monitoring, asset-liability management, and regulatory compliance and relations.

Private equity investors also place great emphasis on a bank's strategy and business model. It is extremely important that banks integrate their capital plans into their strategic plans. Without integrating the capital plan, a bank may well find itself unprepared to execute its strategy and deliver value to its investors. Examining a bank's strategic and capital plans will also reveal the bank's competitive advantages, both in vision and in terms of the skills and expertise to achieve the goals set out in the plan.

But a good bank may not always be a good investment. Obviously, no matter how good a bank is, it may simply be too expensive to own. (If the last several years taught us nothing else, this is it. In the fall of 2006, the price to tangible book value peaked at over 360%—not a good time to be buying banks.) As important as it is to properly price an investment, the numbers don't tell the whole story. In any offering

for new capital, investors always need to ask: What for? How are the proceeds to be used and does this use fit the bank's professed strategy? Is the capital needed to fill a hole on the balance sheet or will it be used for growth purposes? Given the beating bank stocks took over the last four years, we can certainly expect impressive expansion of both earnings and book value multiples. However, without fully comprehending how a bank intends to use its capital, one cannot adequately calculate a range of returns for this investment based on estimates of asset and earnings growth, investment horizon, and risk.

The question of "what for" leads to other concerns. Will the pro forma level of tangible common equity be sufficient (or, just as importantly, will it be excessive) to accomplish the goals set forth by management to achieve management's growth expectations and cushion risk? Does management value and safeguard its tangible common equity? To the extent a bank has integrated its strategic and capital plans, the answer to this question should be affirmative.

Earlier in the discussion of whether the bank was a good bank, we briefly mentioned the subjects of net interest margin and funding mix. Banks create franchise value with low cost stable deposits. The higher the percentage of non-interest bearing checking and transaction accounts the more attractive the core deposit franchise.

Franchise value builds shareholder value and shareholder value can be enhanced when the interests of the executive team and the board of directors are highly aligned. But also enhancing shareholder value is the alignment of ownership—insiders with institutional investors and other large investors. To that end, investors must ask what is the management's strategy for shareholder liquidity. Management must have a realistic plan for shareholders to achieve an exit that is both timely and profitable. Moreover, investors need to have confidence that management is committed and skilled enough to execute on that plan.

Integrating the factors that identify a good bank with the factors establishing a good investment will result in successful bank investing. Banking has become a highly technical and regulated business. It remains a business involving risk and leverage. Sifting through all this data and assessing business plans and management teams is a highly labor- and time-intensive undertaking. But it is a necessary one. As it recovers from the carnage of the last few years, the banking industry is in the process of major transformation, with new regulations and paradigms replacing the old ones. One of the most important roles for investors over the next several years will be allocating capital and choosing winners and losers. We think private equity investors (especially those with strong banking skills and investment management experience) are well-suited to the task of navigating the risks and maximizing the rewards of bank investing.

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