

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: March 31, 2010
SUBJECT: You Never Want A Serious Crisis To Go To Waste

Just over a year ago, the market turned. The 18-month ride down that preceded the turnaround was both exhausting and nauseating. From October 2007 through March 9, 2009, the Dow Jones Industrial Average (DJIA) lost over 50%; same with the S&P 500 and Nasdaq. Those losses looked good compared to banks. The SNL Bank index, which comprises all publicly traded U.S. banks, lost almost 83% in that same period. Either Armageddon was on the horizon or investors were faced with a buying opportunity unlike any they'd seen in their lives.

We know now which it was. On March 10, 2009, investors appeared to tire of their negativity and began buying. Except for catching their breath once or twice, most investors haven't stopped. Since March 9, 2009, the DJIA is up 66%, the S&P is up 73% and the Nasdaq is up almost 90%. Even more remarkably, the SNL Bank index is up over 180%. It is true each of these indices is still below October 2007 highs (the SNL Bank index remains more than 50% off its high water mark on October 5, 2007), but the rally has lightened the mood in a year where investors had much to be wary of. If anything, the rally has proven that even in the face of continued high unemployment, concerns about commercial real estate, imprudent government spending and the near certainty of increasing tax and regulatory burdens, stocks were undervalued.

There is also another element at work here. Last May, when the Treasury Department released the results of its stress tests for 19 of the largest banks, it predicted approximately \$220 billion in 2009 losses for those banks. Treasury was much maligned in the press for being too rosy. Investors, however, weren't buying the dour predictions and soon these banks kicked off a spree of capital raises. As it happened, Treasury's forecasts were, in fact, off base. The losses for the stress-tested banks were 37% *lower* than Treasury's assumptions.* As reality chased away fear, the market continued its rally. (Congress is just now stepping up efforts to pass comprehensive regulatory reform for the financial services industry. Expect your elected representatives to be completely unaware of the current banking environment, and not least the fact that banks outperformed even Treasury's "rosy" assumptions.)

For small banks, the story has been different. The SNL Micro Cap Bank index lost over 66% from its peak in February 2007 until March 9, 2009. But while the index climbed more than 25% until mid-May of 2009, it has since languished. It is now just 12% above its lows from a year ago. The dichotomy between small community banks and the rest of the industry is striking (see Chart 1 below).

* See "The Real World Versus Stress Tests," Nathan Stovall & J.P. O'Sullivan, SNL, March 4, 2010.

CHART 1



Source: SNL Financial, LLC

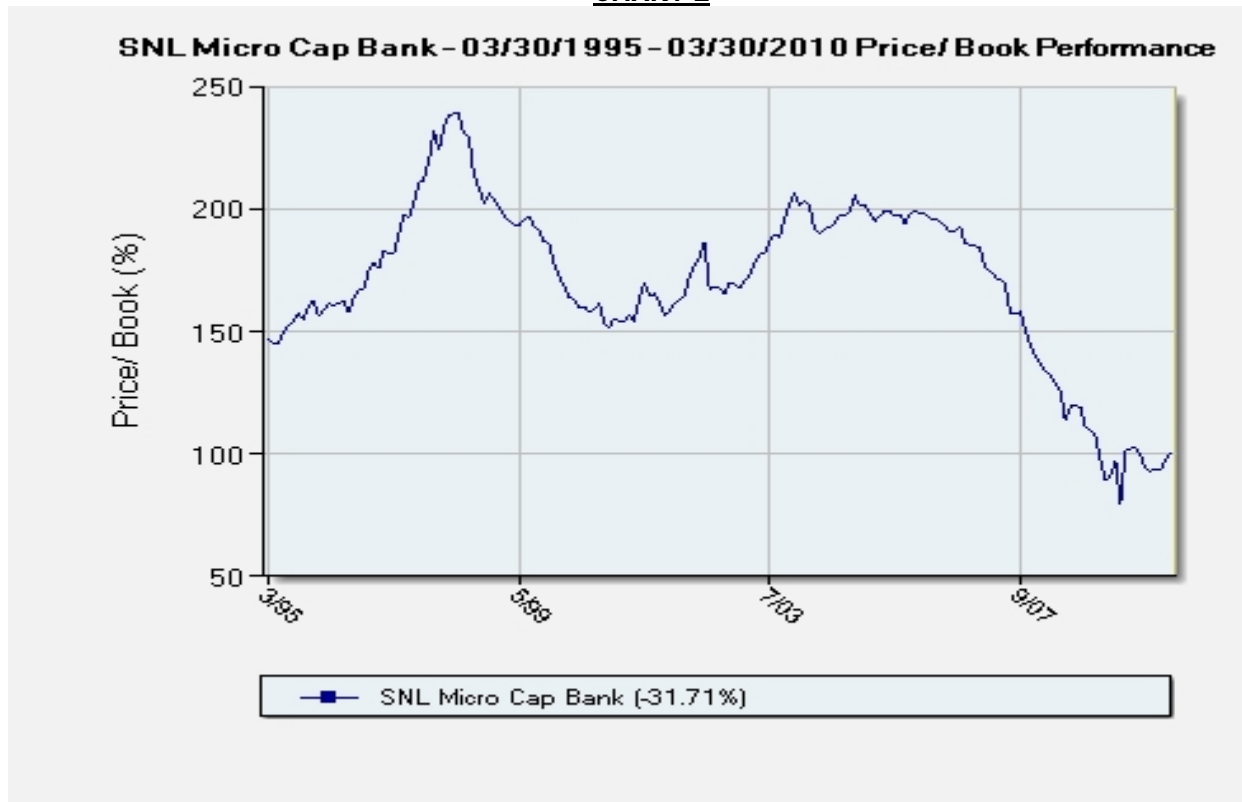
This underperformance is no doubt the result of many different market dynamics, but the most prominent is surely the effect of too-big-too-fail bias against smaller banks. Investors have learned well over the last couple years that the government is at the ready to bail out large banks that have gotten themselves in a mess. Savvy investors favor large banks because they know they won't be allowed to fail.

On the other hand, small community banks are weekly served for dinner on the FDIC's failure Fridays. Whatever the inequities of this arrangement, it is very real. The stocks of many solid community banks have suffered even though they have managed to control asset quality. They are guilty by their association with the string of failures in community banks, just as the larger banks are safe by virtue of their association with the government.

The specter of a commercial real estate disaster has also hung over community banks during the last year. For over two years, industry analysts have suggested that commercial real estate (CRE) is the "next shoe to drop" after the subprime fiasco. Indeed, CRE has suffered with the contraction in economic activity and scrimping by consumers. Many banks have been feeling the pain in their CRE portfolios and most of the attention has been on smaller community banks. Yet, the potential for further distress in CRE does not begin to approach the subprime mess. Moreover, not all CRE is made equal. Much of it is occupied by its owners, giving these borrowers added incentive to perform on their loans. While CRE stress will likely lead to additional losses for banks, we think the concern is overblown.

The micro cap bank sector is full of steals today. Relative to the book values of micro cap banks, stock prices are historically low. Over the last 15 years (including through the 2001 recession), micro cap banks have sold at prices mostly in excess of 150% of book value. Today, they are selling at a mere 100% (see Chart 2).

CHART 2



Source: SNL Financial, LLC

In many instances, this index overstates the prices for banks. There are still well-capitalized banks with low levels of problem assets that remain underpriced and selling at discounts to book value. Notwithstanding the challenges that small community banks will continue to face—regulatory bias against small banks, increased regulatory burdens, and CRE distress—investors have a remarkable opportunity to grow their portfolios with micro cap bank stocks. In all events, prices have a long way up to get to normal. We take comfort in that.

Rahm Emanuel once said, “You never want a serious crisis to go to waste.” The last two plus years have seen one of the worst financial crises in history. As investors in community banks, we intend not to waste it.

Copyright 2010 Fortress Partners Capital Management, Ltd.

FORTRESS

PARTNERS

CAPITAL MANAGEMENT, LTD.

700 Walnut Ridge Drive, Ste 200, Hartland, WI 53029

262-369-1095 (Jon Bruss and James Bruss)

www.fortresspartners.com

THIS COMMUNICATION IS NOT AN OFFER OF INTERESTS IN FORTRESS PARTNERS BANC VENTURES I, LP, FORTRESS PARTNERS BANC VENTURES II, LP, OR FOUNDATION FINANCIAL PARTNERS, LLC. PERFORMANCE INFORMATION IS HISTORICAL AND IS NOT INDICATIVE OF, NOR DOES IT GUARANTEE FUTURE RESULTS.