The FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: April 23, 2007
Subject: On Work and Leadership—in banks, of course; Pulaski & Big Bertha

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We've written in the past on the importance of management in banking—how critical we believe strong, demonstrable leadership is to the success of the banks in which we invest. Recently, Rich Karlgaard, publisher of *Forbes* magazine (April 23, 2007, Digital Rules) entitled this iteration of his column, "Godly Work". He quotes a former University of Wisconsin philosopher who later ran the University of Southern California School of Philosophy (UW has generally not been renown for turning out philosophers who think and write about Judeo-Christian ethics but rather spend most of their time studying Marx and thinking post-modernist thoughts), Dallas Willard, who has popularized the thought, "Work is about the creation of value." We think that helps put into perspective what we do, you and us, each and every day, we "work." We create value. It seems to us that creation of value is a good thing and yet, as Karlgaard points out, all too often, those of us who are God fearing and take that seriously find that our "trusted godly advisors" snipe: "Businesses exploit the weak. They are driven by greed. Their advertisements inflame our baser instincts, such as pride, lust, envy and greed." And, he points out that it is "painful for a God believer to dismiss his trusted godly advisor as a crank. It feels almost blasphemous." And, the result of those feelings which we've all had at one point in time or another? "We don't argue the point when we should" says Karlgaard.

We generally don't delve into the faith life of the folks who manage the banks in which we invest, but we think that we have a pretty good idea of the kind of folks running those banks. And we believe that they are all committed to creating value—value for their shareholders. It is almost a mantra they recite every day and they understand that in order to create value, they, according to Karlgaard (and founding father, James Madison in the *Federalist Papers* and elsewhere) "[need] to act fairly and civilly to attract customers." Bankers *must* act fairly and civilly to attract customers—and, incidentally, to create value. Work *is* about the creation of value.

Karlgaard heard a sermon recently by a particularly astute member of the clergy who said that, "In organizations . . . people, when they're well led, not only accomplish great things but become better people in the process." Karlgaard then continues with the sermon which cited a conversation between a senior surgeon and his newly minted assistant following a just completed surgery where the senior doctor was telling the young man "what he'd done well and what he could have done differently."

> "*Then the senior doctor, with his hand on the shoulder of his younger colleague asked whether he noticed the young man from housekeeping who came in to clean the room. There was apparently a blank look on the younger doctor's face. [Under the circumstances, there would have been on ours as well.] The older doctor went on to explain that the young sweeper's name was Carlos and provided extensive detail including the length of time he'd been at the hospital, the outstanding job he did and the speed with which he did it. He told the young surgeon the name of Carlos' wife and the names of each of their four kids and their ages. Then he said, 'Next week I would like you to tell me something about Carlos that I don't already know. Okay? Now, let's go check the rest of the patients.'*"

That, Karlgaard recalled, the preacher observed is "breathtaking leadership." And it is, isn't it.

However, breathtaking leadership is what we've observed so many times over from many of our CEOs at their places of business, in our meetings with them outside their banks and in phone conversations. These examples of what Karlgaard refers to as "breathtaking leadership" are more common place than one might expect, especially among the banks and bankers we hang around with in which we invest.

Several years ago we became acquainted with a bank manager to whom we were attracted as much for his unique management and leadership style as we were for his bank's financial performance. His name is Bill Donius. He runs a thrift—more like a bank than a thrift actually, which he converted from a mutual holding company to a thrift holding company in December of 1998. Its name is Pulaski Bank (Pulaski Financial Corp. [PULB]) in St. Louis.

There is one aspect of this story that bears a striking resemblance to what the public thinks and knows about thrifts and community banks. In this case, Bill is the third generation of the Donius family to sit in the corner office. However, that's where the similarity ends: he doesn't sit in that corner office much. Maybe that's because he was not a career banker. Before joining Pulaski in 1992, Bill had a decade plus experience in TV production and healthcare. But having the family banking DNA imprinted on his soul at breakfast, lunch and dinner, he succumbed to their call and joined the mortgage department of the 70 year old bank as an assistant to the crusty manager who was twice his age—and a woman. In 1994 the bank converted to a mutual holding company. After learning the ropes, Bill was elected president in 1997 and in 1998 took the bank from a mutual holding company to a thrift holding company through an initial public offering.

As he learned the business, he found the Pulaski Bank to be well run but not meeting the standards of excellence he believed could put Pulaski into the top circles of community banks in the US—a mission the bank holds today in its "Quest to be the Best Performing Small Bank in America" as measured against banks with a market capitalization of $500 million or less. At the same time, Pulaski has set its cap to become **THE** community bank in St. Louis. Tall orders both but made a lot easier with the Pulaski brand of leadership and management and, what the bank refers to as the Pulaski Growth Formula. This formula consists of the **external factor**—the market in which the bank exists plus recognition of its **current position** which when combined with its **competitive differentiator** provides the desired result. As the bank sees it:

- The **external factor** is St. Louis, the community which is its home base, is parochial and provincial, not unlike a lot of other Midwestern cities. It carries with it the legacy of several well known banks which were community oriented and were acquired by much larger banks, but the memory lingers on.
- Its **current position** is that of a community bank with 10, locations with two more scheduled by July 2008. It has a legacy of serving the St. Louis community for 85 years.
- The **competitive differentiator**s, in the company's view, are a superior operating platform, top notch talent, best in class products, unique employee and management communication and incentive system, its Q2B (Quest to Be the Best Small Bank in America) performance focus and its strong ties to its community.

Now all of this may see to be a bit squishy, but combined with the leadership team at Pulaski (as is the case at the other banks in which we invest), the proof is in management's report card. Following are the results, you be the judge:

- **Earnings** per share increased 14% Q1-FY07 (4th calendar quarter) vs. Q1-FY06, 19% annually for the 5 years ending FY-06.
- **Core deposits** increased 42.8% Q1-FY07 vs. Q1-FY06—more than 1/3 of that growth was non-interest bearing demand and money market accounts reflective of the company's success with its somewhat tongue-in-cheek **Big Bertha** deposit campaign. *Remember, core deposits build franchise and shareholder value (and work is all about creating value—but you can have fun working)!*
- **Loans** grew by 28.5% Q1-FY07 vs. Q1-FY06.
- **Loan mix** in last 5 years:
  - Residential—40% in 2006 vs. 70.4% in 2002
  - Home equity—26% in 2006 vs. 23% in 2002
  - Commercial real estate/commercial & industrial (substantially owner occupied)—33.3% in 2006 vs. 3.4% in 2002.
- **Efficiency ratio** of 54.69% (lower is better); declining steadily from 64.73% in 2000. At banking conferences, management stays at *lowest* cost location, most often not at the hotel at which the conference is held—good **management leads by example**!
- **Non-interest income** grew by 31%, Q1-FY07 vs. Q1-FY06 through a combination of mortgage origination and appraisal fees and investment revenues. Non-interest income averages 28%-34% as a percent of revenues—high for a bank this size but incredibly important to temper swings in the net interest margin.
- **Mortgage originations** were $1.3 billion in 2006 in its St. Louis and Kansas City markets through unique relationships with major real estate brokers.
- **Customer satisfaction** was 98%.
- **#1 mortgage lender** in St. Louis.
- **#3 mortgage lender** in Kansas City.

Leadership styles can and do vary from bank to bank but there are a number of factors which we find common to all of good CEOs:

- The CEO seeks to **hire managers who** complement the CEO by being **better and brighter** than he or she.

- The CEO **consistently talks about and praises the banks management team** and provides access to them.
- The **search is never-ending for top quality managers** in our growing banks.
- The **top management team is dedicated to improving themselves and to training** and improving their **subordinates**.
- The **top management team meets with all employees** in groups at least quarterly if not monthly **to discuss financial performance** of the bank and the employees' unit.
- **Recognition and reward go hand in hand** at the banks in which we invest.
- **Managers and employees have fun.**

Breathtaking leadership—we see it in action in our banks all the time, may be viewed as enlightened self-interest. Our bank managers are dedicated to committing not just random acts of breathtaking leadership, to paraphrase the peacenik bumper sticker, but practice breathtaking leadership daily because it is in the best interest of their shareholders, their employees, their communities, their families and themselves.

Breathtaking leadership is a virtue!

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