

***E*-Memo**

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Fortress Partners
DATE: April 29, 2010
SUBJECT: Why Community Banks?

Last month we discussed the current buying opportunity in community banks. Community banks remain undervalued and the prospect for price appreciation is substantial.

Nevertheless, we have fielded the same question from several individuals in the last couple months: are community banks still relevant? The answer is categorically Yes. Community banks fulfill an indispensable function in our economy by funding small and niche businesses as well as service and professional firms. In fact, the more than 8,000 community banks provide 67% of small business lending in the US.

There are several reasons community banks play an important intermediary role between capital and small business. First, the corporate bond market is typically closed to small business, so small business must turn to banks for financing. However, many regional and money center banks prefer larger credits and therefore usually avoid small business. Moreover, community banks are often viewed as trusted sources of financing for small business owners because of their local market knowledge and local decision-making.

Indeed, that is an important component of the value of community banks. Community bankers know their communities and their borrowers and have intimate market knowledge where they lend. They are known for local decision-making and accessibility. Because of their local orientation, community banks are more nimble in their decision-making processes, in embracing new products, deploying technology, dealing with competition, and responding to market changes. True community banking is often a business of managing by exception, whereas larger banks typically move more slowly and by the book. Consequently, and with their nimble decision-making processes, community banks are typically in position to “out local” the regional or large banks, whose nerve centers are usually located well out of market.

The financial crisis has changed the banking landscape, in many ways for the better. The financial crisis has chastened lenders and securitizers. Even as deleveraging continues among businesses and consumers, the credit risk profiles of banks improve. Alongside improving credit, the deleveraging of both households and businesses has boosted cash liquidity which is now at a very high level as a percent of GDP. As a result, there is an unusually large amount of core deposits now available, which can serve as funding for future loan growth when evidence of “animal spirits” returns. This is extraordinarily important because the franchise value of community banks rests firmly on low-cost and stable core deposits generated from small and niche businesses, professional firms, municipalities and the local community in general. Deleveraging be a may drag on the overall GDP, but community banks have an excellent opportunity to turn the resulting liquidity into high quality assets.

Banks that concentrated too heavily on risky construction loans either enabled or perpetuated the conditions that brought on the financial crisis. Most of them have either failed, are about to fail, or have diversified their loan portfolios. As a result, community banks are establishing the underlying conditions—specifically, better credit underwriting and diversification—for high credit quality in the future. Moreover, many banks became too dependent on brokered deposits and other sources of wholesale funding. Consequently, banks are looking for, and finding, more stable sources of core deposit funding.

The financial crisis has already resulted in a large and growing number of bank failures. The failures—especially among small community banks—reduce competition. At the beginning of the crisis, community banks faced pricing competition for deposits and loans from irrational players in their markets, both at the

local level and national players such as Countrywide and Indy Mac. The more reckless competitors have failed or been absorbed by stronger institutions that do not need to chase deposits or loans with unprofitable pricing. In addition, most of the failures have been small, community banks, leaving more space in the market for the survivors.

Asset quality concerns, especially in the well-publicized commercial real estate (CRE) area, remain uppermost in the minds of banks, bankers and bank investors but according to Moody's Commercial Real Estate Price Index, commercial property prices have been rising for the most recent three month period covered by the index. Moreover, unlike residential real estate, much CRE financed by community banks is occupied by owners who have operating businesses and cash flow generation to service loans, even though the underlying collateral values might have declined. Even for investor owned CRE, there is still usually cash flow a creditor can rely upon. In short, there is little reason to expect CRE losses will approach those in the residential mortgage area.

We believe community banks will benefit from some favorable tail winds. There will be an upward sloping yield curve, which should benefit net interest margins. As the economy recovers, there will be a return to a more normalized risk premium on loans. This will further benefit net interest margins. Any potential flight to safety among consumers and businesses alike would result in re-intermediation of deposits, further strengthening the deposit base for community banks. Finally, we have reached a point in this credit cycle where most asset quality issues have been identified and well-defined, real estate values are starting to stabilize, and loan quality is easier to analyze. This positions community banks to take advantage of organic, local loan growth opportunities when loan demand fully rebounds.

We too have been chastened by the financial crisis and we remain cautious. But we are facing what we believe is an historic buying opportunity in a sector that is integral to our economy.

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