

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Scott McCallum and Karl Ostby, Senior Advisors
DATE: June 24, 2011
SUBJECT: We're Here to Help You – Part II: The Merits of SBLF for C-Corps

In the last edition of the *E-Memo*, our colleagues painted a rather cautious picture—at best—of the merits of tapping the Small Business Lending Fund (SBLF) as a capital source for S-Corps and mutuals. And, like past *E-Memos*, it drew colorful feedback on both sides of the argument. This edition focuses on the positive attributes of SBLF for C-Corps, but also provides commentary that applies to bank types across the board. The SBLF application deadline has passed and, as of the date of this writing, only a handful of banks have received preliminary approval.

Three questions should guide any bank and bank investor in evaluating capital alternatives in today's marketplace:

- What are our capital alternatives?
- What is the form of capital and what is the cost?
- If we want no part of an investor-lender relationship with Treasury, where else can we turn?

With community bank equity valuations still depressed and suppressed (typically below book value), and investor sentiment down on the banking industry, attracting new investors to a capital raise is extremely difficult and the pricing will likely be painfully dilutive to existing shareholders. But as bank investors and board members, we reformulate these questions in the terms we had drilled into our heads as bank trainees and commercial lenders:

- What is the *purpose* of the loan?
- What are the *sources of repayment*?

SBLF funding serves several *purposes*. As with any capital raise, SBLF allows the bank to naturally lever itself over time, eventually by a factor of 8x to 10x the amount of the incremental capital. It can also help address the need to achieve sufficient scale to absorb increased regulatory and capital requirements. Unlike capital raises in the markets, however, it provides a relatively low coupon cost (below market alternatives) and replaces TARP with a potentially lower initial coupon; eliminates the compensation restrictions found in TARP; and it extends the refinancing window from 2014 to the fourth quarter of 2015.

In replacing TARP, the coupon can be lowered to 1% based on increased small business lending. Like TARP, the coupon increases to 9% after 4½ years, but refinancing TARP creates an extension of the 5% coupon by 1 to 2 years.

Extending the refinancing window makes possible the *source of repayment*. Banks will be able to take advantage of local, organic growth opportunities (due, in large part, to in-market bank failures, takeovers of competitors by out-of-town players, and improving conditions in the local economy) or growth through mergers and acquisitions. Banks will also be able to generate retained earnings and later take advantage of markets friendlier towards community banks (in terms of valuation multiples) to replace funding with a less-dilutive—or dare we say, accretive?—capital raise before the dividend rate jumps to 9%.

As investors, we should welcome the wisdom of the pithy axiom: Be astute, don't dilute! But, regardless of regulatory capital treatment—Tier 2 capital (for S-Corps and mutuals) or Tier 1 capital (for C-Corps)—SBLF funding should be considered an intermediate term debt instrument to be repaid or refinanced.

There are challenges in becoming more dependent on our government. But a recent blog on SNL quoted Tim Goodsell, CEO of Hyde Park Bank & Trust Company in Chicago, who summed up the situation well:

The intrusiveness of the regulatory process even in the best of times...pretty much give the government the ability to control your bank whenever they feel like doing so. They are judge, jury and executioner without limit. Since that is the case, I don't mind accepting capital from Uncle Sam on terms that would be unavailable to me in the private sector.

Bottom line: If a C-Corp bank wants to grow and/or refinance TARP, why not take down this non-dilutive, low-cost form of capital that qualifies as Tier 1 capital? If so, then view this as 4½-year debt financing, develop primary and secondary sources of repayment, and revisit the plan every quarter. Shareholders can then avoid the pain of dilution while enjoying your bank's growth unrestrained by austere capital conditions.

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