

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: November 30, 2009
SUBJECT: The FDIC Opportunity

By now you have begun to hear of the increasing number of failed banking institutions being assumed by their healthier cousins. These FDIC-assisted transactions, stripped nearly clean of downside risk, can provide excellent opportunities for banks to consolidate their markets and grow. But as failures increase and the vultures do too, it will take a demure and patient buyer to achieve success. The transaction process poses its own uncertainties, and the resulting combination of businesses will inevitably cause headaches and entail costs that are unforeseen.

Many banks and investor groups are salivating at the prospect of quick growth through FDIC-assisted transactions. Many will fall flat on their faces, either paying too much, failing to perform thorough due diligence, or underestimating the difficulty of working through a portfolio of soured loans. Investors will do well to ensure the institutions or groups they invest with have done their homework and are prepared for a long haul ahead. There will be little value in the transactions executed by banks or investor groups that don't meet those criteria.

The opportunity is clear. For banks, there is the chance to add assets quickly. Unlike unassisted transactions, however, the FDIC will cover 80% of the losses on those assets that go bad (up to an agreed upon threshold, after which the FDIC will cover 95% of the downside). With this growth in assets will come the bank's opportunity to consolidate in its market or, as some have already done, expand into new markets. But the FDIC will also tag along. Bankers will do well to assess their appetite for far more frequent contact—and entanglement—with their regulators once they have purchased the assets and assumed the liabilities of failed institutions. The FDIC is charged to take the "least cost" route of disposing of failed banks. Writing off an asset (purchased in the FDIC transaction) will now become a balancing act, harmonizing the interests of the bank and its shareholders with the FDIC fund. The opportunities to cross the regulators in this process will be myriad.

Not only will banks have the FDIC to worry about. They will need to be prepared to actually work through the bad credits at the purchased institution (remember, the FDIC is watching). This will require a team of devoted credit professionals with the experience and wherewithal to manage the junk they find. They can be assured that they will not find all the junk before they have committed to the transaction. (On a side note, many failing banks will attempt last ditch efforts to raise capital or sell their institutions in the months before they fail. These efforts may provide opportunities for buyers to begin due diligence well in advance of the extremely expedited timeframe offered by the FDIC.)

Banks that commit themselves to expansion through FDIC-assisted transactions will also find, in many cases, that poor credit quality is only one of the problems they have inherited. Whether through a misguided attempt at quick growth or to take advantage of cheap deposits, many failed institutions built their deposit franchises through non-core deposits. These franchises will be of little value to the buyers, who will need to be highly aware of the deposit makeup before they bid.

This is not an attempt to build a case against investing in FDIC-assisted transactions. Quite the opposite: these transactions provide excellent opportunities for growth and consolidation, while minimizing risk. But risks remain. The effort, headaches, time, and costs involved in working through the nasty credit portfolio may be prohibitive to banks unprepared for the task. The increased regulatory involvement and chances to incite regulators to displeasure and action are important considerations. They will become even more important once Congress or the media inevitably decide that FDIC-assisted transactions are

yet another example of corporate welfare for the banking industry. Finally, even though the strategic potential of these transactions will remain high, as more banks fail and the pool of buyers grows, the competition will drive down the financial potential for FDIC deals.

We are mindful, as always, of the financial, regulatory, and execution risks these transactions present. As we survey the field, however, we are confident we will find buyers that can harness the potential of these deals and succeed in building highly valuable banking organizations.

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PARTNERS

CAPITAL MANAGEMENT, LTD.

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

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

www.fortresspartners.com

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