

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: December 4, 2006
Subject: Getting It Right

We all wish we could. Get it right, that is. You do, we do. And we hope that we “get it right” more often than not as portfolio managers picking micro and small-cap banks. We think Rich Karlgaard, publisher of *Forbes*, “got it right” in his column, Digital Rules (see November 27, 2006 issue). That column entitled “Our Challenge is Change, Not Globalization” points out that America’s role in the world was the “alpha issue of the Nov. 7 election . . . [and] is certain to be the big issue again in 2008.” “Economic globalization” is all wrapped up in America’s role in the world.

Politicians on the left and the right are each divided between “globalists” and “antiglobalists.” The globalists see the world integrated through trade, financial flows and knowledge—a recognition that the factors of production are used on a world-wide scale. The antiglobalists, like Lou Dobbs of CNN fame, are engaged in “nightly rants against global capitalism” and others, like radio talk show host, Michael Savage, trumpet a theme of “borders, language and culture.” Karlgaard thinks that as antiglobalists rise on both the left and the right, they “dangerously mistake the symptom for the cause.” He sees the cause of our nation’s angst as change, not globalization.

In the December 11 edition of *Forbes*, Karlgaard in Digital Rules says that the antiglobalists may sound futuristic but that actually “want a slower pace . . . which would slow progress . . . by draw[ing] the curtain on international trade and hike risk capital costs with higher taxes.” The yellow caution flag antiglobalists on both the left and the right want to throw over the economy is “tied to economic speed-sickness and nostalgia.”

We think he has gotten it right! As the pace of economic and business change accelerates “wildly and unstoppably”, we see many in the business community and the banking community, out of breath, falling by the wayside. How has this all happened? Here are a few of Karlgaard’s observations:

- **Declining cost of technology:** The cost of technology is coming down fast. For example, the 312-MHz chip in a Blackberry 8700 costs \$20 and the Blackberry itself cost less than \$300. In 1989 a 33 MHz chip in a Compaq DeskPro 486 computer cost \$13,999 in 1989 dollars. The performance/cost ratio of the Blackberry chip is 675 times greater than the 33 MHz chip.
- **Billions can afford technology:** By 2010 two billion people will own phones with Web browsers—two billion people with “tickets to the global economy.”
- **Internet search and transparency:** Ten years ago, competitive research on operating models and economics of any industry or business would have cost tens of thousands of dollars from McKinsey & Co. or Goldman Sachs. Today it can be performed by bright MBA students with access to Google a lot faster and for free.
- **“Mash-up economy”:** A startling new development, according to Karlgaard, is the ability of firms to build customized enterprise software for smaller businesses using “prefabricated” code.
- **Lots of risk capital:** He calls it a “glut”. There may be something like “\$2.1 trillion” in venture, private equity and LBO funds looking for investments. The point is that “large publicly traded US companies no longer have a capital advantage over smaller and nimbler . . . private companies. The companies with the best prospects will get the money.”
- **Incredible capital efficiency:** “Craigslist, an on-line classified advertiser, . . . generates \$25 million a year and has just 24 employees . . . [but] with its vastly lower costs . . . is like a terrorist threat to the \$30 billion-a-year US newspaper classified-ad business.”
- **Amazing human capital efficiency:** “Each new generation of tech leaders does more with fewer people.” Google, on a forward basis will generate \$1.3 million in revenue per employee—twice the level as Microsoft, Intel and Cisco.

Karlgaard’s list of changes can take your breath away. As we see it, these changes and more like them are sweeping all businesses in America today, including banks, large and small. While the big guys focus on

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globalization, the small banks, like those in which we invest, can put readily available technology together with highly efficient human capital and the increasing availability of risk capital to run circles around their big bank cousins.

Here's how they've done it.

Affordable Technology: Take for example **asset-liability management**, a function which is a key determinant in the profitability of any financial company, especially a bank or thrift. Through a fairly complex set of calculations, a bank can determine the appropriate pricing and maturity mix for its loans, investments, deposits and other borrowings to maximize its net interest margin. Net interest margin generates more than 75% of the revenues of the typical bank. Twenty years ago, only the largest banks could afford the software and hardware to run such complex programs. With the advent of desktop computing, such software programs found their way into the more progressive of small banks by the early nineties and today, such software is available for just a few hundred dollars. Where, in the past, it may have taken a man-week every month to create just one simulation, it now takes only a few minutes. Similarly, advances in CRM or customer relationship management software enable even small banks to view each of their client's total relationship with the bank on a desktop PC.

Or how about **Web-based banking**? We can't afford to invest in any bank that doesn't use the Web to provide products and services to its individual and business clients. We routinely ask our banks what kind of penetration our have they achieved with their Web-based services. One of our banks does very well in this regard with over 35% of its business and individual client base using Web banking—and the percentage is increasing industry-wide. It may seem counterintuitive to find ways to keep clients out of your offices but it saves them time (and time is still money) and allows them and their employees to be more productive. Many clients prefer this "self-service" approach for routine banking transactions. A more recent development, remote capture of deposits in a client's office through terminals provided by their bank, allows a client to deposit checks without "going to the bank" and gives them immediate credit for their deposit.

Yes, small banks like the ones in which we invest are **getting it right**. They are investing in and optimizing their use of low cost technology at a faster pace than their larger competitors because they are not tied to legacy systems in which their IT guru has a vested interest.

Availability and Efficiency of Capital (risk and human): There is **equity capital** available for banks with the best prospects (and even for those whose prospects seem mediocre to us). Not, perhaps, as much capital as there seems to be "sloshing around" as Karlgaard describes it, for retail, commodity or technology businesses, a few of sectors that seem to have gotten headlines recently, but plenty, nonetheless. We see the best banks focused on managing and optimizing their capital structures. Some of the banks in which we invest tweak their capital structures annually with small private placements of common equity and trust preferred shares (and speaking of which, the process to issue the latter has become so incredibly efficient that today's trust preferred issuing banks have virtually no issuing costs). Investment bank assisted offerings of common equity for start-up banks have become almost common place, making it possible for the entrepreneurial bankers to focus finding human capital.

Without fail we hear that the greatest challenge faced by our banks is finding and retaining **human capital**. Not just any old broken down lender or customer service person will do. Our banks want the best they can find—the best being defined as those with a proven track record of high asset quality, high touch service and a following of clients that will find their way to the hiring bank. Our banks have recognized the powerful combination of good people and good technology in improving efficiency. Yesteryear, banks with \$2 million of assets per employee were looked upon as being high performing banks. Today, highly productive, growing, low risk and profitable banks have seen their investment in the best bankers available pay off with assets per employee as high as \$8 million.

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In both technology and in capital, small banks, like the ones in which we invest, are **getting it right**. They have enthusiastically embraced change and are being rewarded with more attractive price-to-earnings multiples on their stocks.

But, as Karlgaard says in concluding his piece on change:

The pace of change is accelerating. Rewards are going to those companies [we'd add: "and banks"] that are exceedingly fast, clever and capital efficient. There is no mystery here, no conspiracy, no abstract villain. Globalization is not the problem. Change—that's our challenge.

Our job, as we view it, is to find those banks that seek and create change, rather than investing in those that wait to adapt to change. In waiting, the opportunity to meet and beat competition has often been passed. If we are to thrive in an increasingly globalized economy, we need to create the changes we seek. If we don't, others will do it for us.

**MERRY CHRISTMAS
AND A
HAPPY AND PROSPEROUS NEW YEAR!**

FORTRESS

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