

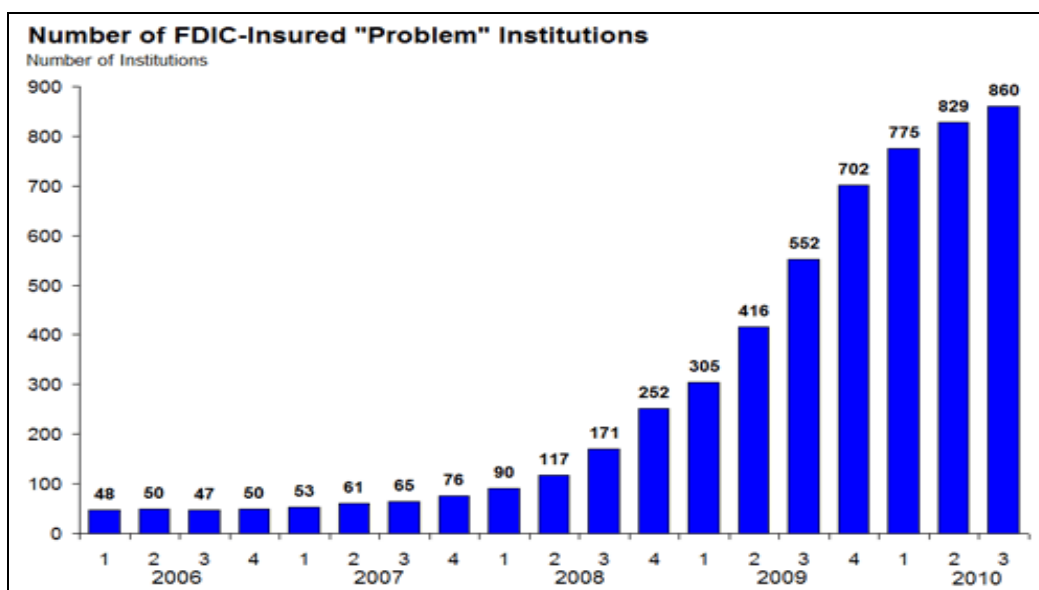
Deck the Halls – And Clear the Decks

This is the time of the year when we want and need to step back, relax a bit, spend some convivial time with family and friends, and try to push the everyday pressures into the background. It is a welcome and healthy respite. In a few short weeks, however, another year will be upon us, triggering the typical process of reviewing the last year and making resolutions which might help make the new year a better one.

We think that, for many community bankers, this process should be more rigorous than normal, and should focus on taking what may be near-term uncomfortable actions to put asset quality problems behind them (ideally, before the wrapping up of the fiscal year) and begin the process of getting capital ratios to unarguably strong levels. Neither of these steps would be at all fun, but both would be wise and far-sighted; in our view, the new banking environment is one in which a strong balance sheet is not just comforting, but can be a major competitive advantage.

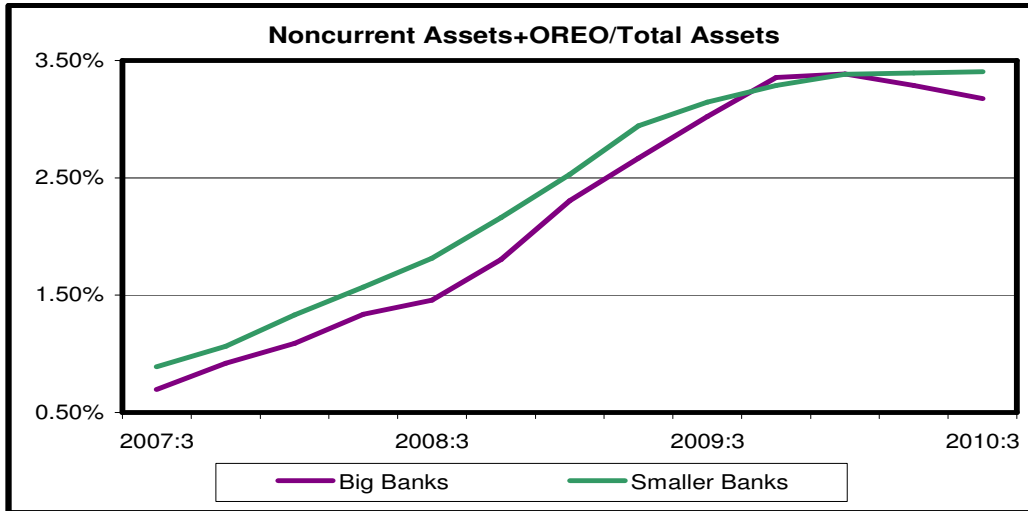
The Turmoil Continues

As we said in our last monthly newsletter, many community banks have a lot of work to do to strengthen their balance sheets; the community bank industry contains a substantial number of walking wounded – hanging on, but not healthy, and still vulnerable to life-threatening asset quality surprises. This was underscored by the recent FDIC Quarterly Banking Profile report, which showed (as we indicated in last month's report) that the banking industry still has a lot of work to do before it returns to good health. The following chart shows that the number of problem institutions continues to increase, and that is after a quite a few failures – 41 in the quarter, 127 through the first nine months. And since the number of problem banks is still climbing, we can only presume that the number of problem bank resolutions (a lagging indicator to the following chart) has quite a lot further to go on the upside.

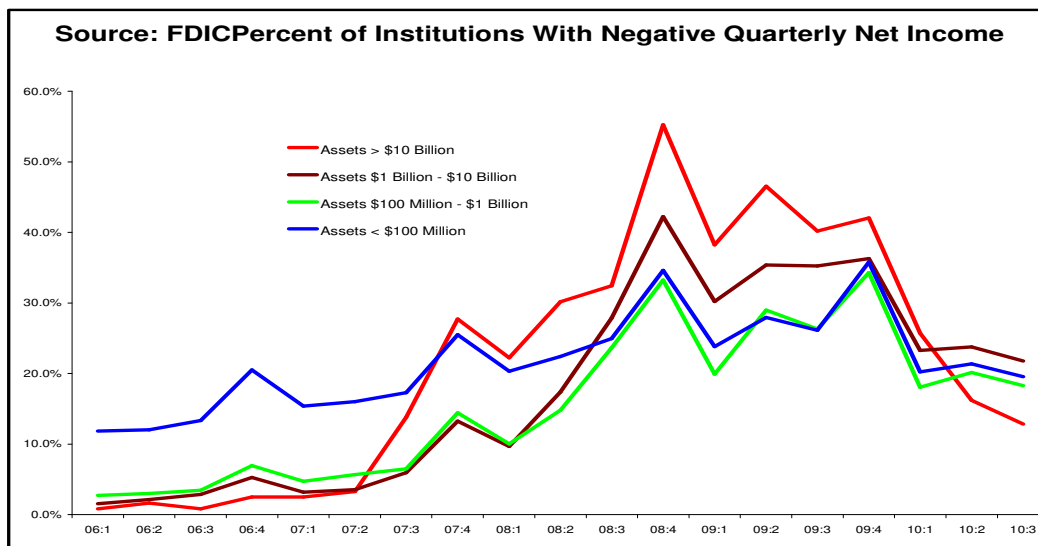


Source: FDIC

Although the number of insured institutions on the FDIC’s “Problem List” increased from 829 to 860 (the largest since March 1993), it is interesting to note that the total assets of “problem” institutions declined for the second quarter in a row, from \$403.2 billion to \$379.2 billion. This tells us that bigger banks are getting healthier faster than the smaller end of the industry. To a certain extent, the following charts bears this out:



Source: FDIC



Source: FDIC

We think the differences in the trajectories of the lines, while not dramatic, reveals a significant message: the large banks are “curing” faster than the smaller banks. **This is not because large-scale banking is inherently a better business than community banking – if anything, we would argue the opposite.** It’s simply that the bigger banks were forced by regulators and investors to more closely hew to a mark-to-market approach, taking bigger and earlier hits to get on top of their asset quality problems and accessing the public equity markets to rebuild their capital ratios after those hits. In other words, those banks that took the near-term pain to get healthier (though they are still not adequately healthy) seem to be ahead of the curve, showing something of a rolling over of asset quality problems and consequent earnings pressures. The smaller banks, on the other hand, are showing little improvement, as many of them have been

unwilling or unable to take the large hits because of weakened capital ratios, a concentration in real estate (often CRE) loans, and an inability to raise new equity in the public markets on reasonably attractive terms.

We believe that the industry split between banks with healthy balance sheets and their weaker brethren is no longer just an analytical distinction, but will become a dividing line between those successful banks (adequately profitable and growing) and those which are not (stagnant, under constant regulatory pressure, and struggling with unhappy shareholders and disheartened employees). In our view, we are not just in the midst of a transition from one year to the next, we are in a transition from a time when virtually all banks have been completely inward-looking into a time in which a smaller subset of banks, having taken the necessary rebuilding steps, will be able to grow – typically at the expense of their weaker competitors.

Looking just at the community bank segment of the industry, we believe that the banks now fall within one of three camps – those which have taken the steps necessary to be prosperous, those which have been so hammered by asset quality problems and capital erosion that success (even viability) is doubtful, and the large group in the middle that can probably survive but are unlikely to prosper unless they, with intense effort and some additional pain, push themselves into the top category.

Banks on the high end of the spectrum, because they avoided the practices that brought on the industry misery or because of early and aggressive response to asset quality and capital problems, are in an enviable position, and we would counsel them to take advantage of their competitive strength. We are convinced that we are entering a period of consolidation within the community bank industry that could rival that of the mid-1990s, with bank failures opening up market shares for the taking as troubled bank managements and board decide to toss in the towel rather than continue to fight seemingly interminable battles against asset quality, a sluggish economy, and difficult regulators. These healthy banks could indeed be looking at the opportunities of a generation, and we recommend that they position themselves to take full advantage by thinking critically about what their acquisition strategies should be, developing planning outlines for possible transactions, and discussing their thoughts with their accounting, legal and financial advisors. Waiting until an actual transaction is at the doorstep would be asking for trouble.

Banks in the bottom tier – for example, those with Texas ratios of 100 or more – are in a much grimmer situation. Those that need to burn up virtually all of their energy in getting healthy, those that are under the regulator's microscopes, will not only be unable to expand their loan portfolios, but will tend to shrink their asset bases as a backhanded way of achieving higher capital ratios. In other words, franchise value will be eroding further. Regulatory pressure to aggressively resolve asset quality and capital issues, and perhaps to find an acquirer, seem likely. It strikes us that the best response would be to proactively negotiate a merger, even at less than favorable terms, which could result in a bank with increased size, opportunities for merger-related cost reductions, and improved prospects for long-term success. To state the obvious, a small share of something is better than a large share of nothing.

Most community banks in the middle segment are facing a choice: stay in a “circle the wagons” mode and survive while experiencing little, no, or even somewhat negative growth, or move onto the tough road to a stronger balance sheet and the resulting ability to grow. Unfortunately, it is not going to be easy for any middle-category bank to climb into the top tier. Badly embarrassed

regulators and examiners are not going to cut the banks any slack in terms of aggressively shrinking problem assets and boosting capital ratios, nor is new equity capital likely to be broadly available on what we would think of as attractive terms; investors have noticed that private equity investors who jumped into this group too early have been badly burned, and we're pretty sure that new equity is going to be available only to those banks which clearly can use it to achieve strong and healthy growth. Even then it will be more expensive (i.e., lower price/book, more dilutive) than we have seen in the past.

OUR MESSAGE – CARPE DIEM

The long-term rewards of Clearing the Decks should more than justify any short-term pain. If your balance sheet can handle the hit, take it now, get it behind you, and be better prepared for next year. If growth is your path of choice, then now is the time to do your body building. We believe that there will be a lot of market share up for grabs over the next few years, and those banks that have well thought-out strategies, solid management teams, and strong balance sheets should be able to acquire much of that share through acquisition and organic growth.

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