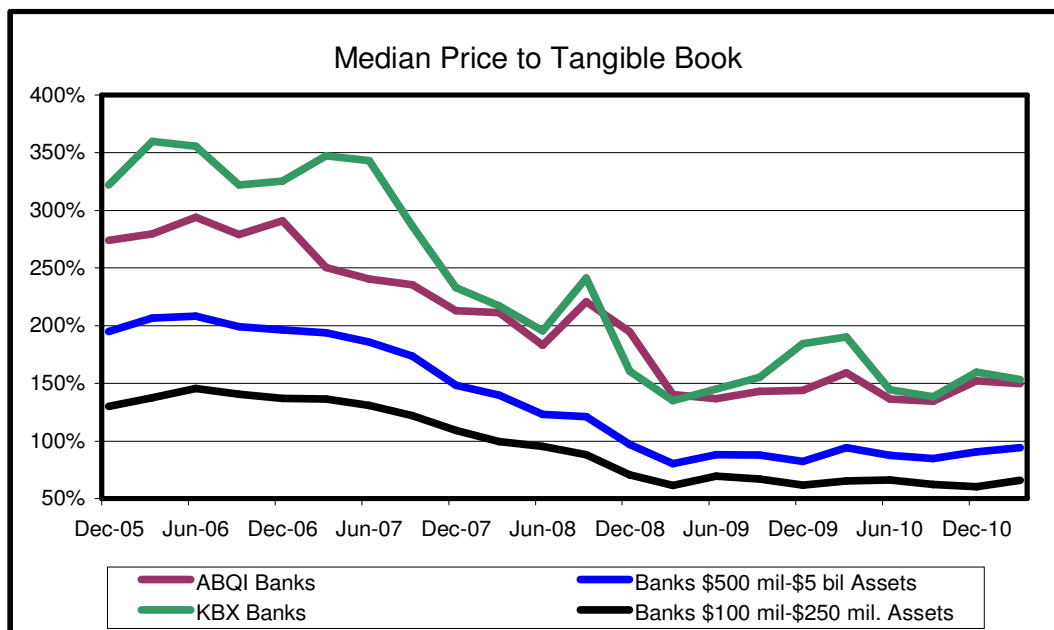


M&A in the New Reality

In last month's Community Banking Monitor, we spent a little time looking at the very low valuations of bank stocks, and in particular the shares of smaller banks. We'll start this month's report by repeating a chart from that report, with a slight modification – we added a line for smaller publicly-held banks, those with assets between \$100 million and \$250 million. As we discussed last month, there is a very clear direct relationship between asset size and valuation; the smaller you are, the cheaper you are. The smallest-bank group is even more cautiously valued than the others, as shown below; the median price/tangible book value for smallest-bank group was just 66% at the beginning of March.



Source: Highline Financial data, Oak Ridge calculations

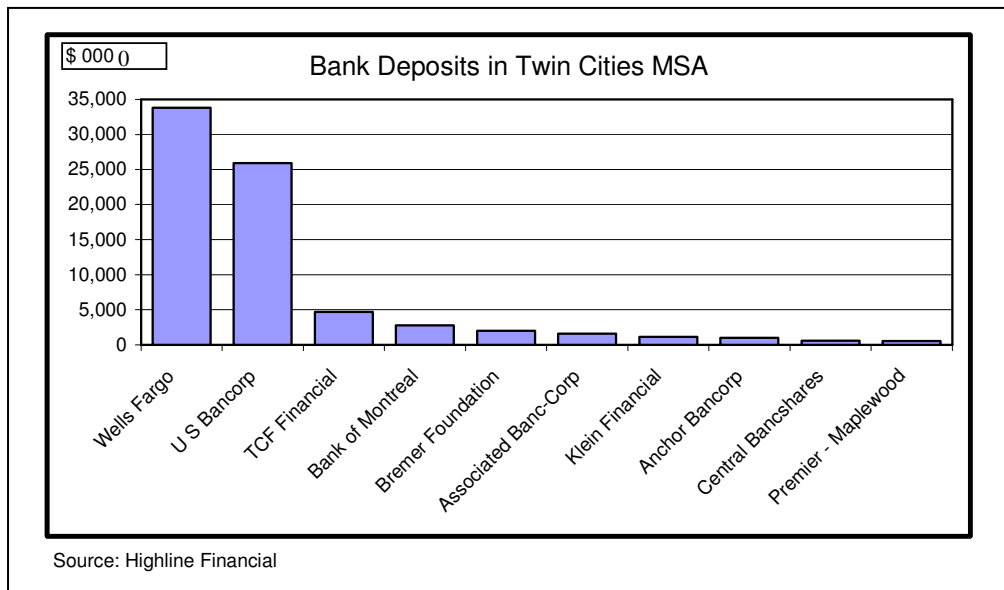
Granted, there are quite a few troubled banks in this smaller-bank group, with large holdings of real estate-based loans relative to their size, but to have a median value of only 2/3 of tangible book value seems pretty extraordinary. And while such a valuation would seem to create the potential for some attractive values for investors, it creates some very real problems for bank managements.

For one thing, access to new equity capital would come at a painfully high price – given the very low valuations, it would take a large increase in shares outstanding to make a meaningful contribution to equity, severely diluting current shareholders. Given the need for additional equity on the part of many banks, this is a giant problem, and there does not seem to be much chance of a substantial improvement in the situation any time soon.

Of course, an improving economy should help, supporting stronger loan growth and continued

reduction in problem assets, both of which would provide some boost to investor optimism about the banks and lead to improved valuations. Yet we believe that a major increase in valuations is unlikely until we see a meaningful pickup in merger & acquisition activity in the industry. To once again repeat what we said last month, it is our opinion that a substantial percentage of equity investors see the appeal of small and mid-sized banks as being their potential as acquisition candidates. Furthermore, it is our opinion that a major pickup in merger and acquisition activity will not only depend upon a clear settling down of asset quality issues, but also the emergence of a group of midsized banks willing and able to execute the “roll-up” strategy which was so prevalent and successful in the latter half of the 1990’s. To figure out how this might work, we are going to use the Twin Cities (Minneapolis-St. Paul, MN) market as an example, thinking that most other large markets are somewhat similar.

The Twin Cities has 154 financial institutions doing business in the market. The chart below pictures the top ten banks, ranked by deposits. As can be seen, bank size drops off pretty quickly; there are just a few big banks, a few mid-sized banks, and a whole lot of small banks. Premier (number ten on this chart) has a bit over \$500 million of deposits, number 20 (not shown on the chart) has slightly over \$300 million. In effect, we have a market with something of a barbell structure.



This structure has significant implications for the potential for consolidation (mergers and acquisitions) in this market. In our opinion, neither of the two “giants” (Wells Fargo and U S Bancorp) would have any great interest in acquiring \$200 million or smaller-asset banks in the Twin Cities, nor would the mid-sized banks – TCF, Bank of Montreal (which recently bought M&I), or Associated Banc-Corp – get very excited about the prospect of acquiring such small banks. Bremer is somewhat unique by its ownership structure and would therefore be a cash only buyer. Additionally, broadly speaking, there is a significant amount of impairment in the market both on the part of potential sellers and acquirors which has delayed the onset of significant M&A activity

In sum, we have a real shortage of banks with acquisition currency, a track record of making successful acquisitions, and the \$2-\$3 billion of assets that would be required to make a \$300-\$500 million-asset bank a relatively easily-digestible acquisition.

Bulk Up?

In other words, a viable list of active roll-up buyers has yet to be created in the Twin Cities. If you look at other markets, there may currently be active buyers, although we believe that more are necessary to effectively consolidate the markets. We believe that it will happen, since the opportunity seems so attractive in this essentially healthy economy and fragmented community banking markets. In recent months, we at Oak Ridge's Financial Institutions Group have had the opportunity to meet with several Boards of Directors, management, legal and accounting advisors and regulators to discuss the current market place. As might be expected, these discussions have been centered on loan impairment, capital raising, bank stock valuations and the need for new capital and or consolidation. Almost everybody agrees that there is a lot to be done, but as of yet there has been little action.

It will, however, require some creativity. Low bank stock valuations and limited investor interest in the group make it unlikely that a bank with less than close to \$2 billion of assets could pull off an initial public offering, so the creation of one or more "roll up instrument" will likely depend on interim steps -- mergers of non-public banks, probably via somewhat non-traditional transactions. Theoretically, a major roll-up player could be created out of mergers of equals, except for the fact that history tells us that such transactions rarely work because of executive suite conflicts and questions about who actually makes the decisions.

What we think is more likely to happen is a series of "book-for-book" acquisitions, where the selling bank receives no premium and experiences no liquidity event, but becomes a part owner of a larger and more viable (and attractive to buyers) bank. Ultimately, such a bank could grow to a size that would make a public offering achievable, or to a level where it has created enough franchise value to make the bank an attractive acquisition candidate to a larger bank that wants to move into the Twin Cities market with a significant market presence (or even to another local bank executing a roll-up strategy). In sum, we think the odds favor a large amount of consolidation within the small-bank segment (say, \$100 million assets to \$500 million assets) of the Twin Cities banking market over the next five years or so.

So, What to Do?

Not everyone need choose to play in this game, of course. Given the prospects for a continuing economic recovery, a bank that has managed to survive the last couple of years and has adequate capital and manageable credit quality could probably settle into a cautious, comfortable but very limited-growth mode. Profitability should be reasonable, though probably a bit less than we experience in the past, and risk/volatility pressures should recede. Depending upon the ownership of the bank, a low-risk, modest-return situation might be quite acceptable.

If, on the other hand, a bank would like to achieve healthy growth, and perhaps a liquidity event in 3-5-7 years, then a do-nothing strategy is unlikely to be the right choice. In our opinion, the current in-flux environment is the right time to lay out a bank's strategic plan for how it wants to navigate the next several years. This would lead to important decisions on several key questions:

- Do we want to be a buyer or a seller? Although not necessarily an either/or decision, the choice of being a buyer would require an advance build-up of the additional strengths and capabilities needed to accomplish acquisitions and manage them post-deal, skills not necessarily in place in community banks. Some solid self-examination is in order here.

- Do we have a clear vision of our strategy, and what it will take to execute it? Vague goals would be of little help, and could in fact be dangerous; mergers and acquisitions create a lot of turmoil, and a clearly stated and understood business plan can significantly increase the odds of success. Again, careful self-examination is strongly advisable.
- Do we have what it takes to execute our strategy? If not, what do we need to do to get ready? Again, specific planning is required to increase the odds of success and reduce the odds of a blow-up. Skilled and experienced staff (beyond what is required to run the existing bank) and good relations with regulators, legal counsel, accountants, and investment bankers need to be put in place before any transaction occurs, not during or after the transaction.
- Who should we pick as our partners in this “bulking up”? This is a key decision, one that should be made very thoughtfully. Unlike the traditional sale, which is a liquidity event in which the overwhelming goal is to extract the highest acquisition price, a “partnering up” transaction is aimed at creating incremental franchise value that will boost earnings potential, increase the ultimate sale value, or both. In other words, such traditional and immediate issues as “what price/book am I receiving/paying?” are not so important – the seller isn’t going to get very much by historical standards anyway. The real question is how much long-term franchise value is being created. The answer to that question would involve issues such as how branch networks might fit together, how to maximize high-value deposits and high-value loans (and minimize construction, development and other real estate-based loans), and maintain or even improve our asset quality picture.

Once these strategic decisions have been made, a specific plan of attack should be developed. As stated earlier, we expect a great deal of restructuring (consolidation) of the community banking industry in such markets as the Twin Cities, and the early leaders in this process are likely to reap the best risk-adjusted returns from this consolidation.

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