Spring 2012

To our Clients and Friends in the
Financial Institutions Industry:

Walt Moeling and Jim McAlpin spoke at the 2012 Acquire or Be Acquired Conference sponsored by Bank Director Magazine. Their topic was "The Path to Recovery – Building Value in a Changing Environment." In preparation for their presentation at the AOBA conference, Walt and Jim surveyed a group of leading industry observers to obtain their insights. We thought you would be interested in what we heard this year in response to these questions, and the following is an excerpt from Walt's and Jim's presentation at the AOBA Conference:

**Background**

- 6,800 commercial banks (91% of all U.S. banks) have assets of less than $1 billion. Only 560 banks have assets between $1 billion and $10 billion, and only 106 institutions have assets greater than $10 billion. 2,500 banks (33% of all U.S. banks) have assets less than $100 million.

- Both ROE and ROA for banks with less than $10 billion in assets improved in 2011, but still were about 65% to 70% of historical averages.

- Economists surveyed by *The Wall Street Journal* expect U.S. GDP growth of just 2.3% for 2012. [*The Wall Street Journal,* December 22, 2011.]

**2012 Bryan Cave Survey**

We surveyed 50 industry thought leaders, including bank consultants and advisers, investment bankers and partners at private equity firms. We asked them to look forward over the next few years and give us their thoughts on factors considered by bankers and boards of directors when conducting strategic planning. We received more than 40 responses from across the country. Many of our respondents have allowed us to share their comments either with attribution or anonymously.

**"What will be the pace of growth in the U.S. economy and in bank assets over the next 3 years?"**

Survey respondents consistently predicted the pace of growth in the U.S. economy over the next 3 years to be between 2% and 3%.

Estimates for growth in bank assets ranged from 2% to 5% in 2012, and from 3% to 5% in years 2013 and 2014.

**Jim Stokes of SunTrust Robinson Humphrey**: *"Almost all community bank budgets for 2012 have shown zero loan growth, but improved earnings through cost control and normalized provision. Margins may improve slightly as NPAs resolve."*

**Chris Marinac of FIG Partners:** "*Bank assets, in the aggregate, likely expand by no more than 5% cumulatively from year-end 2011 to year-end 2014. If the economy expands 1.5% on average in each of the next 3 years, then the cumulative effect is 4.6%. We think a rising economic output could be funded entirely with cash and existing resources such that credit does not expand, but, since interest rates are at historic lows, we think credit expansion still occurs and probably mirrors the macro GDP figures nationwide*."

**Bill Wagner of Raymond James**: "*I think you have to separate the banking industry into sub-segments. The larger banks will return to normalized profitability within the next two years. However, smaller community banks will unlikely return to pre-recession profitability within the next three years due to margin pressures, credit costs (especially in the Southeast) [and] regulatory burdens."*

**"What changes should be expected in profitability for top quartile performance banks by year end 2014?"**

For banks under $500 million in assets, survey respondents predicted 2014 ROA in a range of 60 bps to 90 bps and ROE between 8% and 10%.

For banks between $500 million and $1 billion in assets, respondents predicted 2014 expectations for ROA in a range of 70 bps to 100 bps and for ROE to fall between 9% and 11% in that same time period.

For banks between $1 billion and $10 billion in assets, expectations for 2014 ROA ranged between 100 bps to 125 bps, with ROE for the period predicted to be between 12% and 15%.

For banks with assets over $10 billion, 2014 predictions for ROA ranged from 115 bps to 130 bps, with ROE predictions for the same period falling between 12% and 15%.

**We next asked our survey respondents about anticipated acquisition multiples by year-end 2014.**

From the responses we received, it appears that 1.50x book is the new 2.50x book.

For well performing banks with under $1 billion in assets, our survey respondents predicted a range of 1.25x to 1.50x book and 12 x to 14 x earnings by 2014.

Again this year, a number of our respondents shared the view that the greatest likelihood for "premium" pricing will be for banks between $1 billion and $10 billion in assets. A range of 1.50x to 1.75x book was predicted for banks in that size range, with the possibility of 1.75x to 2.00x book for the very strongest. Price to earnings predictions ranged from 13.5x to 18x.

**"What conditions will need to exist before the open M&A market becomes vibrant again, and when do you think that may happen?"**

Instead of a summary of the responses, we have included below a few of the responses to this question that capture the overall sentiment of our survey participants.

**Chris Marinac of FIG Partners**: *"In my opinion, the calendar just needs to turn another 3 to 6 more months and more signs of credit stabilization just need to naturally occur. We think folks will be pleasantly surprised to see the natural "mating process" happen on its own in 2012. [This will] start really slow but modestly gain momentum as 2013 unfolds, and by 2014 it will be a great deal different."*

**Peyton Green of Sterne Agee**: *"Rising collateral values (real estate) are the key. ALL of the buyers we speak to are at best suspicious of the marks that targets have taken. Sellers need to become realistic about the pricing conditions. Fair Value accounting and weak real estate conditions remain the biggest hurdles to clear."*

**"Assuming adequate capital and the absence of any special regulatory restrictions, what are the most important steps that a bank with $250 million in assets could take over the next few years to build greater market value in its franchise?"**

We've picked a few responses that capture what we heard from many of the survey participants.

**Curtis Carpenter of Sheshunoff**: *"Organic loan growth is quickly becoming the key to community bank profitability. If the current low-interest rate environment persists, the ability to generate loans will become the distinguishing characteristic of profitable banks. Consequently, those banks with proven loan generation capability will fetch the highest prices in mergers."*

**Jon Winick of Clark Street Capital**: *"Focus on 2-3 things that differentiate your bank and leverage your capabilities. While it may make sense to diversify beyond commercial real estate, don't blindly follow the herd into C&I lending. In fact, it is going to be difficult for most banks to grow assets organically without considering commercial real estate. While expense control is important, do not ignore the revenue side. Poach a high-quality lender from a larger competitor so that you can demonstrate portfolio growth."*

**Jeff Brand of KBW**: *"Dominate your 'micro' market as it relates to deposits and your lending competency and try to achieve critical mass (~$750m)."*

**Mark Ross of Stifel Nicolaus:** *" . . . Clean house on the credit side until you have a pristine portfolio. Take the pain as soon as possible. [If you] have ability to expand the franchise . . . be in the most desirable locations (although that is a moving target)."*

**Bill Herrell of Morgan Keegan**: *"For a bank <$250MM in assets, preserve capital by managing NPAs and expenses closely while building local deposit market share. Growth will continue to be constrained by increased demands for higher capital ratios and lack of access to outside capital. By building a local deposit base, there is a higher likelihood you become a favored target in your market. You can then take the capital you have preserved and "invest it" in the larger buyer's liquid currency."*

**We then asked our respondents how their answer would change for a bank with $1 billion in assets.**

**Mark Ross of Stifel Nicolaus:** "*The same [as for smaller banks], except with a greater ability to expand de novo locations to optimize desirability to an acquirer or make small acquisitions of branches . . . "*

**Sal Inserra of Crowe Horwath**: *"Need to hire a very good treasurer who sees an investment portfolio as a viable alternative for long term objectives so we don't chase every new fad. Need to revisit investing capital in brick and mortar. No more columns and elevators. Need to be leaner and more techno savvy . . . . Technology will be the key to growth. Need to also identify your profitable customers. Since banks this size are typically inefficient, there are a number of smaller customers that are a net cost to the bank they cannot afford."*

**Matt Kelley of Sterne Agee**: *"Banks with healthy capital should be buying back stock more aggressively when trading at discounts to TBV. Need to have faith that terminal values for healthy banks (1.6x TBV in Northeast) will at least hold steady over the next several years. Buying back shares below TBV is a safe and well received use of capital Also shows the investment community your own positive view on valuation and future value."*

**Our next question was "What are the most significant factors in achieving enhanced profitability for a typical bank with $250 million in assets?"**

- One of our survey respondents wrote that a bank in this size range should focus on efficiency: "For every dollar of expense we are going to get $2.00 to $2.50 of revenue."

- Another responded that a bank should not be afraid to consolidate jobs.

- A common response was that a bank should focus on non-interest income and exercise tight control on cost of funds (deposit pricing).

- Many responded that the most important factor is credit quality, especially since the profit equation is so fragile.

**We then asked if there are different factors to be considered for a bank with $1 billion in assets**. **The responses included**:

- A greater emphasis on inexpensive core funding;

- Develop a robust wealth management practice. This service can deepen the client relationship and provide consistent fees;

- Do not be afraid to try new initiatives; and

- Recognize that efficiency is key at this level, given lower yields on larger credits.

**Finally, we asked if the respondents had any other advice for bank management.**

**Bill Herrell of Morgan Keegan**: *"Let's get the boards and management to think about strategy as a series of options versus sequential decisions. If the chosen strategic path doesn't work then the other options may have expired by the time you decide to pursue them. Making either/or decisions on strategy assumes options are mutually exclusive. In volatile times like these, execution on any option is difficult so we need to pursue various options simultaneously. The capital markets, regulators and competition are too dynamic to pursue options sequentially."*

**Phil Moore of Porter Keadle Moore:** *"Sometimes the blocking and tackling basics are a competitive advantage – provide the services desired on par with the big banks with care and concern."*

**Paula Johannsen of Carson Medlin**: *"I don't know what the PV of owning 100% of the risk and waiting for better market multiples is, but I think that it's not as much as perceived. Therefore, we would advise most of our clients to consider seeking partnerships now – it's likely to remain a buyer's market for the foreseeable future."*

**Geri Forehand of Sheshunoff**: *"Determine if your bank intends to remain independent. If so, the best way to control your own destiny is to achieve high performance."*

## What is the Bryan Cave perspective?

There is no industry that has such a vast array of financial data transparently available. Transforming data into a functional strategy is seldom easy, but our group is continuously monitoring the regulatory market and industry conditions. Based on the information we have been provided and our own experiences in representing over 400 banks coast to coast, we offer the following:

- We can once again anticipate economic growth (which is a plus), but as always, it will vary greatly from market to market. For most markets, including traditional Sunbelt markets, particularly those plagued by the real estate declines of the past four years, economic growth for the next three or four years should continue to be slow, in the 2%-3% range.

- There is a strong consensus that regulatory costs will increase, regardless of the size of the bank. These costs will be both direct, as compliance costs grow and FDIC considers the appropriate level of the deposit insurance reserve, and indirect, as the costs of higher capital requirements eat into return on equity.

- Slower growth, higher capital, and higher costs will limit the ability of banks to achieve traditional returns on equity, and for many banks, single digit returns on equity of 8%-9% will represent a significant return.

- For many directors, the new economic reality is totally inconsistent with their ongoing expectation of 15% returns, 2x to 3x book purchase prices, and 15x to 20x price to earnings multiples. Too many directors have not confronted this reality as part of their ongoing strategic planning.

- Banks will have to rethink both their board and management/employee staffing. Directors will have to work harder and longer and be more sophisticated in their approach, regardless of the size of the bank. Employees who are not highly motivated and adequately trained to take on their new tasks in this different environment must be retooled or terminated. This will happen automatically if the bank fails or is sold, but in order to survive and prosper, the bank itself will have to take these steps.

- Core deposit relationships will again be recognized as the primary basis for bank value, and a technologically current platform will be essential to both attract and retain core deposits. The development of technology in payments and other areas has not slowed during the past four years, but for many banks, staying current or adapting to these changes has not taken place. Leveraging core deposit relationships can and should be done to generate current earnings.

- With more modest returns on equity, bank investors will be seeking less volatile and more stable returns supported by increasing dividend payments. This is a return to the model that banks followed until the early- to mid-nineties, when growth and the availability of virtually unlimited leverage caused many investors to be attracted to growth over consistent profitability. As the world at large is less leveraged, we believe a stable and continuing return in low double digits will produce strong investor interest as stability and current returns drive a more stable investment environment.

- Good banks will continue to rid their balance sheets of problem assets, since stable returns cannot be achieved so long as a significant percentage of the loan portfolio is classified or non-performing. We have yet to find bankers who have complained to us that they were unhappy that they sold problem assets and wish they could reacquire them for the price they received.

- Do not count on M&A for an exit strategy: Asset quality concerns, purchase accounting marks, modest share pricing of acquirer's shares and competition from failed bank sales will continue to dampen acquisition prices and thus activity. Nonetheless, it is wise to monitor what factors are being valued by acquirers.

- In this changing environment, banks, boards, managements and employees must all be refocused on rational objectives that are consistent with both the capacity of the individual banks and the markets in which they operate, and, having achieved that refocus, must devote significant attention purely to execution. The time for bemoaning the fate of tougher regulation, higher capital, lower returns, etc., has passed. We all must recognize the world in which we are now operating and get about the business of serving our constituents once again.

From all of this, we are optimistic that banks aligned as described above will be successful for as many years going forward as they wish. While size will make some of these matters easier, we also believe that with significant focus and the proper board and management team, even small banks can prosper. Everything is relative, and the days of 2000-2007 of unlimited leverage and "Regulation Lite" will not soon return, but so long as banks are able to keep their focus on their constituents, their communities, and their strategic objectives, they can succeed.

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We would welcome the opportunity to discuss the results of our survey with your management team or Board. Please feel free to contact any member of the Bryan Cave Financial Institutions Group.

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