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COMMUNITY BANK VENTURES

NEW BULL MARKET OR BEAR MARKET RALLY?
A ROUNDTABLE DISCUSSION

Community Bank Ventures hosted a roundtable on July 1, 2009 with three leading fund managers in the community bank industry. The roundtable discussion focused on:

1. The Bank Stock Rally
2. NPA Trends
3. TARP
4. Bank Failure Trends
5. Profitability
6. Regulatory Trends
7. Fund Manager Top Bank Picks
8. Commercial Real Estate Trends – Impact on Bank Stocks

The following article is a transcript from the roundtable discussion.

The roundtable was moderated by Jeff Rigsby, President and CEO of Community Bank Ventures. The participating fund managers were:

David Moore *is the Managing Member of Marathon Financial Ventures I, LP, a private equity fund focused on investments in private and micro-cap banks and thrifts. He is an organizer and director of Embarcadero Bank, a 2006-vintage de novo commercial bank based in downtown San Diego, California. In addition, he is a director of First NBC Bank Holdings in New Orleans, Louisiana. David also provides ongoing investment advisory services to a fund-of-funds with over $4 billion in assets under management.*

Han Schroeder*, is the portfolio manager for Green Street Capital Management, an investment advisor specializing in small-cap financial services companies. Mr. Schroeder has been analyzing and investing in community banks and thrifts for 19 years. Green Street's subsidiary investment fund, the Green Street Regional Financial Fund, has been one of the top-performing long-focused community bank investment funds in the country since 2002.*

> *"…a number of the natural buyers of small bank stocks such as locals and small investment funds , are bruised and fatigued by the longevity and severity of this particular bank stock bear market."*
>
> -Hans Schroeder

Darren Tymchyshyn*, CFA is a Member and co-portfolio manager of Hot Creek Capital, L.L.C. Mr. Tymchyshyn has over eleven years of prior experience as an analyst and investor in Financial Services Companies. Mr. Tymchyshyn earned a B.S. from Cornell University.*

BANK STOCK RALLY

Rigsby: Is the current rally in big-cap bank stocks the beginning of a new bull market or just a bear market rally and why?

Schroeder: I think the big-cap banks have seen their lows for this cycle though I do not think that the current rally resumes until it has a test of those lows. I am not convinced that a robust economic rebound will be forthcoming in the third quarter.

Tymchyshyn: I think on the large-cap names, we went from an Armageddon and global depression scenario to the reality of where we are today, and that is a pretty severe recession and that these guys need capital. They continue to

Continued on Page 2

VOLUME 4, SPECIAL ISSUE

In this issue:

JULY 1, 2009

Announced Last Three Months:

* De Novos: 7 Filed, 5 Approved, 7 Opened
* 35 Bank Mergers (April-15, May-8, June-12)
* 45 Capital Offerings Totaling $589 Million
* Approx. 9,923,144 Shares Authorized for Repurchase

Note: Capital Offerings ***ONLY*** *include Banks below $3B in assets.*

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 1

need capital. The reality of the recession we're in I can't see them moving materially higher until we get some clarity on how bad commercial real estate is going to be, how these banks are going to be moving the assets off the books, and when the consumer finally gains traction de-leveraging their own balance sheet.

Moore: I agree with all of that. I don't think we're going to go back to the lows that we saw previously only because the banks have been able to raise a lot of capital and I think the economy is still declining, but at a declining rate, so I would say that that would argue for not going back to Armageddon valuations. But I think that the recent rally's extent has been more than is justified by the current facts. So I would think that we'll get some sort of a pullback at some point once we start to see commercial real estate losses coming through. And also a lot of the leverage loans and other stuff like that is going to be refinanced this year or next year and into 2011, which will cause some problems.

So I guess, yes, we're kind of into a new bull market-in that I don't think we're going to pierce through the previous lows, but we've probably gone a little too far in this rally.

Rigsby: Why did the small- and micro-cap banks lag so dramatically in the recent rally?

Tymchyshyn: Well, obviously, liquidity. It's tough to buy these names so you're not going to jump into them first because you can't make a quick buck like people think you can in the large-cap names. A lot of funds that specialize in this niche like we do have either died or are dying and they're choking on this illiquid stuff. They'd love to find a bid to move it. So knowing that there are still sellers out there that have to move the stocks, why step in and buy at any price unless you think you're stealing it?

Also, look at the community bank's balance sheet – the majority has a concentration in commercial real estate and that's a major issue today. Until we get some clarity on how bad that's going to be, I don't think they will rally materially.

Schroeder: I agree with that. I think a lot of the rally that took place was in banks that had large short interest ratios or had riskier operating models. In addition, a number of the natural buyers of small bank stocks such as locals and small investment funds , are bruised and fatigued by the longevity and severity of this particular bank stock bear market.

Moore: Yeah, I think one thing is that KBW Index was down 86 percent peak to drop, and I believe the NASDAQ Bank Index and the SNL Micro Cap, I think they were down 65 percent. So I think the large caps got beaten up more than the small caps, so the big caps have had a bigger rally, playing a bit of catch-up performance wise.

So the micro caps didn't fall as fast as the big caps in the first place, and as Darren was mentioning you can't trade the micro caps. So if you're going to buy these micro cap banks, you've got to buy them to own them. And so that's why I think that part of the large-cap rally is overdone because the people aren't willing to buy the small-cap stuff and actually hold on to it, and it looks to me like at least some portion of the large-cap rally is just one big trade. It could fall apart at any minute.

Schroeder: Another component, I think, is the fact that normalized earnings have become the current standard in terms of valuation for the large caps, whereas that hasn't been accepted with the small caps, which are still trading on a burned down tangible book value methodology. So they're valuing large cap banks on 2011 to 2015 normalized earnings, whereas that's not happening in small caps.

Moore: But actually, also one issue that Darren brought is commercial real estate. Two factors to consider are: (1) the smaller banks are less leveraged than the larger banks, and (2) the balance sheets, even though they have a lot of commercial real estate, they're more transparent. So I think you could argue that, generically, the community banks are in better shape than the

Continued on Page 3

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 2

really big banks in the country only because there's less leverage and greater transparency. It's easier to understand what they've got on the balance sheet.

I wouldn't say that the balance sheets of the community bank, and again, outside of those banks that have a lot of construction and development exposure, I wouldn't say that the banks that just have a lot of commercial real estate exposure are necessarily more risky than the larger banks.

NON PERFORMING LOAN TRENDS

Rigsby: When will non-performing loans peak and why?

Moore: Well, obviously, it's just a guesstimate. I would say some time maybe around the end of next year. I think the construction and development problems are probably going to peak towards the end of this year and we'll see the industrial loans- commercial and industrial stuff - probably peak in the middle of next year, and then commercial real estate problems I'm guessing will peak toward the end of '10.

So my guess is, again, it's just a guesstimate, I would say some time around the end of next year we'll see asset issues peaking based on all of that 2005 and 2006 adjustable commercial real estate production that needs to be rolled over at the end of next year and the beginning of the following year. So that's my guesstimate.

Tymchyshyn: I have nothing to add to that. I agree with David and everything he said. If anything I would push that off maybe to 2011 just because a lot of these commercial real estate loans you can't re-finance them anywhere so you're stuck with them. With cap rates rising and rents coming down as quickly as they are and commercial real estate being a larger part of the balance sheet with community banks, I think that's going to be more of a longer-term issue in 2010. I think it's going to go into 2011. But that being said if houses start selling and they're building again and they can rid their selves of their construction and land development loans, maybe it might be 2010 but I'm more in the 2011 camp.

Rigsby: When should banks rally or when do you think we'll see the bank rally come back based on what you've just said?

Moore: Sometime next year, I don't know. Sometime in 2010, I guess.

Tymchyshyn: I guess I agree. I have no idea. If we knew and could time the market like that, we probably wouldn't be sitting in this discussion today.

Schroeder: Like we've seen in previous cycles, the banks rally six to nine months before the peak in non-performing assets. I don't think that it's going to be different this time. However, community banks largely trade on secular M&A trends and I don't see premium M&A transactions picking up prior to nonperforming assets peaking. So it might even be a little bit further out.

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>
> -Darren Tymchyshyn

TARP

Rigsby: What's your opinion of community banks and TARP capital and why?

Schroeder: For certain community banks I think it's not a bad idea. It's cheap capital for the most part, especially if you're not listed. And there are few alternative sources of capital for banks of that size at this time.

Tymchyshyn: I think for the small private guys who need the growth to build out their franchise, I would agree it's kind of a cheap form of capital. For the larger guys who are publicly traded and might have access to the capital markets, I view it as its capital but you've got to re-pay it and you got to somehow re-pay it out of earnings or out of a new capital raise in the next five years. So as an investor, I sure hope you qualify for it but don't take it unless you absolutely need it.

Moore: I like it for a couple of reasons: (1) It's relatively cheap capital; (2) I like it because of all of the restrictions that the government is placing on what the banks can and can't do. And so I know a lot of banks hate it for that very reason, but as an investor I kind of like the fact that there's caps on salaries and all that other sort of business because the chances are that if you took the capital, there's at least a hint of something that you're nervous about, and, obviously, as management you put your bank in that position.

The other thing I like about it is that it's going spur merger activity. If you have TARP capital you're probably more likely than not going to end up having to look for a merger partner five years down the road because not everyone is going to be able to re-finance that debt. You know, as Darren mentioned it really is just debt. So I like the fact that it is going to push a lot of people to sell.

BANK FAILURES

Rigsby: How many bankers are going to fail during the cycle?

Moore: I'm going to guess and say 400. I think we're at, I'm guessing we have about 80 for this cycle if we start with the Metro Bank back in '07 or whatever it was, the bank in Pittsburgh, so I don't know. Yeah, I'm thinking about 400 or so.

Tymchyshyn: I think the number is probably closer to a thousand. That may sound a little draconian but if you look at how many Denovos were started in the past five years, they basically

Continued on Page 4

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 3

had two business models: one was to be the construction lender and those have either died or they're zombies today, and then there's the ones who concentrated on commercial real estate and I think those ones have so much pain ahead. Without more capital it's hard to imagine them not dying.

So you look at any bank that started in the past five years, there really is no earnings power at these companies to offset the losses. So as we experience more losses and more problem credits without access to capital, there is no real franchise to sell so the regulators are going to have to eventually shut all these guys down.

Schroeder: I would guess the number is not as high as a thousand but that's not out of the question. I would say 550.

Moore: Yeah, I agree with what Darren is saying, but I think that a lot of those… they're not going to shut all of them down. Some of these banks will get some capital, some of them won't and those will be ones that get shut down, but I think there's around 300 to 350 banks on the FDIC's troubled bank list. Let's assume that over the next year that doubles. So maybe it goes up to 700 and let's assume that they close down most but not all of those. Some of them manage to find capital and you get to a number of, I don't know, 400 to 600 or so.

Tymchyshyn: I think 1000 should fail. Whether 1000 do fail, who knows? I'm surprised we haven't shut down a couple of hundred already. The regulators might know something that I don't and there might be capital out there, but I doubt it very much.

Moore: Well, the other issue is that in banking, time basically can heal pretty much every hole. If you're on a long enough timeline, almost any bank can eventually earn its way out. Now some of them would take 100 years and some of them will take two or three, but I think that's also part of the reasoning behind them moving so slowly is that they know that as long as the bank is open and not making new loans, it earns money on the spread. With lower operating and interest expense, and the hole that they've got gets filled just a tiny bit at a time, so some of those banks that are marginal, just giving them some extra time might actually allow them to live.

Rigsby: Do you think there's going to be any compulsory merger activity or do you think what's going on with the Bank of America (BAC), you know, before the regulators would kind of nudge you in the direction of buying someone and I guess it also depends on the extent of the CRE cycle and comfort of acquirers with the acquiree's portfolios? What do you guys think about the concept of seeing more banks merge rather than being taken over in this cycle?

Moore: Yeah, I think we're going to see that.

Tymchyshyn: I think we have to see it. I just don't know when it will happen. I think due diligence causes a lot of deals to fall on their face just because how do you value these assets today and how do you justify using excess capital to buy anything today? Everyone is scared of everyone else's balance sheet. So until we get into more of a "normal world," I don't think we're going to see much of it other than maybe a $200 million bank that obviously needs to be 350 to 400 to make any good money, can't really grow due to capital constraint, then hooking up with the stronger balance sheet and a more liquid currency makes a lot of sense. It's just a matter of are those bigger banks willing to make those deals today or are they going to hold on and see if they can get that from the FDIC for free eventually down the road.

BANK PROFITABILITY

Rigsby: Hans when will bank profitability normalize and why?

Schroeder: I think probably not until 2012, 2013, and obviously that's a function of asset quality issues being worked through the

Continued on Page 5

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 4

balance sheet.

Moore: Yeah, I've got 2013 to 2014, so, you know, I'm maybe a year behind Hans but, you know, right around in there, three, four, or five, probably four years out at least.

Tymchyshyn: I agree with that. I think if the non-performers peak in late 2010 or 2011 it's going to take 18 months for these guys to still get their cost structures in line and put a little growth on the books at decent spreads.

Moore: Yeah, and also they'll have, again, assuming the banks that are alive and are going to live and they're profitable, they're going to have a lot of NOLs to eat through at some point so a lot of these banks won't be paying taxes for a while.

Tymchyshyn: And they'll be bleeding reserves because they'll be so high now that the auditors will be back on them to take them back down again.

Rigsby: Kind of going along that same track, when will bank trading and acquisition multiples normalize and why?

Tymchyshyn: I think we won't be back to see any kind of three times book deals for a long, long time if we think earnings are going to normalize in 2013. After what these banks have gone through and the acquirers still cleaning up their balance sheets from bad deals done in the past because of overpaying, I don't think you'll see any kind of eye-popping M&A multiples for at least three or four years after earnings normalize.

Moore: Well, Darren, let me ask you this - sorry, but to butt in on the question side - when do you think the acquisition multiples, you know, getting to the heart of this question, when do you think they'll normalize? In other words, when do you think… if we're to look at the last 20 years of M&A activity, correct me if I'm wrong, I think that community bank acquisition multiples are somewhere around two times tangible or something like that. When do you think we'll see average numbers like that? Not so much the three and four times craziness that we get at the end of every cycle, but just normalized valuations.

Tymchyshyn: I think it depends on the acquirer. Look at the banks who are going to be buying these guys. I think in a normalized market when the big guys are trading at three or four times tangible, then two and a half to three and half times tangible book deals were normalized because the stocks were so inflated from the buyer side.

So let's say that we go back to a median M&A multiple of 1.75X of tangible for the group, 1.75X to two times for the larger guys, then I think 1.50X to 1.75X would be a normalized market and I think that will happen shortly after normalized earnings come back.

Moore: Yeah, I'd agree with that.

REGULATIONS

Rigsby: What regulatory changes are coming down the road and how will that impact profits and valuations?

Moore: Okay, I've got… I'm basically divided this into the big banks and the small banks. The big banks, the level three assets are going to drop because the regulators are going to demand that. There's got to be more transparency on the large bank balance sheets, and so they're going to force those Level III assets down and then they'll slowly disappear over time. You've got limited securitization activity that's never going to return to the levels that we saw in the last cycle. I think you're going to see consumer lending regulations increase, which we're already seeing. We're seeing higher FDIC deposit fees.

And finally, I think we're going to see much higher capital ratios applied to the large banks. Not immediately, because I think the regulators are trying not to scare investors right now. They're not saying that right now, but I think that once these banks get back on their feet and we've seen the worst, I think they're going to march in and say, guess what? Everyone's going to have to raise their capital levels. Either you can choose not to grow or you can choose not to pay dividends or whatever, but we want you to build your capital up over the next 5 to 10 years so that we don't see the sort of problems like we've seen recently again, which basically just means lower ROAs and ROEs for the biggest banks.

I think that the cyclical highs in profitability that we saw back in '04 and '05 and '06 we may not see those again. I think with less leverage and with a higher cost of doing business and little securitization activity, I just think that the fundamental banking model at the big bank level is just not going to be as profitable going forward.

Where the small banks are concerned, I think there's going to be explicit concentration limits applied to loan portfolios. I think we're not going to see banks able to get up to 30 and 40 percent construction again, which will be a good thing. And with the big banks' limited securitization activity, which was a pretty big source of profits for community banks being able to shove that stuff out the door and make money on it in the form of fee income, and then, obviously, the higher FDIC deposit fees, life is going to be tough for community banks, but nothing like what the big banks are going to go through.

So, with the big banks, I think we're going to see kind of a secular change in profitability. But I don't think we're really going to see that so much at the community bank level because less of the profitability was coming from these kinds of one-off transactions and level three assets.

Tymchyshyn: I totally agree on the small banks side; I don't really have a theory on the large banks. I've thought about it but I don't know how it really affects these guys going forward. I definitely agree on higher capital and more concentration limits.

Continued on Page 6

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 5

When you require more capital and restrict the most profitable lending products you naturally have lower profitability. I think we're in for a decade at least of lower ROEs because of it.

TOP BANK PICKS

Rigsby: Can each of you share what your two or three favorite banks on the public side for long term investments and why?

Schroeder: There are a couple of banks I like at current valuations. One of them is Louisiana Bancorp (LABC), a 100-year-old institution based in New Orleans. LA. It has $300 million in assets, 25 percent capital, low NPAs and is trading less than 90 percent of tangible book value. They continue to capitalize on the rebuilding of New Orleans after Hurricane Katrina. I think it is a good value and I feel that they are going to be a likely acquiree in the next three to five years.

Another one would be a bank in San Diego, Security Business Bank (SBBC), trading at 75 percent of tangible book value, 13 percent capital, non-interest bearing deposits of over 30 percent and they've been recently quite successful in recruiting bankers from a number of distressed competitors in that market. So those are two of my favorites at the moment.

Moore: I'd say if I had to pick two, I'd say American Business Bank (AMBZ), a commercial bank up in LA, $840 million in assets. Huge DDA balances, pristine asset quality. They haven't had a charge-off that I can recall. They opened about 10 years ago and they don't have any non-accruals or non-performing loans, and it's run by a group that is fairly shareholder-friendly. So I think at some point in the next three, four or five years they will probably sell and that will be a pretty big multiple. Whatever the premiums are - and we don't know what they are going to be - but whatever they are, this one will go for one of the highest.

And then the second one would be Pacific Premier (PPBI). This is a little more controversial. It's a bank that used to be a thrift. Roughly $750 million in assets up in Costa Mesa, very good asset quality, and the valuation is right. Right now it's trading at about 50 percent of tangible book value and it's got a large, highly concentrated institutional shareholder base that will have various alternatives if management ultimately turns out to be hostile to shareholders, which is an open issue at this point. So those would be my two… I also like Security Business Bank (SBBC) as well, so I will second Hans to his nomination of that bank.

Tymchyshyn: I would say one of them would be Old Line Bank (OLBK) in Bowie, Maryland on the east side of D.C. - $330 million bank, only has two bad loans as of March 31, 2009. The CEO has a philosophy of acquisition by stealing talent; meaning he basically hires the best bankers out of the bigger banks and builds around those guys putting on good business. It trades at about 60 percent of tangible today so I think that has some very good value.

And then if I wanted to take another one, I'd probably say Tower Bank (TOFC) in Fort Wayne, Indiana - $700 million in assets; it has the number one community bank market share at Fort Wayne. That may not sound exciting but it's a slower growth market that has a lot of wealth in it. They're doing all the right things, identified their issues early and have been working through them for at least two years now. The Company also has a $700 million, very profitable trust company and a large health savings account platform for a bank this size. It trades at approximately 45% of tangible book.

COMMERCIAL REAL ESTATE AND STOCK VALUE

Rigsby: The forecasted dramatic deterioration in most categories of commercial real estate seems to be widely acknowledged. Is this already priced into the majority of regional and community bank stocks?

Tymchyshyn: I would say for the most part, yes. I think these

Continued on Page 7

NEW BULL MARKET OR BEAR MARKET RALLY?, CONT.

Continued from Page 6

things have been sold indiscriminately on the downside. Bids have just been whacked on the smaller and more illiquid names. Some of them are at levels where all they have to do is live and you're going to make a lot of money over time. So the majority of them, yes.

Some of them are still priced for perfection. Pacific Continental Bank(PCBK) pre-released yesterday. That's more of a construction issue but some of these "safe haven" banks are still operating in the same infested pools as everybody else and they're going to have their issues. Some are still at 160% or 170% of tangible book, obviously in those the problems ahead are not priced in.

Moore: I agree with everything Darren just said.

Schroeder: I definitely agree with that. I think it's priced in for the most part in these smaller, micro cap banks.

Moore: Although, I guess one exception would be all of those banks that are trading in the low, low single digits, in the $1 and $2 area. I think a lot of those banks are going to fail, so you could argue that the banks that are going to fail that are publicly traded aren't priced properly by definition - they should be zeros. But yeah, that would be my only exception to what Darren was talking about.

Rigsby: Coming out of each of the credit cycles over the last 20 years, the rally of the community bank stocks have been powerful and multi-year in length. Will this cycle be different?

Moore: Yeah, I think it's going to be less powerful and I think it's going to be longer because I don't think we're going to see this V-shaped recovery. I think we're going to see five or 10 years of very low, maybe one percent real GDP growth on average each year, with some fits and starts. And so because of that, I just don't think we're going to see this enormous rally.

On the other hand, because of all the regulation coming in and because of how deep we've gone into this recession, the bull cycle may actually last longer. So I think we're going to have a longer up cycle but it's not going to be as dramatic, with these years where we're seeing 20 and 30 percent gains on these little stocks, like we've seen in the past. I think it's going to be a long, slow trudge. That's my guess.

Tymchyshyn: I agree with that entirely. I think it will be less powerful but maybe a little longer and more steady than the past. You won't see those 50 percent years back to back but you'll still see very good returns. Things got so bad and we talked about earlier how much the bank index was down. They were whacked so hard that there's a long way to go once the market normalizes on the upside.

Schroeder: I agree. I think it's going to be dependent upon the growth we see in the economy. It's largely based upon regional economic performance for these banks, but I think it's going to be long lasting and multi-year.

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>
> \- David Moore

Rigsby: Last prepared question: Emerging from the bank stocks fair market of the late '90s, early 2000 is fast growing and often construction and development-fueled banks outperformed peers. Which class or category of community banks do you expect to outperform in this recovery?

Schroeder: I think there will be a category that's going to be explosive. Perhaps it will be led by SBA or a mortgage product. The securitization market will eventually show more life, but the trend is surely to see more assets being kept on the balance sheet.

Tymchyshyn: Once people de-lever greed will find another bubble to create and the bank that specializes in that bubble, whether it be, who knows, hopefully it's not mortgage again but maybe it's a niche product, those will probably outperform until that bubble cracks and the party ends.

But I have a theory - how about the plain vanilla commercial bank that focuses on real core deposits and real customers and aren't chasing the latest trends. I think those are the ones who create real value. And when you think about an M&A market if I'm a buyer I don't want a one trick pony. I want to buy something that has real lasting value, so I think those are going to be the banks that are going to make you the most money over time.

Moore: I think it's even more generic than that. I just think that the banks that focused on asset quality and didn't bite the construction and development apple, I think those banks are going to outperform first because asset quality is what people are most concerned about right now. They may see a bank that's got a nice deposit base but if the loan portfolio is dubious, then that thing is not going to move. So I just think generically, the banks that focus on asset quality, they're going to be the ones that will probably outperform in the recovery because there will be fewer questions regarding the balance sheet.

Rigsby: This concludes the Community Bank Ventures Industry Roundtable discussion for July 1st. I want to thank Darren, David and Hans for their insights and stimulating discussion and we hope we can pull everybody back together real soon.