

## First Quarter 2009 Mergers & Acquisitions Review

The first quarter of 2009 sustained further declines in merger and acquisition activity and pricing. Plummeting economic activity and the lack of clarity surrounding the government's response to the financial crisis as the new administration sought to establish its footing severely impacted transaction activity. By the end of the quarter, signs began to emerge that transaction volume was about to pick up as we anticipated in our last newsletter. Merger activity is likely to be divided into distinct groups: institutions with non-fatal levels of problem assets seeking a way out, government-assisted transactions, and healthy institutions for which the timing is right to sell.

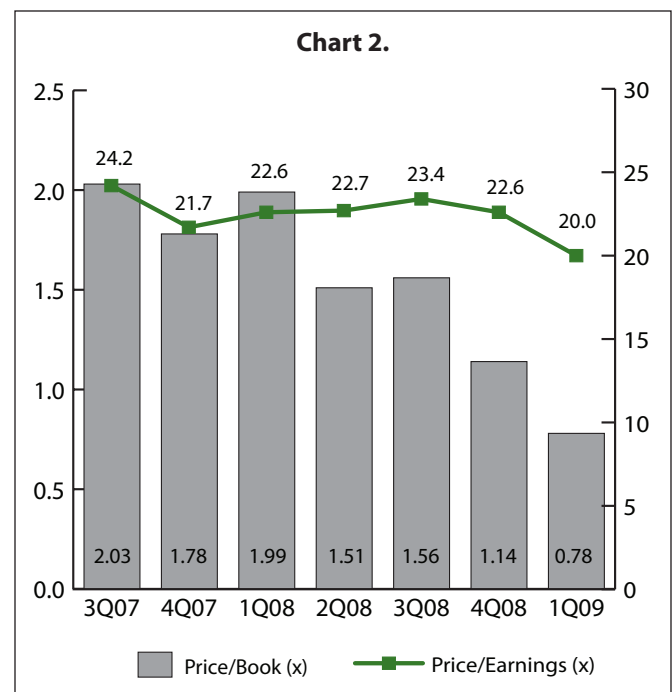
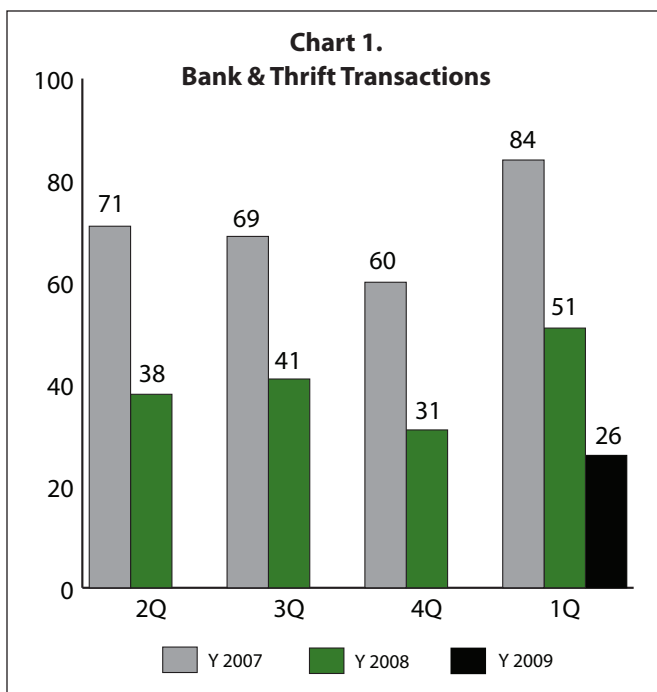
After finding some stability at the end of 2008, financial institution stocks plumbed new lows for the first two months of the first quarter due to uncertainty about new government rescue programs for the economy and the financial sector and to the fears of "nationalization" of several large banks. Prices rebounded sharply after Treasury outlined its plan for removing "legacy assets" from the system involving public and private equity investment in funds composed of these assets. Assuming that investors and asset managers are comfortable with the details of Treasury's PPIPs, removal of legacy loans and securities should help restore investor confidence in the financial sector, which would enable institutions to access the capital markets over time.

Additional help came from the FASB which, after Congressional prodding, agreed to revise its position on accounting for other than temporary impairments and mark-to-market adjustments. Allowing institutions to break out the credit and market losses in determining OTTI and enabling them to value assets using discounted cash flow models where no effective market exists should provide some equity relief especially if assets previously written-down can be revalued.

### MERGERS & ACQUISITIONS

Bank and thrift transaction volume in the first quarter of 2009 continued the downward trend the industry has been experiencing since the first quarter of 2007. Total bank and thrift transactions set a new low of 26, roughly one-third of the 84 transactions reported in the first quarter of 2007 and only four more than the number of failures during the first quarter of 2009. Chart 1.

Of the 22 bank transactions during the first quarter, nine did not report the price, including three of the healthier banks that sold. Four thrift transactions were reported, only two with pricing. As a result, the pricing metrics shown on page 5 should only be taken as indications for the median institution. Chart 2 shows how far pricing has fallen over the last seven quarters.



The first quarter's pricing multiples set records as all the median pricing metrics except price to earnings reached their lowest level since SNL began recordkeeping in 1990. The first quarter of 2009 was the only time since 1990 that the median price to book and tangible book were below 1.0x. The highest price to book reported in the quarter was investor Wilbur Ross's purchase of \$83 million-asset First Bank & Trust Company of Indiantown, Florida at 1.38x. Overall, asset quality weighed heavily on pricing as the median NPAs for all sellers was 3.16%.

Median pricing statistics in the first quarter are not instructive regarding the value of banks in today's market. Only 13 of the 22 transactions reported pricing, and the majority of those that did report pricing involved sellers in distressed situations. In fact, the sellers in the first quarter with the healthiest institutions chose not to report pricing. Several of the transactions so far this year have involved investor groups seeking an inexpensive way to enter or re-enter the banking business. These investors typically seek a low price-point entry from which they can launch an alternative business model. We anticipate the 2nd and 3rd quarters will bring the announcement of transactions involving some healthy banks in stable markets that will provide more meaningful points of comparison. Table 1 contains a list of the first-quarter bank transactions.

## PUBLICLY TRADED MARKETS

Publicly traded financial stocks led the broader markets down during the first quarter of 2009 after stabilizing (albeit at a low level) during the final month of 2008. Doubts about the solvency of Citigroup and Bank of America outweighed government actions to stabilize the markets. In fact, new government programs and changes in terms of existing programs such as TARP heightened investors' concerns of a possible government takeover of the largest troubled banks. At one point, the SNL Bank index (which is market-cap weighted) was off almost 60% from the 2008 year-end level. (This was on top of the 46% loss registered last year.) The indices for the \$1 billion to \$5 billion-asset group and the \$5 billion to \$10 billion-asset group tracked the overall Bank index closely.

In contrast, the smaller \$500 million to \$1 billion-asset group was off only 11% through the first quarter. Three principal reasons for this divergence are that this group has little exposure to "legacy" assets, the group is more community-based, and its stocks are not as widely held. However, the smaller groups are not exempt from general economic conditions or local credit markets. The SNL Thrift index was down about 13% in the first quarter. Chart 3.

**Table 1.**  
**1Q 2009 Bank Deals**

| Buyer/ Target  | City           | ST | Total Assets | Equity/ Assets (%) | Tang Equity/ Assets (%) | NPAs/ Assets (%) | ROAA (%) | Price/ Book (x) | Price/ Tang Book (x) | Price/ LTM Earn-ings (x) | Price/ Assets (%) | Price/ Deps (%) |
|--|----------------|----|--------------|--------------------|-------------------------|------------------|----------|-----------------|----------------------|--------------------------|-------------------|-----------------|
| Prvt Invtr - Wilbur L. Ross/ First B&TC of Indiantown      | Indiantown     | FL | 83,462       | 9.33               | 9.33                    | 4.26             | 0.65     | 1.38            | 1.38                 | 20.0                     | 12.87             | 14.70           |
| Banner County Ban Corporation/ Cowboy State Bank           | Ranchester     | WY | 41,047       | 10.29              | 9.80                    | 2.49             | 0.28     | 1.34            | 1.41                 | 28.3                     | 13.77             | 16.37           |
| Glacier Bancorp Inc./ First Co.                            | Cody           | WY | 282,474      | 8.62               | 8.62                    | 3.44             | -0.97    | 1.20            | 1.20                 | NM                       | 6.19              | 7.15            |
| New England Bancshares/ Apple Valley Bank & Trust          | Cheshire       | CT | 84,583       | 7.29               | 7.29                    | 1.82             | -0.67    | 1.15            | 1.15                 | NM                       | 8.36              | 9.65            |
| Merchants Bancorp Inc./ CB Bancorp Incorporated            | Higginsport    | OH | 110,988      | 9.70               | 9.70                    | 4.64             | 0.43     | 1.00            | 1.00                 | 22.6                     | 9.73              | 10.80           |
| Hantz Holdings Inc./ Davison State Bank                    | Davison        | MI | 46,062       | 7.55               | 7.55                    | 4.60             | -0.43    | 0.86            | 0.86                 | NM                       | 6.51              | 7.43            |
| 1st Financial Services Corp./ AB&T Financial Corp.         | Gastonia       | NC | 170,683      | 14.35              | 14.35                   | 2.98             | -0.11    | 0.71            | 0.71                 | NM                       | 10.14             | 14.26           |
| CommerceWest Bank NA/ Discovery Bancorp                    | San Marcos     | CA | 172,746      | 11.62              | 11.62                   | NA               | -2.86    | 0.52            | 0.52                 | NM                       | 6.08              | 7.26            |
| NewStar Financial Inc./ Southern Commerce Bank NA          | Tampa          | FL | 206,179      | 17.95              | 10.43                   | 0.62             | -0.41    | 0.51            | 0.97                 | NM                       | 9.22              | 13.50           |
| Southern Bancorp Inc/ Timberland Bank                      | El Dorado      | AR | 139,402      | 8.90               | 8.90                    | 4.68             | -1.84    | 0.48            | 0.48                 | NM                       | 4.30              | 5.68            |
| Colorado Financial Holdings/ New Frontier Bancorp          | Greeley        | CO | 2,032,185    | 6.57               | 6.57                    | 6.16             | 0.20     | 0.44            | 0.44                 | 14.5                     | 2.89              | 3.57            |
| Lexxiom Inc./ Baxter Bancshares Inc.                       | Baxter Springs | KS | 36,680       | 16.37              | 14.96                   | NA               | NA       | 0.31            | 0.34                 | 8.6                      | 5.45              | 7.57            |
| Community Exchange Bancshares/ Hindman Bancshares Inc      | Hindman        | KY | 158,849      | 12.38              | 12.38                   | 0.25             | 1.20     | NA              | NA                   | NA                       | NA                | NA              |
| Intercontinental Bankshares/ Intercontinental Bank         | West Miami     | FL | 128,661      | 11.02              | 11.02                   | 0.00             | 0.84     | NA              | NA                   | NA                       | NA                | NA              |
| First Wagoner Corp./ Green Country Bancorp. Inc.           | Ketchum        | OK | 24,284       | 8.94               | 8.94                    | 0.58             | 0.77     | NA              | NA                   | NA                       | NA                | NA              |
| Meskwaki Tribe/ Pinnacle Bank                              | Marshalltown   | IA | 66,026       | 13.14              | 13.14                   | 1.04             | -0.18    | NA              | NA                   | NA                       | NA                | NA              |
| Liberty FncI Services Inc./ United Bank & Trust Company    | New Orleans    | LA | 25,378       | 6.20               | 6.20                    | 4.75             | -0.47    | NA              | NA                   | NA                       | NA                | NA              |
| University Financial Corp Inc/ EastBank                    | Minneapolis    | MN | 20,915       | 13.49              | 13.49                   | 3.34             | -0.90    | NA              | NA                   | NA                       | NA                | NA              |
| Florida Traditions Bank/ Providence Bank                   | Winter Haven   | FL | 41,802       | 11.97              | 11.97                   | 0.00             | -3.03    | NA              | NA                   | NA                       | NA                | NA              |
| Investor group/ Colonial BancGroup Inc.                    | Montgomery     | AL | 25,816,306   | 5.21               | 3.41                    | 2.75             | -3.29    | NA              | NA                   | NA                       | NA                | NA              |
| Border Bancshares Inc./ Marshall Bank NA                   | Hallock        | MN | 69,989       | 11.25              | 8.73                    | 6.02             | -6.61    | NA              | NA                   | NA                       | NA                | NA              |
| Orchard First Source Asset Mgt/ Beverly Hills Bancorp Inc. | Calabasas      | CA | 1,496,481    | 2.15               | 2.15                    | 5.42             | -8.57    | NA              | NA                   | NA                       | NA                | NA              |

What is most uncharacteristic is that the median trading prices for banks are higher than the median acquisition prices. The table below compares the median trading metrics for banks to the median transaction metrics for the first quarter. As noted above, bank transaction pricing multiples are not reliable due to the small sample size. However, the acquisition discounts to publicly traded book and tangible book values are indicative of the dislocations in the financial markets.

|                 | Price/ Book | Price/ Tang Book | Price/ LTM Earnings |
|-----------------|-------------|------------------|---------------------|
| Publicly traded | 0.90x       | 1.71x            | 13.9x               |
| Acquisition     | 0.78x       | 0.91x            | 20.0x               |

### SPECIAL TEXAS RATIO REVIEW

Twenty-one institutions failed during the first quarter of 2009, more than in any quarter since the fourth quarter of 1992. The questions of “how many” and “who’s next” are heard everywhere. In an attempt to define the risk of failure of community-based institutions, we reviewed the Texas ratio that originated during the late-1980s and is one of the key ratios used by many industry insiders. The ratio measures the level of tangible capital impairment. It is calculated by dividing the total amount of non-performing assets (NPAs) by the sum of tangible equity and the allowance for loan and lease reserves. A ratio of 100% means that all of an institution’s reserves and tangible capital are impaired.

To gauge the breadth and depth of capital impairment, we analyzed the 8,265 institutions under \$15 billion in assets using December regulatory information. We calculated the Texas ratio for each institution and also determined the amount of “free” tangible equity for those institutions with a Texas ratio less than 100%. Free tangible equity is the amount of tangible equity in excess of the amount needed to support NPAs after fully utilizing the institution’s reserves. Finally, we determined the amount of free tangible equity to tangible assets for each institution as an indication of the institution’s capital adequacy.

One caveat regarding this analysis is that one should not rely on a single ratio as indicative of an institution’s overall health. Each institution is unique in its balance sheet composition, nature of problem assets, access to capital and other resources, business model and market. Of particular importance in this analysis is the composition of the non-performing assets. Some factors that may limit further deterioration in asset quality are that NPAs may be limited to a few larger credits or “out-of-market” credits while the rest of the portfolio continues to perform well, a large portion of NPAs is comprised of performing restructured loans that will return to performing status over time, and OREO is cash flowing and saleable at a reasonable price. Moreover as this analysis was performed at the institution level, it does not account for cash or other liquid assets at the holding company level that could easily be injected as capital nor does it include any “capital on the sidelines”.

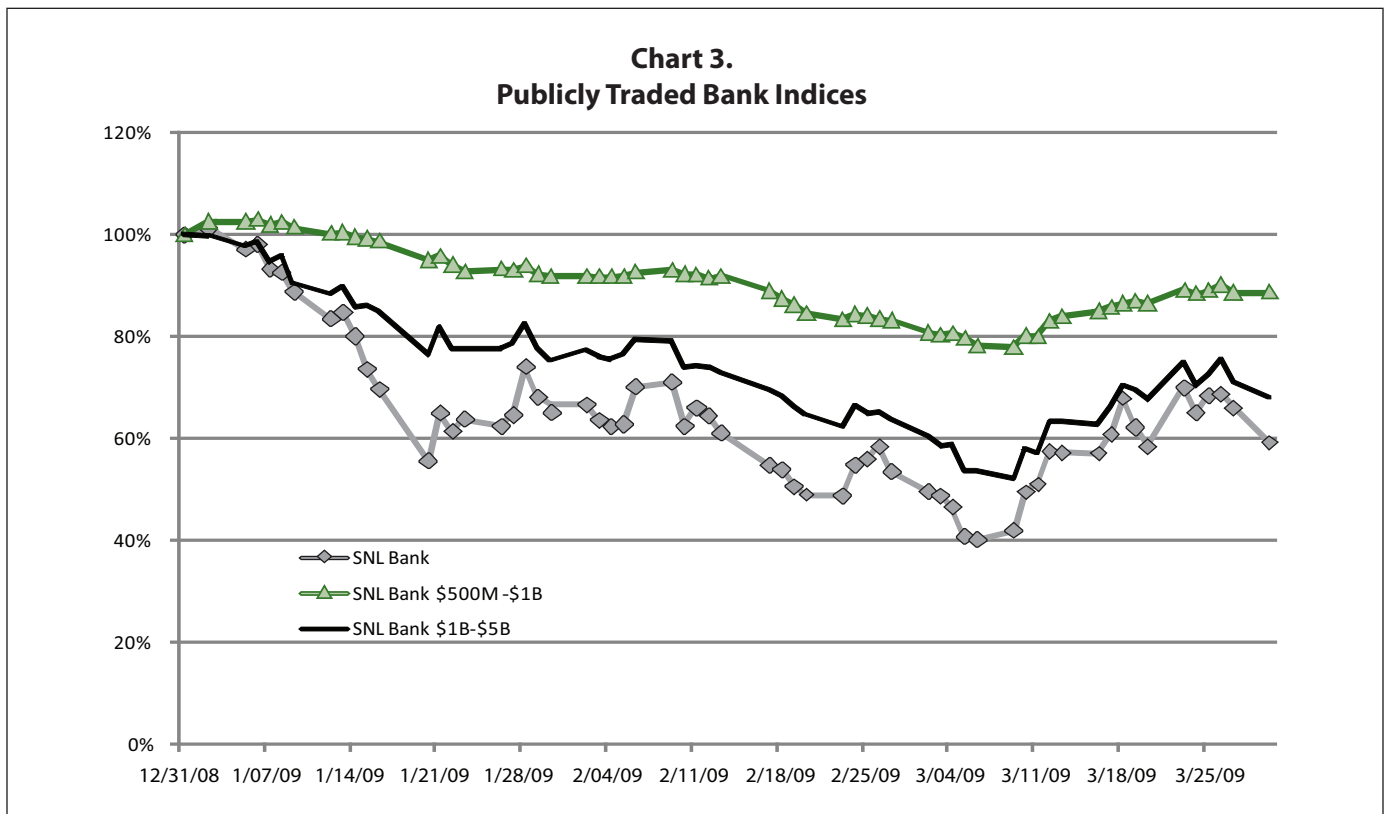


Table 2 shows the industry broken down by deciles up to a Texas ratio of 100% and those above 100%. Half of all institutions analyzed appear very healthy and had a Texas ratio less than 10%. This group is composed of smaller institutions as indicated by the median size. Many of these institutions are located in small cities or rural areas. However, there are institutions in or near the distressed areas with strong asset quality and plenty of capital capable of exploiting opportunities in their markets. At the other end of the spectrum are 158 institutions, only 1.9% of all institutions, with total assets of \$106 billion sporting Texas ratios above 100% that are clearly challenged.

The median free tangible equity ratio (Free Tang Equity/ Assets) and reserve coverage ratio (Total Reserves/ Total NPAs) suggests that institutions in the first three deciles (83% of all institutions below \$15 billion) should be able to weather this current credit cycle provided they don't experience further material asset quality deterioration.

The remaining institutions in the 30-40% through 90-100% deciles face varying degrees of stress. Judging by the level of free tangible equity to tangible assets, it would appear that most should have sufficient capital resources or access to capital. A \$200 million-asset institution with 5% of free tangible equity would need to raise just \$6 million to achieve free tangible equity of 8%. As the Texas ratio increases, the amount of capital needed in any potential capital raise increases rapidly. Compounding this issue is that the median reserve coverage ratio decreases considerably as the Texas ratio increases revealing a potential need to further bolster reserves.

One take-away from the above is that roughly three-fourths of community-based institutions have strong asset quality and are well capitalized. The number of institutions undergoing a period of severe testing is fairly limited. Failures from this point forward may be limited to 100 to 300 institutions. However, during the first quarter of 2009, the effects of the plunge in economic activity have touched all parts of the country and the results of this analysis will likely show further weakness once first quarter regulatory data are available.

Another take-away is that in these turbulent times with the economy still plumbing the depths for a bottom and high levels of regulatory and legislative uncertainty, management must be proactive in building and conserving capital. It takes little deterioration in asset quality to consume available capital resources. Institutions with Texas ratios above 30% should be thoroughly assessing their capital options, at least as an abundance of caution. That assessment should include determining the availability of additional capital through internal means and existing shareholders or with external investors, partnering with another institution in a merger-of-equals, and the potential sale of the institution as ways of preserving shareholder value.

## CONCLUSION

Merger and acquisition activity was muted in the first quarter as buyers and sellers were paralyzed by the disorienting stream of news and pronouncements from the Treasury and regulators. The majority of the transac-

**Table 2.**  
**Financial Institutions < \$15B in Assets by Texas Ratio**

| Number of Institutions |                            |                     |                          |                            |                                |              |                                |                                 |                   |                       |
|------------------------|----------------------------|---------------------|--------------------------|----------------------------|--------------------------------|--------------|--------------------------------|---------------------------------|-------------------|-----------------------|
| Texas Ratio (%)        | Total Reserves/ Total NPAs | Tang Equity/ Assets | Free Tang Equity/ Assets | Tang Equity / Assets <6.0% | Free Tang Equity/ Assets <2.0% | Group Total  | Group Total/ Total Inst <\$15B | Group Assets/ Total Inst <\$15B | Median Asset Size | Total Assets in Group |
| 0-10                   | 166.7%                     | 10.6%               | 10.5%                    | 35                         | -                              | 4,147        | 50%                            | 38%                             | 107,046           | 1,290,675,329         |
| 10-20                  | 60.4%                      | 9.1%                | 8.6%                     | 22                         | -                              | 1,807        | 22%                            | 24%                             | 170,683           | 829,535,637           |
| 20-30                  | 39.4%                      | 9.0%                | 7.6%                     | 19                         | -                              | 893          | 11%                            | 15%                             | 171,819           | 501,522,232           |
| 30-40                  | 30.7%                      | 8.7%                | 6.4%                     | 20                         | -                              | 483          | 6%                             | 8%                              | 184,502           | 267,206,709           |
| 40-50                  | 24.9%                      | 8.6%                | 5.5%                     | 8                          | -                              | 295          | 4%                             | 5%                              | 201,570           | 159,251,768           |
| 50-60                  | 22.4%                      | 8.8%                | 4.6%                     | 5                          | -                              | 182          | 2%                             | 3%                              | 204,404           | 96,738,501            |
| 60-70                  | 21.8%                      | 8.2%                | 3.5%                     | 11                         | 1                              | 119          | 1%                             | 1%                              | 199,461           | 42,504,839            |
| 70-80                  | 19.9%                      | 8.4%                | 2.5%                     | 9                          | 17                             | 85           | 1%                             | 1%                              | 191,590           | 47,284,559            |
| 80-90                  | 19.0%                      | 8.0%                | 1.3%                     | 11                         | 49                             | 55           | 1%                             | 1%                              | 185,112           | 21,487,611            |
| 90-100                 | 17.8%                      | 7.9%                | 0.5%                     | 6                          | 41                             | 41           | 0%                             | 1%                              | 183,608           | 47,069,526            |
| >100                   | 15.9%                      | 6.7%                | NM                       | 62                         | 158                            | 158          | 2%                             | 3%                              | 207,344           | 106,058,932           |
|                        |                            |                     |                          | <b>208</b>                 | <b>267</b>                     | <b>8,265</b> |                                |                                 |                   |                       |

All banks, thrifts & MHCs at institution level

Medians except total number & total assets

tions announced involved sellers in need of a quick exit and opportunistic buyers.

As the smoke begins to clear from the near-collapse of the world's financial system, some assessments can be made regarding the health of community banks in the United States. As noted above, the majority of community banks have come through this time of trial in good financial condition. While there is significant uncertainty regarding how the industry will be configured going forward, banks that are well capitalized will likely have numerous opportunities. Our analysis indicates that several hundred banks will need to find a stronger partner with additional capital resources in order to survive. We believe this reality will bring a sharp increase in the volume of merger activity in the quarters to come.

Meanwhile the scheduled expiration of the current 15% capital gains tax rate and the natural life-stage developments of bank owners and management teams will bring

numerous healthy, profitable banks to market. We believe the sale prices of these banks will reflect a return to more traditional valuation methodologies. In today's economy that will likely mean top-end pricing for the best performing banks in the strongest markets will be well shy of the three times book benchmark of the past few years.

Meanwhile, the industry will need to digest the likely downsizing of some of the nation's largest institutions and closure of 200 or so community banks with too little capital or liquidity to survive. This confluence of distressed and healthy institutions in the market will create many diverse opportunities for buyers. There is no doubt that in this time cash is king and those buyers with access to capital will have ample opportunities to use it. ■

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## Mergers & Acquisitions of Banks and Thrifts Announced in the 2009 First Quarter National Medians

|                          |                              | Financial Ratios |                    |                   |              |              | Pricing Ratios |                         |                   |                  |                    |
|--------------------------|------------------------------|------------------|--------------------|-------------------|--------------|--------------|----------------|-------------------------|-------------------|------------------|--------------------|
|                          |                              | Number of Deals  | Asset Size (\$000) | Equity/Assets (%) | ROAA (%)     | ROAE (%)     | Price/Book (x) | Price/Tangible Book (x) | Price/LTM EPS (X) | Price/Assets (%) | Price/Deposits (%) |
|                          | <b>ALL BANKS<sup>1</sup></b> | <b>22</b>        | <b>97,786</b>      | <b>10.00</b>      | <b>-0.43</b> | <b>-5.29</b> | <b>0.78</b>    | <b>0.91</b>             | <b>20.0</b>       | <b>7.4</b>       | <b>8.6</b>         |
| By Asset Size            | > \$5 Billion                | 1                | 25,816,306         | 5.21              | -3.29        | -38.88       | NA             | NA                      | NA                | NA               | NA                 |
|                          | \$1 - \$5 Billion            | 2                | 1,764,333          | 4.36              | -4.19        | -38.92       | 0.44           | 0.44                    | 14.5              | 2.9              | 3.6                |
|                          | \$500M - \$1 Billion         | 0                | NA                 | NA                | NA           | NA           | NA             | NA                      | NA                | NA               | NA                 |
|                          | \$100 - \$500 Million        | 8                | 164,766            | 11.32             | -0.26        | -1.41        | 0.61           | 0.84                    | 22.6              | 7.7              | 9.0                |
|                          | \$50 - \$100 Million         | 4                | 76,726             | 10.29             | -0.43        | -4.76        | 1.26           | 1.26                    | 20.0              | 10.6             | 12.2               |
| Return on Assets         | < \$50 Million               | 7                | 36,680             | 10.29             | -0.45        | -5.80        | 0.86           | 0.86                    | 18.5              | 6.5              | 7.6                |
|                          | > 1.50%                      | 0                | NA                 | NA                | NA           | NA           | NA             | NA                      | NA                | NA               | NA                 |
|                          | 1.00% < 1.50%                | 1                | 158,849            | 12.38             | 1.20         | 9.63         | NA             | NA                      | NA                | NA               | NA                 |
|                          | 0.50% < 1.00%                | 3                | 83,462             | 9.33              | 0.77         | 7.58         | 1.38           | 1.38                    | 20.0              | 12.9             | 14.7               |
| By Region                | < 0.50%                      | 17               | 110,988            | 9.70              | -0.67        | -7.59        | 0.78           | 0.91                    | 22.6              | 7.4              | 8.5                |
|                          | East                         | 1                | 84,583             | 7.29              | -0.67        | -8.06        | 1.15           | 1.15                    | NA                | 8.4              | 9.7                |
|                          | Midwest                      | 2                | 78,525             | 8.63              | NA           | -0.35        | 0.93           | 0.93                    | 22.6              | 8.1              | 9.1                |
|                          | North Central                | 4                | 51,353             | 13.32             | -0.90        | -6.30        | 0.31           | 0.34                    | 8.6               | 5.5              | 7.6                |
|                          | South                        | 7                | 158,849            | 11.97             | -0.11        | -0.71        | 0.71           | 0.97                    | 20.0              | 10.1             | 14.3               |
|                          | Southwest                    | 3                | 25,378             | 8.90              | -0.47        | -7.59        | 0.48           | 0.48                    | NA                | 4.3              | 5.7                |
| Structure of Transaction | West                         | 5                | 282,474            | 8.62              | -0.97        | -12.60       | 0.86           | 0.86                    | 21.4              | 6.1              | 7.2                |
|                          | 100% Cash                    | 8                | 97,225             | 9.12              | -0.11        | 0.37         | 0.86           | 0.97                    | 21.3              | 9.2              | 10.8               |
|                          | 100% Stock                   | 2                | 171,715            | 12.99             | -1.49        | -11.69       | 0.61           | 0.61                    | NA                | 8.1              | 10.8               |
|                          | Mixed                        | 4                | 106,622            | 9.82              | -0.82        | -10.33       | 1.17           | 1.17                    | NA                | 7.3              | 8.4                |
| Geographic Expansion     | Other                        | 8                | 68,008             | 11.82             | -0.54        | -3.88        | NA             | NA                      | NA                | NA               | NA                 |
|                          | In Market                    | 7                | 69,989             | 11.25             | -0.67        | -7.59        | 1.15           | 1.15                    | NA                | 8.4              | 9.7                |
|                          | Market Expansion             | 7                | 139,402            | 8.90              | -0.43        | -5.29        | 0.86           | 0.97                    | 28.3              | 6.5              | 7.4                |
|                          | Partial Overlap              | 3                | 170,683            | 11.62             | -0.11        | -0.71        | 0.71           | 0.71                    | 22.6              | 9.7              | 10.8               |

**Banks<sup>1</sup>** 1 of the 22 deals were announced without terms  
Source: SNL Financial, LC

NA = Not Available; NM = Not Meaningful

Regional definitions:

East (CT, MA, ME, NH, NJ, NY, PA, PR, RI, VT)

South (AL, DC, DE, KY, FL, GA, MD, MS, NC, SC, TN, VA)

Midwest (IL, IN, MI, OH, WI, WV)

Southwest (AR, LA, NM, OK, TX)

North Central (IA, KS, MN, MO, NE, ND, SD)

West (AK, AZ, CA, CO, GU, HI, ID, MT, NV, OR, UT, WA, WY)

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**Industry Leader**

Sheshunoff & Co. Investment Banking led the nation in the number and market value of transactions announced in the first quarter.

In good times and in trying times, no one knows community banks like Sheshunoff & Co.