

Sheshunoff & Co

INVESTMENT BANKING

2009 2nd Quarter Mergers & Acquisitions Review / Midyear Update

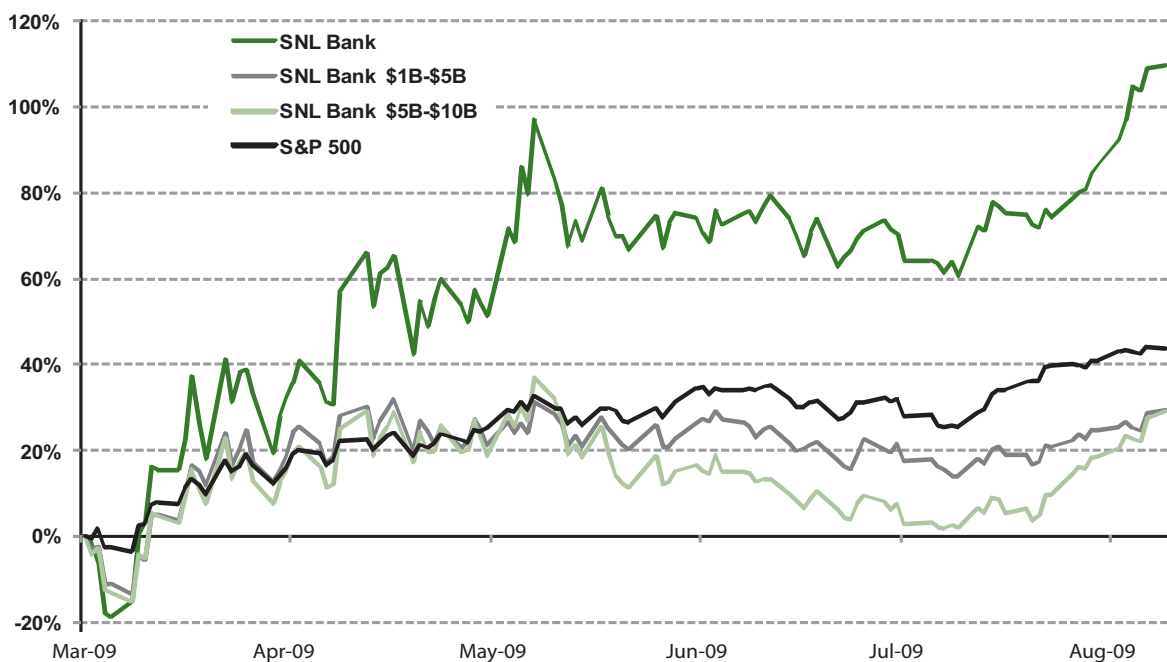
Merger and acquisition activity and pricing remained near record lows in the second quarter restrained by capital and credit concerns. Merger activity continues to center on weak institutions selling to stronger buyers at low price points. The steady drumbeat of weekly bank failures has many of the strongest buyers distracted. The possibility of buying a large franchise with FDIC loss-sharing benefits has many quality buyers in a wait-and-see mode while sellers in relatively good shape are being put on the back burner.

Meanwhile, the second quarter results showed continued deterioration in bank performance and credit quality throughout the nation. As of June 30, 2009, only 20% of banks and thrifts posted an ROAA of 1.00% or better for the last twelve months. On the other end of the spectrum, 29% of banks and thrifts reported net losses for the same period. Credit quality is also slipping as 20% of banks and thrifts now have over 4% NPAs as of June 30. In the regions hardest hit by the real estate collapse, the number of problem banks is rising faster than the FDIC can close them. As the cumulative effect of the recession builds, asset quality problems are showing up on the books of banks in parts of the country that were previously thought to be immune.

The rebound of financial stocks during the second quarter and the equity capital raised are the good-news stories thus far this year as concerted efforts by governments around the world began bearing fruit. Financial markets continued the rebound started in the first quarter as macro-industry fears subsided. As a measure of the fundamental change in market sentiment since November, the TED spread dropped to 0.25 in August from a high of 4.64 in early October 2008. (The TED spread is the difference in the rate for three-month Libor borrowings and three-month T-bills. The greater the spread, the greater the perceived risk of interbank lending.)

After plummeting almost 60% from the year-end 2008 level in early March, the market-cap weighted SNL Bank index led the broader market higher. First quarter earnings surprises from Wells Fargo, JP Morgan Chase, Bank of America and Citigroup boosted investor confidence in the sector. Bank stocks, particularly the largest banks, rocketed higher erasing almost all of the year-to-date losses on the announcement of the results of the stress tests on the 19 largest banks by federal regulators. The rally continued to pick up steam with second quarter earnings announcements as shown in Chart 1.

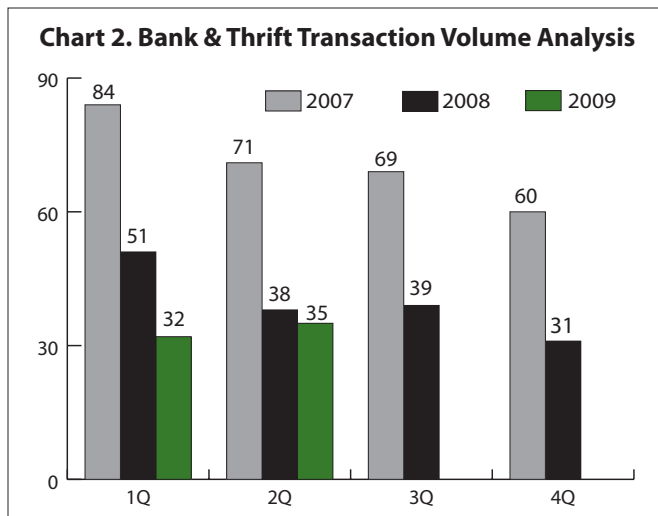
Chart 1. Publicly Traded Bank Indices



With the release of the stress test results and the concomitant rise in stock prices, banks that were found to need capital under the program raised over \$60 billion of common equity. Many regional banks also came to market with common stock issues. Issuances by banks under \$20 billion of assets totaled \$1.5 billion spread over almost three dozen companies. In contrast to the largest 19 banks, over 65% of these issues were priced above tangible book value. The issue prices ranged from 11% of tangible book value to 263% of tangible book, with a median of 128%. As the range indicates, some of banks that came to market did so as part of a survival plan while others took the opportunity to augment capital for strategic purposes or out of an abundance of caution.

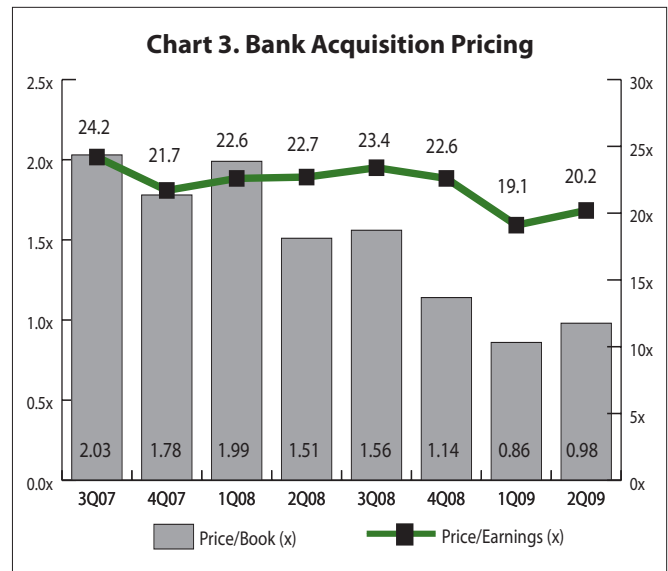
MERGERS & ACQUISITIONS

Bank and thrift transaction volume during the second quarter of 2009 remained subdued with 35 transactions reported. Combined with the 32 transactions reported in the first quarter, this is the lowest volume for any first half of a year since reliable records became available. Merger activity seems poised to increase as buyers have been able to raise capital and the number of banks seeking to exit grows. Chart 2.



Pricing multiples nudged higher from the record-setting lows of the first quarter as shown in Chart 3. Forty-eight percent of the selling banks in the second quarter had NPAs/ Assets below 1.00%, compared to just 25% in the first quarter. Likewise, thirty-four percent of the second quarter sellers reported a positive year-to-date ROAA, while only 16% of first quarter sellers did. However, median pricing statistics for the quarter provide limited guidance as no pricing data were reported for almost half of the announced transactions.

Recovery of financial institution acquisition volume and pricing hinges on two key issues. One issue – capital – is in the process of being resolved. Most of the recent raises have been to rebuild capital decimated by credit charges and mark-to-market adjustments, others were to repay



TARP preferred issues, but a few were to augment capital for strategic opportunities. The second issue – asset quality – continues to be a question mark as focus shifts from toxic securities and construction and development loans to prime residential mortgages and commercial real estate.

Merger and acquisition activity by the typical buyer segments (institutions between \$1 billion and \$10 billion in assets) will likely remain subdued until both capital and credit quality issues are settled.

With most of the publicly traded buyers and larger private institutions sidelined by low stock prices or asset quality problems of their own, many privately-held, smaller banks have been filling the void. In the 2nd quarter, the median buyer size fell to \$435 million in assets (down from \$1.4 billion in 2007).

Private equity in various forms emerged as a major force behind the limited merger and acquisition activity in 2009. Almost one-third of all buyers during the first six months of 2009 were private non-bank entities. Institutional private equity investment in banks has been growing since 2006 initially attracted by the then high returns. Most of these investments took the form of a minority interest in the common stock or of debt or other capital instrument convertible into equity. MatlinPatterson Global Financial's \$350 million investment in convertible preferred for an effective 77% of Flagstar Bancorp, Troy, Michigan in January ushered in a new era. Another majority investment by institutional private equity involving Temecula Valley Bancorp, Temecula, California announced during the quarter was cancelled after quarter-end because the investment would not meet the rate of return required by the investment groups.

With an unofficial moratorium on the approval of new charters, investor groups wanting to enter the industry are left with no option other than acquiring an existing bank. Four non-bank financial firms took the acquisition

route seeking the stability and access to funding that banks provide.

Thirty-three branch sales were announced during the first six months of 2009 involving 143 branches. On an annualized basis, the number of sales is on a par with 2008 while the number of branches sold is up by 50%. The median deposit premium paid was 3.44%, down from 5.00% in 2008. The amount of deposits transferred on a nominal basis mushroomed 267% to \$7.6 billion from \$2.8 billion for the full-year 2008. PNC Financial's sale of 57 branches and \$4.2 billion of deposits to First Niagara Financial Group, Lockport, New York accounted for most of the increase.

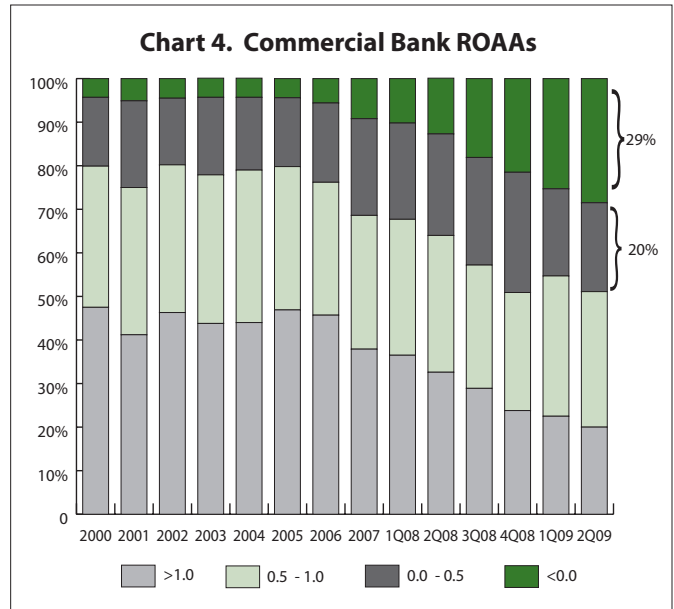
A sale of branches is a relatively inexpensive method of raising capital quickly and in most cases reducing the balance sheet. Branch purchases represent a low-cost avenue to expand with low execution risk. We expect more institutions will turn to branch sales as the credit costs embedded in their loan portfolios erode capital ratios.

INDUSTRY REVIEW

It seems to us that the seminal issue during the second quarter is the state of the broader banking industry. As we have at times in the past, we analyzed the regulatory data for the second quarter to discern the current condition and any developing trends. Data for 7,611 reporting institutions were analyzed.

While the largest banks garnered headlines for their return to profitability (albeit with great assistance from the accountants), a look at the full industry indicates a worsening trend. As Chart 4 shows, almost one-third of all commercial banks reported a loss in the second quarter, compared to only 10% in 2007. Moreover, another 20% posted ROAAs less than 0.50%. A short four years ago, almost 50% of commercial banks enjoyed returns above 1.00%.

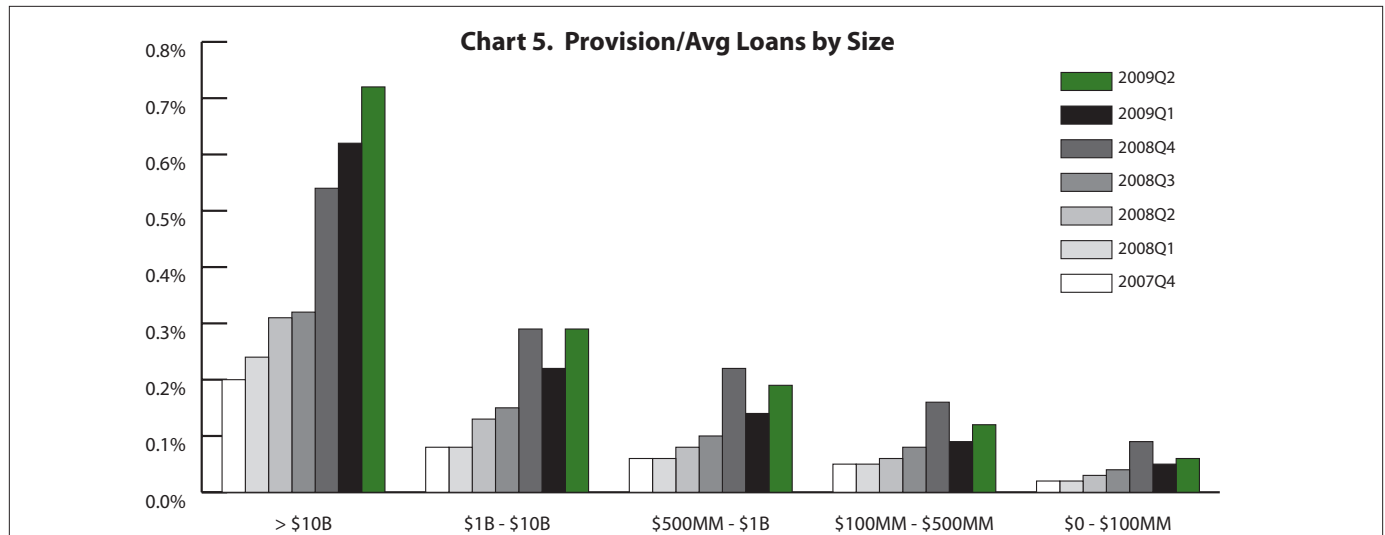
Segmenting profitability over the last twelve months (LTM) by asset size revealed that earnings on a pre-provi-

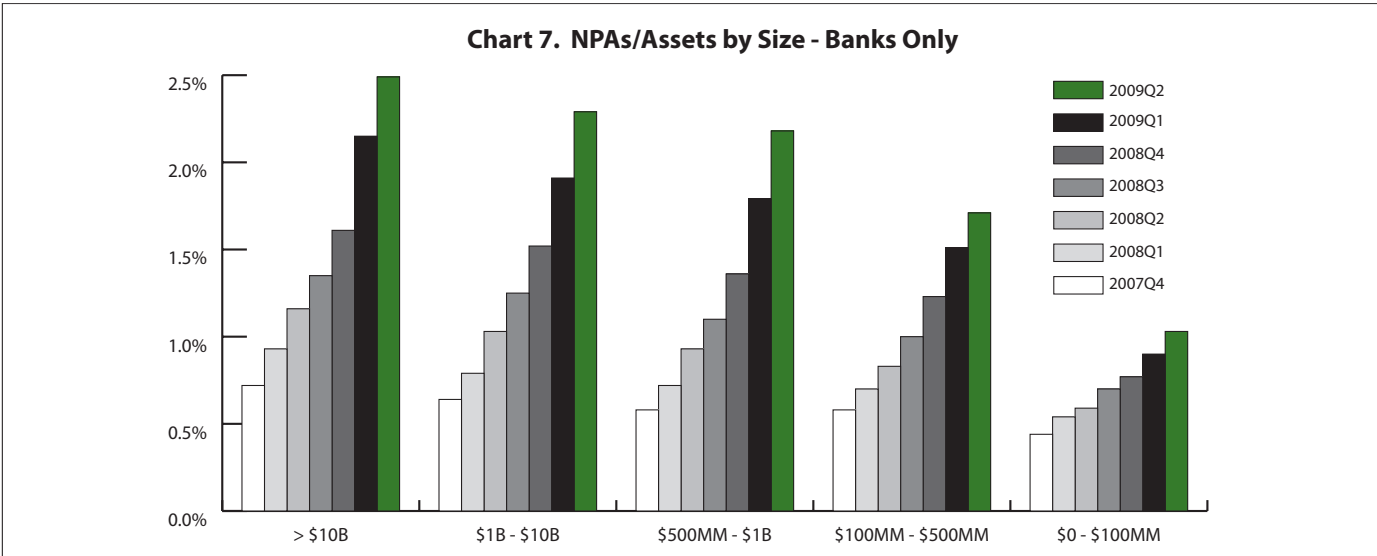
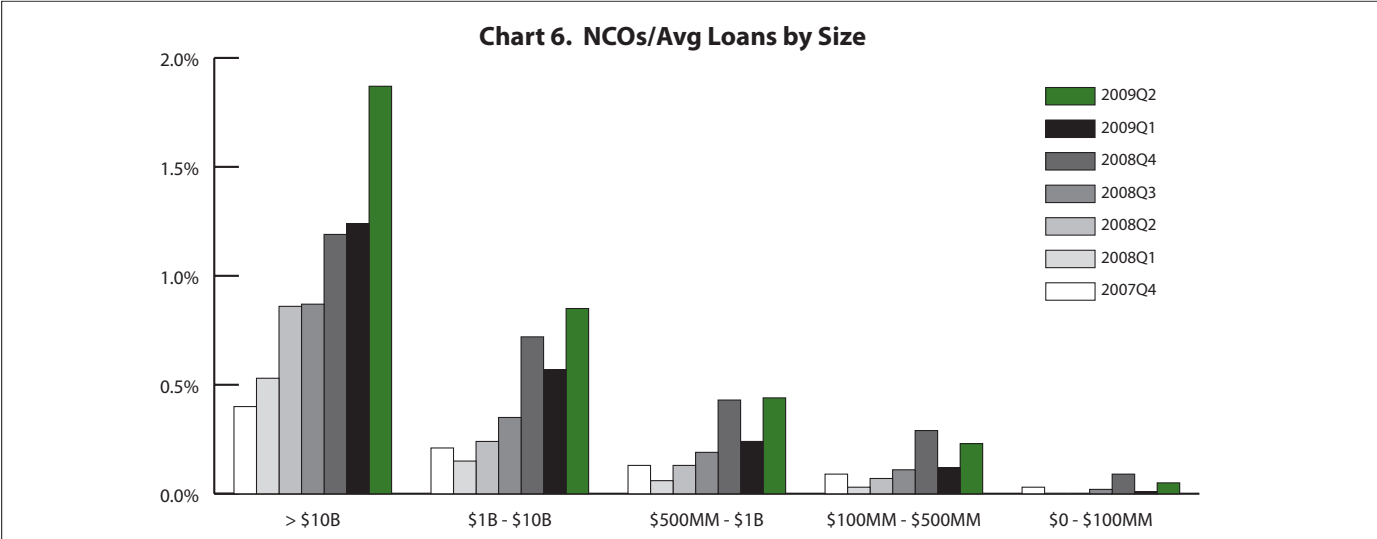


sion basis declined in step with the size of the bank, which has generally been true over the last ten years. The largest banks boast the highest level of non-interest income and the lowest level of non-interest expenses.

Income Statement/Average Assets (Medians)

	> \$10 B	\$1 B to \$10 B	\$500M to \$1 B	\$100M to \$500M	< \$100M
Interest Income	4.61	5.14	5.29	5.44	5.40
Interest Expense	1.38	1.91	2.04	2.02	1.78
Net Interest Income	3.23	3.23	3.25	3.42	3.62
Non Interest Income	1.33	0.80	0.71	0.58	0.51
General & Administrative	1.50	1.70	1.86	1.96	2.16
Amortization of Intangibles	0.05	0.02	0.00	0.00	0.00
Other Non Interest Expenses	1.05	0.90	0.93	0.96	1.04
Non Interest Expenses	2.60	2.62	2.79	2.92	3.20
Pre-Provision Earnings	1.97	1.41	1.17	1.08	0.93
Provision for Losses	1.68	0.81	0.59	0.40	0.19
Net before Taxes and Other	0.29	0.59	0.58	0.68	0.73





Over the last twelve months, provision expense consumed this great earnings advantage, leaving the largest banks with the lowest returns.

Provision expense for the largest banks has been rising since the first quarter of 2008, but escalated beginning in the fourth quarter of 2008. As Chart 5 shows, all groups are taking higher provisions. However, it is most pronounced in banks over \$1 billion in assets. Banks under \$100 million have not been impacted by the bursting housing bubble and the resulting severe economic contraction thus far. Banks in this group also hold a greater portion of earning assets in lower risk securities than banks in the larger groups.

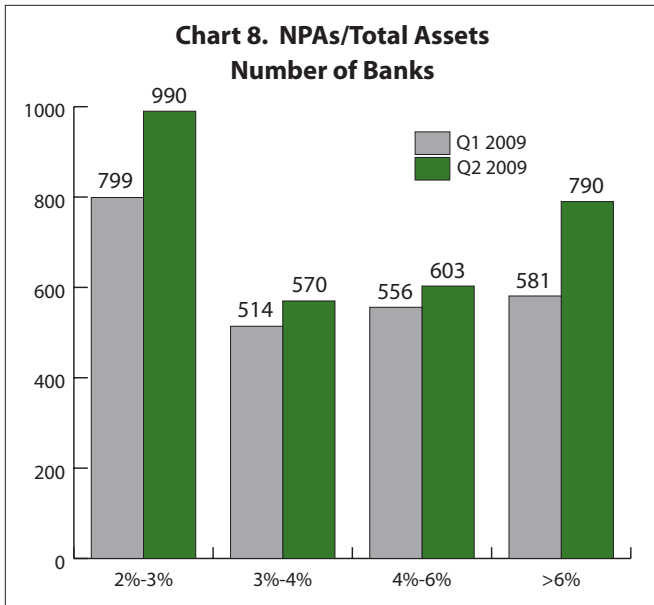
Of course, the reason for such high provisioning is that the level of net charge-offs has continued to increase with each passing quarter. The similarities between Chart 6 and Chart 5 are remarkable but expected. As charge-offs have increased over the last twelve months, provisions have followed suit to replenish reserves.

NPAs/Assets by size appear to be trending in the same pattern as Provision and NCOs with the level rising with each passing quarter. Another similarity is that the largest

banks currently hold the highest level of NPAs/Assets with each successively smaller group holding less. The difference is that slope is much flatter across the groups. In fact, the median level is below 2% for only the smallest two groups.

Chart 7 depicts NPAs at the median bank for each group growing at a similar rate as provisions and net charge-offs. Although the level is worrisome it appears manageable. However, a different story is revealed in Chart 8 which shows the number of banks with NPAs/Total Assets in certain ranges. Note that as of June 30, 790 banks have NPAs greater than 6% of total assets. At this level and assuming capital of 8 to 9%, there is practically no margin for further deterioration. This is not to say that all these banks will fail, but they certainly face severe challenges. In addition, there are another 603 banks with 4 to 6% of NPAs that will likely need to raise capital or shrink their balance sheets to reduce capital pressure.

Construction and development (C&D) loans have been the biggest culprit so far in this credit cycle with 12% of total C&D loans now on non-accrual and another 1.4% over 90 days past due. Non-accrual residential mortgages

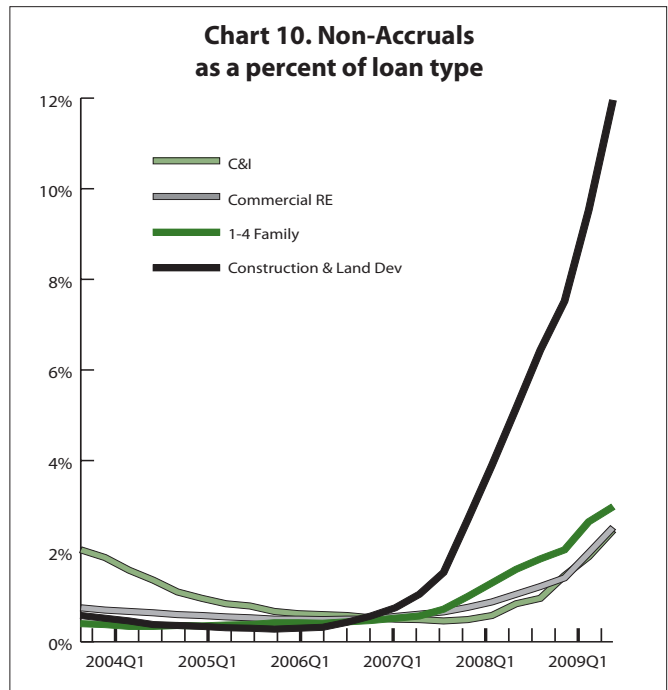
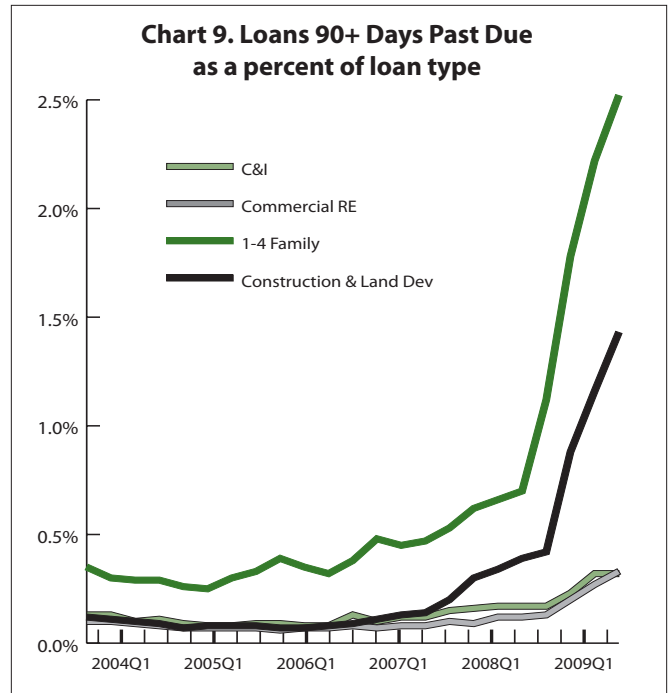


hit the 3% level in the second quarter and another 2.5% are over 90 days past due. (This doesn't count the mortgage loans held in the form of mortgage-backed securities where delinquencies have been mounting as well). Ominously, prime fixed-rate mortgages are now the fastest growing segment of non-performing mortgage loans. Although 2% of commercial and industrial loans and of commercial real estate loans are now on non-accrual, both of these categories also have the potential to worsen dramatically in the current economic environment with the scheduled looming maturities of CRE loans originated in 2005 and 2006 to worsen dramatically. Charts 9 & 10.

In sum, despite reasonably good net interest margins due to a steeply sloping yield curve and somewhat better pricing power, deepening asset quality problems created losses at almost one-third of all institutions in the second quarter. For the first half of the year, asset quality weakened at an accelerating rate pushing problem assets to a critical level at 1,400 institutions, 20% of the total. As a result of the growth of problem assets and very weak earnings (or losses), there are now about 300 institutions with a Texas ratio greater than 100%.

CONCLUSION

We are seeing a noticeable change in the attitude of buyers. There appears to be a growing sense of urgency as buyers realize the once-in-a-generation deals presented by this economic cycle may not be around much longer. After two harrowing quarters, capital is once again flowing into the stronger players in the industry. At the same time, the operating environment for a growing number of institutions grows more challenging with each day. We expect that this confluence of circumstances combined with an inevitable change in the capital gains tax rate after December 2010 will spur merger and acquisition volume in the coming quarters.



On the other side of the equation, we are seeing more wounded banks realistically assessing their options and divesting of non-strategic branches in an effort to deleverage and build capital levels. Meanwhile, healthy bank sellers in stable markets are testing the waters to see if the price is right. The prospects of lower projected earnings exacerbated by the headwinds of higher FDIC insurance costs and an increasingly difficult regulatory environment have more than a few owners wondering if selling now at a reasonable, but reduced, price in the current capital gains tax environment might net more to shareholders than waiting for a full economic recovery when the tax environment will likely be far less favorable. ■

Curtis Carpenter • Managing Director

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-Gary Blossman, CEO of Parish National Bank

Sheshunoff & Co. Investment Banking acted as financial advisor to Parish National Bank of Covington, Louisiana.

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