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BANKERS' FORUM 2011

Mergers & Acquisitions:
Considerations in the Current Environment


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Buy vs. Sell Considerations

Buy Side Considerations	Sell Side Considerations
✓ Leverage capital/dilution	✓ Tired management/Boards
✓ Ability to get new capital, if needed	✓ Growth outlook
✓ Cost-savings	✓ Regulatory burden increasing
✓ Ability to forecast combined entity	✓ Tax implications
✓ In-market vs. geographic expansion	✓ Unusual contracts/buyouts
✓ Legal lending limits (in-market customers)	✓ TARP (if applicable)
✓ TARP (if applicable)	✓ Cash vs. stock consideration
✓ Due diligence capabilities	✓ Ability to achieve scale
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✓ Unknown regulatory environment	✓ Fiduciary responsibility
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✓ Ability to generate assets/revenues	



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Current Economic Environment

- Economy recovery unknown and uncertain pace
- Macro uncertainties weigh heavily on valuation of Financial Sector
 - Real GDP – overall level and growth
 - Unemployment Rate – level and duration
 - Treasury Yields (~2%)
 - Euro/Global Issues
 - Real Estate/Housing Prices
 - Are we at the bottom???

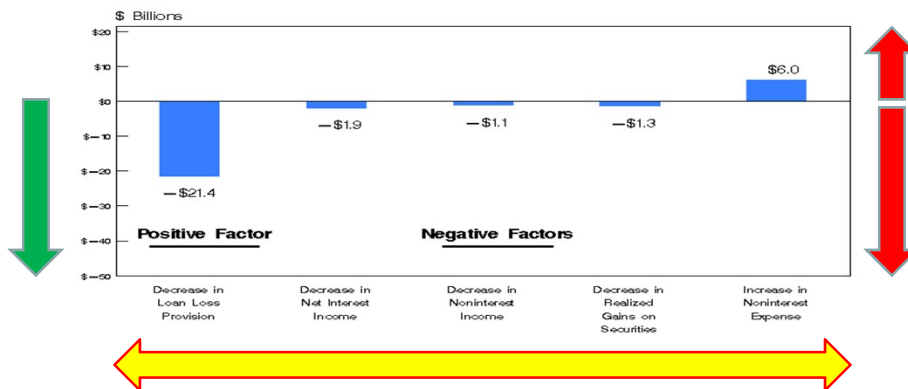
Current Banking Environment

- Slow recovery
 - ***“Banks have continued to make gradual but steady progress in recovering from the financial market turmoil and severe recession that unfolded from 2007 through 2009, this trend has expanded to include a growing portion of insured institutions.”*** – Martin Gruenberg, FDIC Acting Chairman in Second Quarter 2011
FDIC Update
- 
- **60%** reported Y/Y earnings improvements (**8th** consecutive quarter)
 - **15.2%** still reported losses, down from 20.8% a year ago
 - Provisions declined for the **7th** consecutive quarter
 - NCOs dropped to **1.65%**, lowest since 3Q08
 - Delinquencies at **5.77%**, lowest since 1Q09
 - Average ROA improved to **0.85%**, from 0.63% a year ago
 - Loans showed actual growth for first time in **12 quarters**
 - Equity to assets at 11.3%; highest since **1938**
 - FDIC Problem List declined for first time in **19 quarters (\$372 billion)**

Lower Provision; but Declining PPNR

Source: FDIC Quarterly Banking Profile

Major Factors Affecting Earnings 2nd Quarter 2011 vs. 2nd Quarter 2010

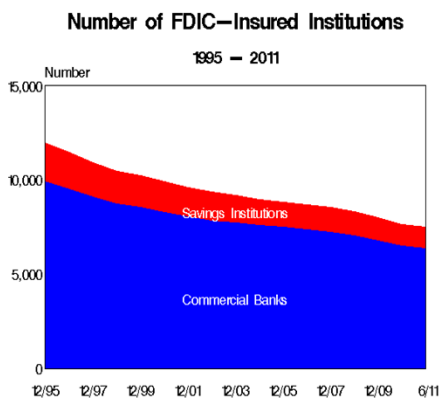


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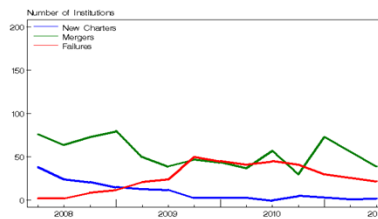
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Declining Numbers; Limited M&A

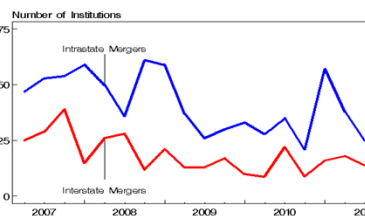
Source: FDIC Quarterly Banking profile



Changes in the Number of FDIC-Insured Institutions Quarterly, 2008 - 2011



Institution Mergers: Interstate vs. Intrastate Quarterly, 2007 - 2011



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FDIC Assisted Acquisitions

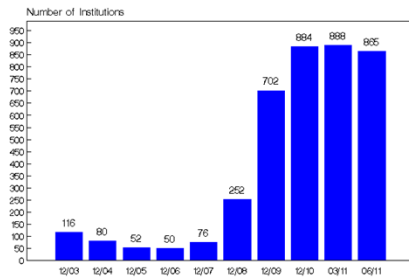
- FDIC Troubled List
 - Still high; started to decline
- Geography – “In-Market vs. Expansion”
 - Limited activity in MS, TN, AL, LA
 - Concentrated so far: FL, GA, IL
- Competition
 - Traditional strong, acquisitive banks
 - Beginning to become very competitive
 - “Blind-Pools”/Venture Capital
 - A lot of capital to deploy (or return to investors)
 - Option: Recapitalize vs. Failure



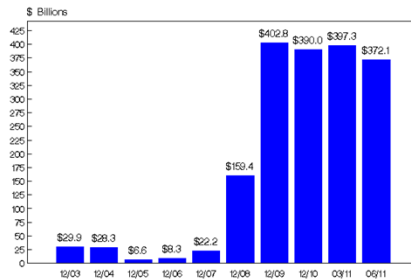
FDIC “Problem” Institutions

Source: FDIC Quarterly Banking Profile

Number of FDIC-Insured “Problem” Institutions
2003–2011



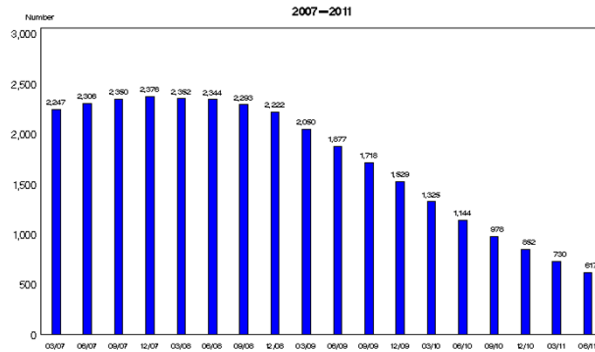
Assets of FDIC-Insured “Problem” Institutions
2003–2011



Perhaps an Insight to the List.....

Source: FDIC Quarterly Banking Profile

Number of Institutions with Construction Loan Concentrations
(Construction Loans Exceed Total Capital)



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Valuation Considerations




- **Today – Tangible Book Value is KING!**
 - Banks trading ~75% of TBV last 2 yrs
 - Multiples not likely to change until:
 - Uncertainties are resolved – economy and regulatory!
 - Overall ROTE and ROA improve dramatically!
 - Most acquirers develop view of adjusted TBV
 - Impact of Unrealized Security Gains/Losses
- **Price to Pre-Provision Net Revenue (PPNR):**
 - Record lows of ~5X PPNR; vs.
 - Average @ 8X PPNR for 1991-2011

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Accounting Considerations

- ALLL  FMV = Big Disconnect
 - ALLL based on incurred losses
 - FMV based on cumulative losses/returns, etc.
 - Can significantly impact adjusted tangible book basis
 - No ALLL brought over to acquiring bank
 - Also relevant to OREO – based on revised management intentions
- Valuation of core deposit intangibles/deposits
- Securities: large unrealized gains given low rate environment
 - Also, asset impairment issues in some cases (TRuPS, etc.)
- Does deal qualify as a “business vs. assets” (branch deals)?
- FMV of debt acquired – Trust Preferred
- Direct Acquisition Costs now expensed vs. capitalized

Tax Considerations

- Section 382 Limitations on Tax Attributes
 - $\geq 50\%$ Change in Ownership
 - Limits NOLS and other carry forward credits
 - Limits net unrealized built-in losses (“NUBL”) – projected for five years
 - Net Charge-offs for 1 year (under conformity election)
 - Limited to Deal Value X IRS Long-term Tax Exempt Rates
- S-Corp Considerations
 - Are you beyond the 10-year window (5 years though 12/31/2011)?
 - Will this be extended in “next” Stimulus package?
 - Tax on net built-in gains as of date of election
 - Paid by Bank not shareholder
 - Value may not be there today
- Asset (taxable) vs. Stock Deals (nontaxable)
 - Deductibility of Goodwill/Intangibles

Regulatory (“CAMEL”) Considerations

- Capital Considerations
 - How much dilution?
 - Ability to get new capital – limits on non equity instruments under DFA
 - <\$500 million in assets – can include existing and new
 - >\$500 to \$15 billion – existing included no new instruments after May 2010
 - >\$15 billion – phase out of hybrid instruments TBD
 - May acquire instruments at HC level – how counted under DFA?
- Asset Quality
 - Impact on levels of classified/nonperforming, etc.
- Management Considerations
 - Ability to handle increased volume of “work-out” assets?
- Earnings
 - Ability to forecast in current environment
 - Loan growth; margin; credit costs; cost saves; regulatory costs
- Liquidity Considerations
 - Is combined funding base stable?
- Integration/Operational Risk
 - Do you have a successful track record of doing integration, etc?

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James is an assurance services partner at HORNE and is the partner in charge of the Memphis, TN, office. He provides assurance and advisory services such as audits, merger and acquisitions, risk management/internal audit services, litigation support, and consulting to public and non-public enterprises. As a partner with HORNE from 2004-2007, James served as the director of assurance and SEC services and then returned to the firm in 2011. He has 24 years of audit and financial institutions experience.

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