

**Strategic Management for Community
Banks: What Small Community Banks
Need to Do Today**

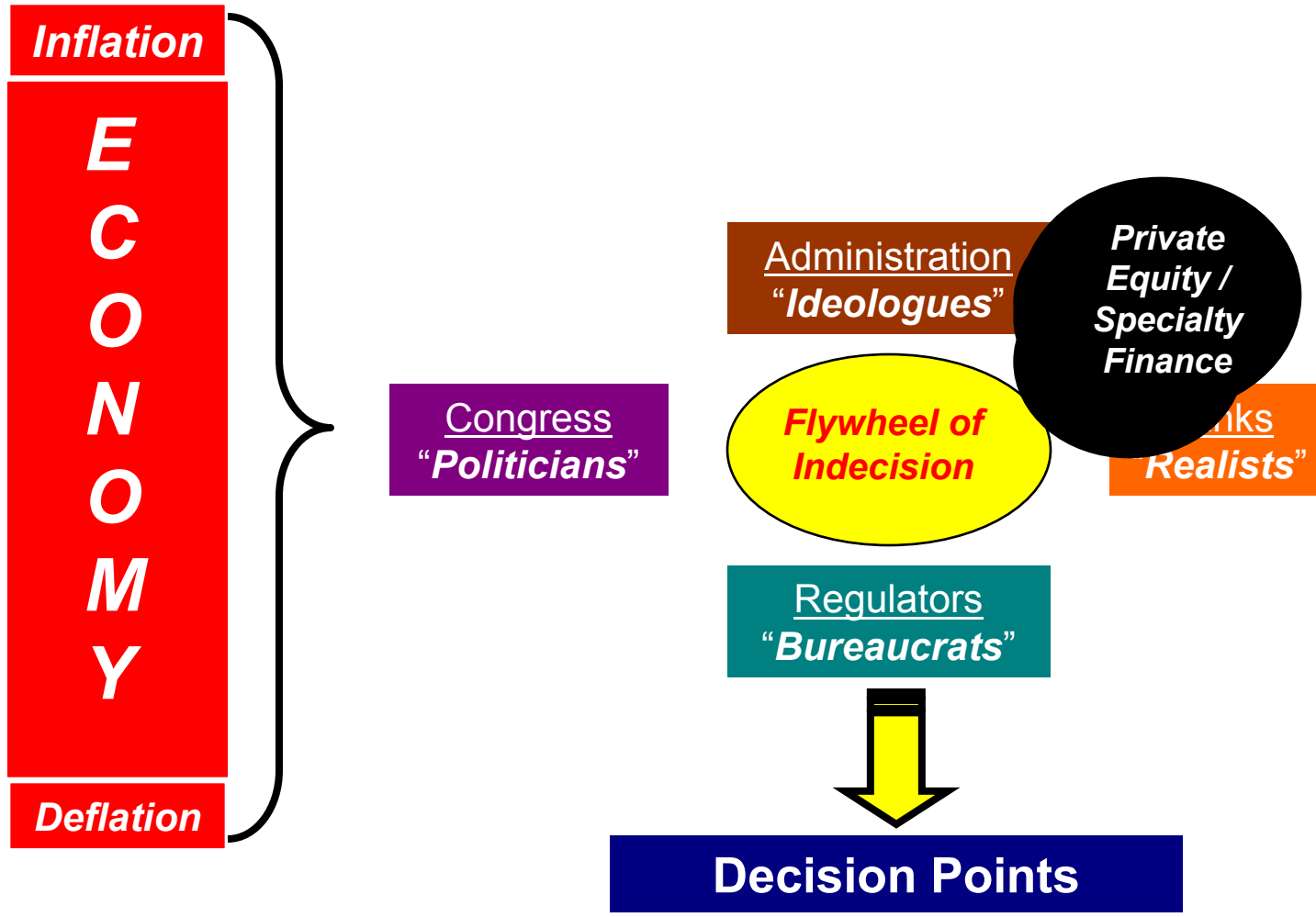
Strategic management for community banks is changing dramatically. This presentation has been broken into three areas to facilitate discussion . . .

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1. Key Issues Facing Community Banks
 2. Organic Growth Strategies
 3. Acquisition Strategies

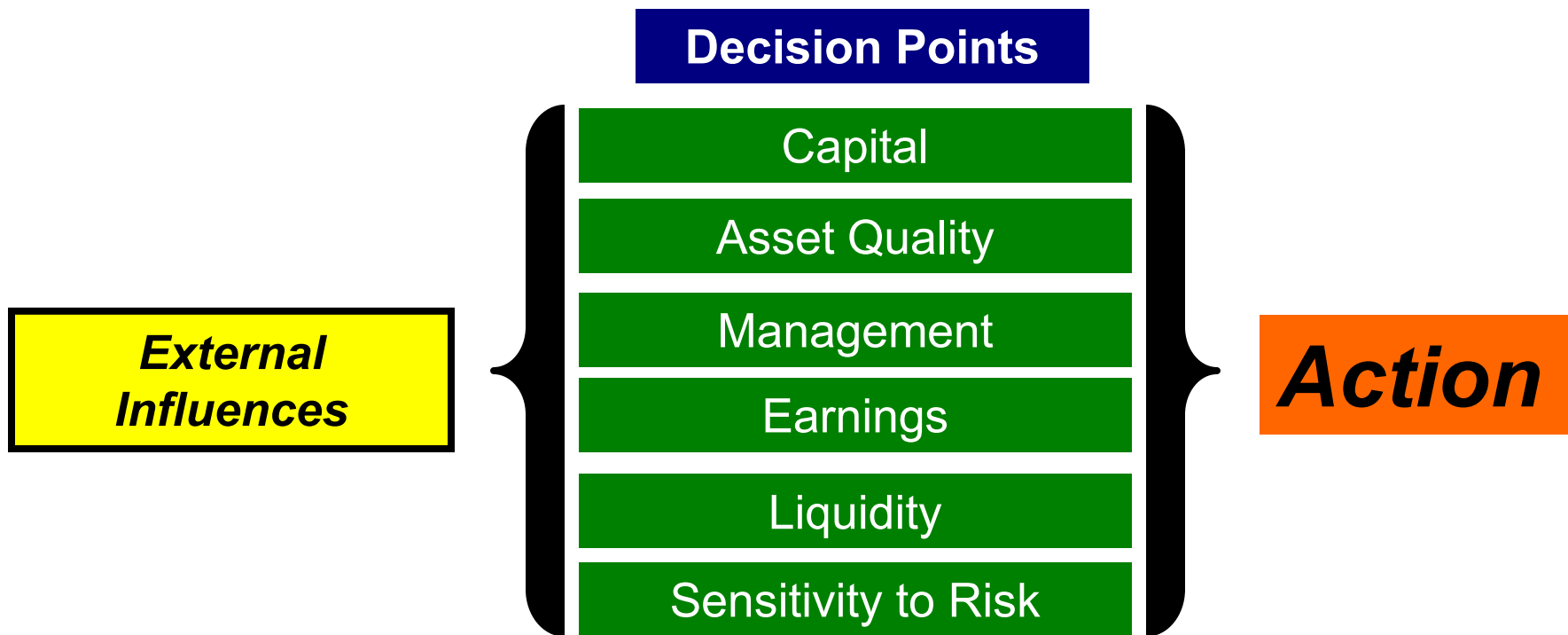


Key Issues Facing Community Banks

As bankers, we face a new reality, one with changing rules that are causing plenty of chaos and spinning us in the wheel of indecision . . .



How we manage through this chaos will determine who will win or lose in the future . . .



As a result, the key issues facing community banks can be outlined in a CAMELS format . . .

Capital

- The industry is capital starved, especially smaller community banks.

Asset Quality

- Asset quality continues to plague the industry with no abatement.

Management

- Lacking bench depth, many institutions fail to execute their plans.

Earnings

- Many institutions are fortifying capital through retained earnings and slashing dividends.

Liquidity

- Regulators are focusing on contingency funding plans as liquidity failures brought down financial behemoths.

Sensitivity to Risk

- Small community banks should use growth to manage interest rate risk.

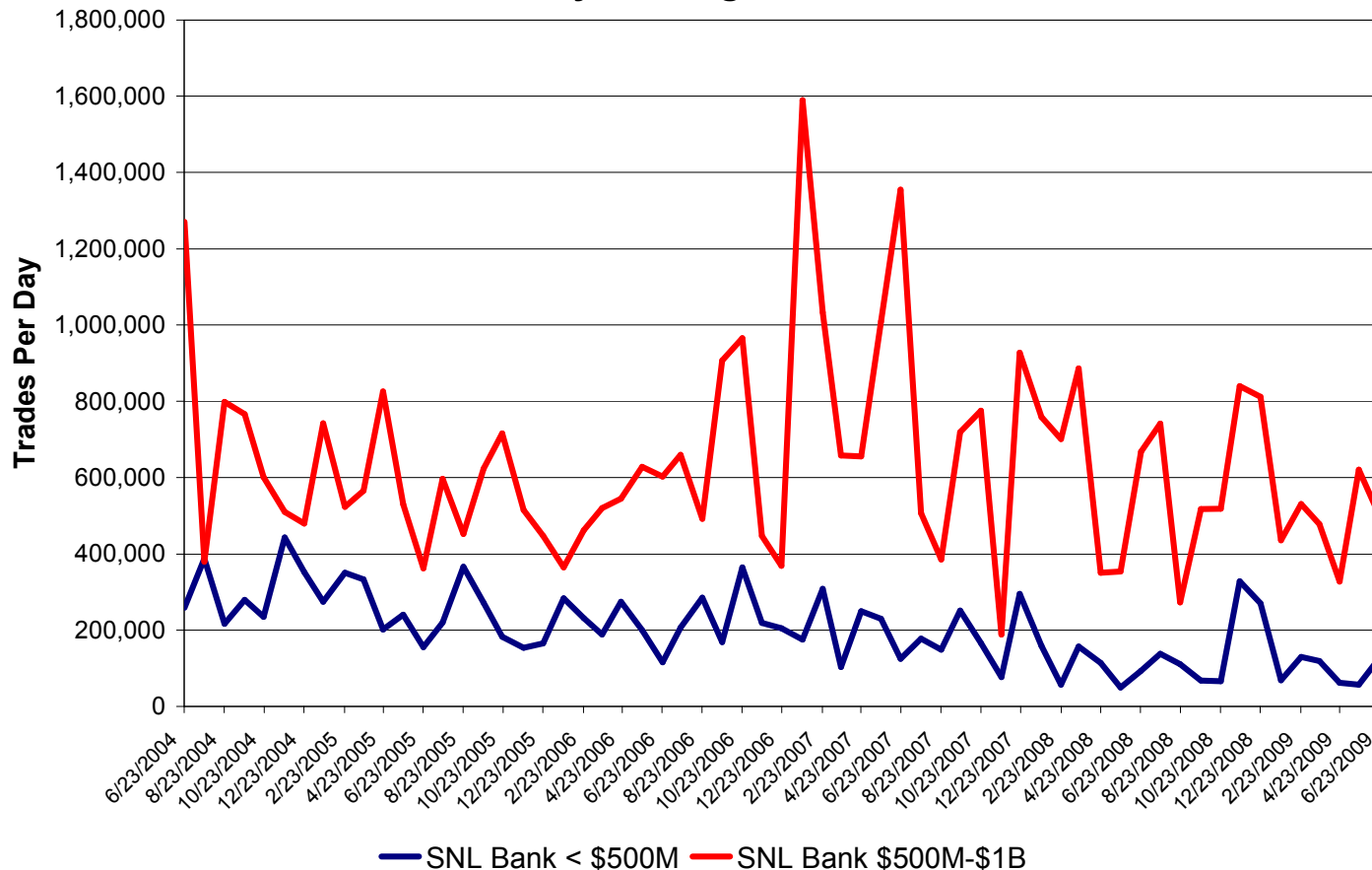
Capital

Small community banks lack the ability to access the capital markets as efficiently as larger institutions and therefore cannot recapitalize themselves . . .

- Many of the community banks lack a holding company, which limits their capital raising sources. There are several capital raising sources that are available to bank holding companies that are not available to stand alone community banks, including:
 - Trust preferred
 - Bank stock loan
- Compared to stand alone community banks, the bank holding company structure provides more flexibility in the acquisition process

In addition, smaller community bank trading volume is significantly less than larger institutions. Due to their lack of liquidity, investors are less likely to invest in community bank stocks . . .

Daily Trading Volume



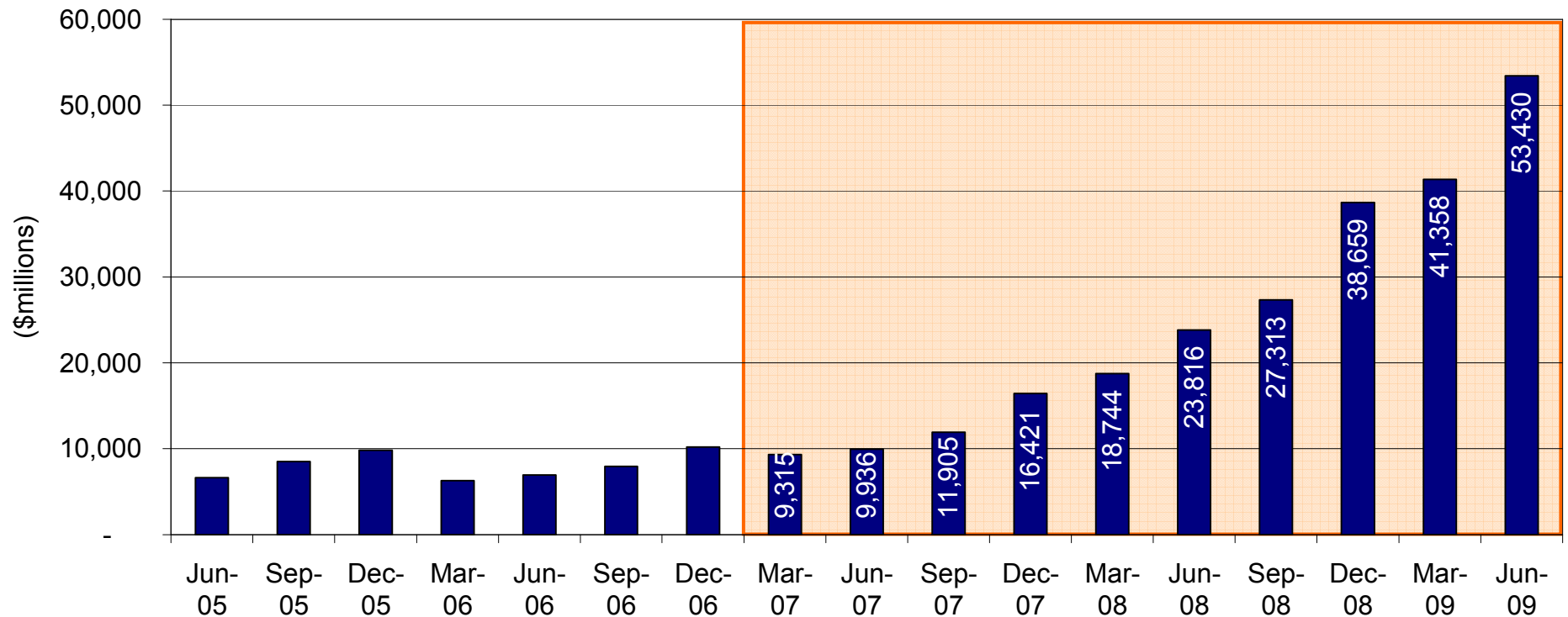
Some new capital realities . . .

- Capital preservation is paramount – I never thought I'd say that!
- More is better
- 10% is the new 8%
 - Preservation of capital is different than building capital
 - Can someone explain why we are increasing capital standards at this critical time
- Capital is hard to get today
- Investor expectations are huge
- More utilization of non traditional forms
- Some secondary offerings are getting done

Asset Quality

As of June 30, 2009, net charge offs for the entire banking industry increased for the ninth consecutive quarter. Managing asset quality and maintaining underwriting standards is imperative . . .

Total Charge-Offs



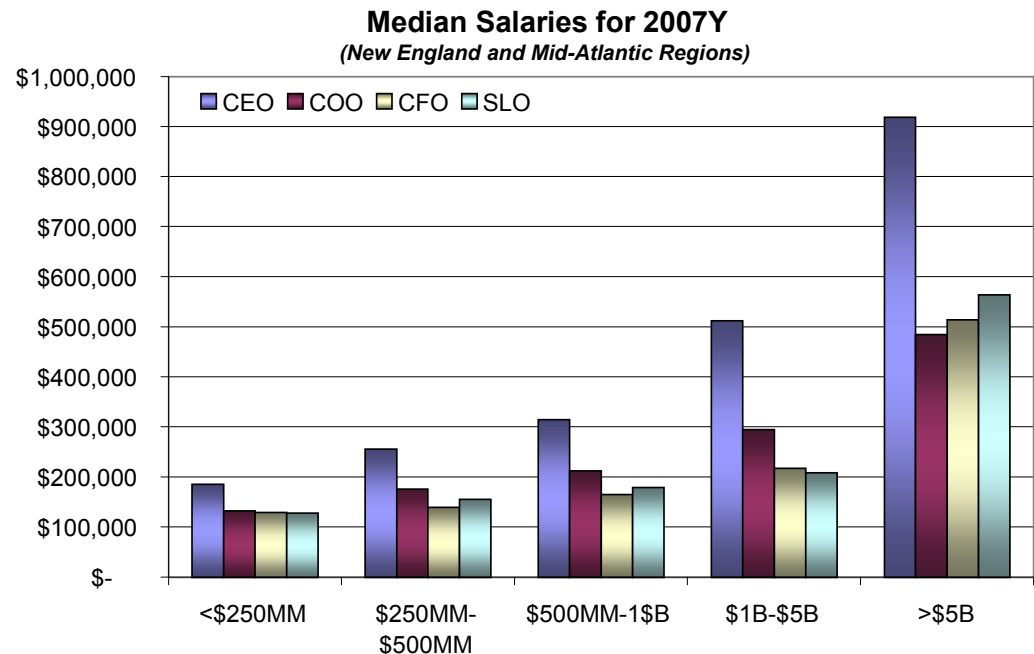
Some new asset quality realities . . .

- Land, ADC and Construction is dead
 - Regulators are making it hard to work out of these problems
- CRE will soon turn south
 - Finally proving the regulators right after five years
- C&I is risky because business is risky
- Investments are also deteriorating
- The mark-to-market should have been fixed in late 2008 – it will have little effect today.
- So even though the Administration wants us to lend – I argue we are accelerating the credit crunch.

Management

As a result of small community banks lacking scale, it is more difficult to afford and retain top management. They also do not have the depth of talented people to promote from within . . .

- Larger institutions have higher median salaries than smaller institutions for the top four executive positions
- Smaller banks have traditionally lacked internal training and “grooming”, figuring that when management nears retirement the bank will be sold
- A 2007 American Bankers Association survey reported that nearly one-third of financial institutions do not have a formal succession plan

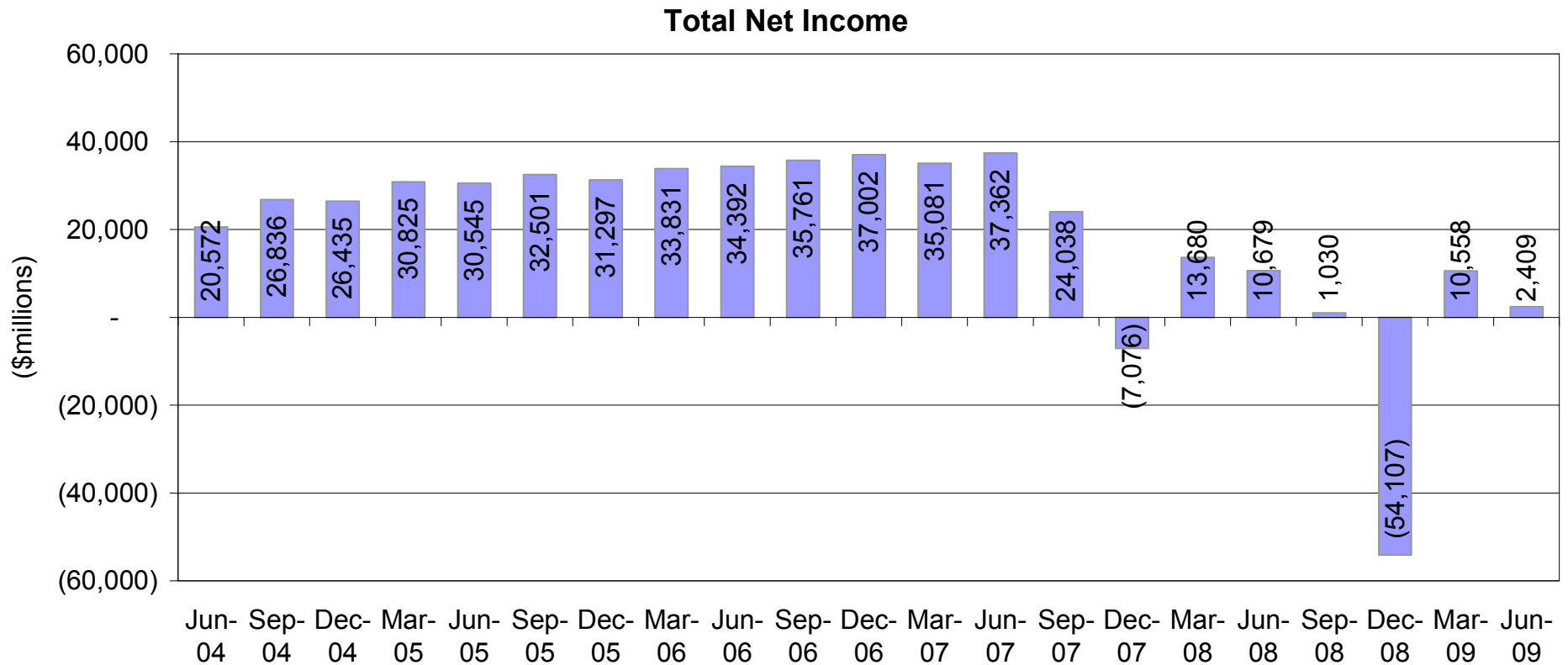


Some new management realities . . .

- Beware of the influx of Ex Wall Streeter's
- Expect higher turnover at the top – Succession planning is not evil, it is necessary
- Strong team approach appears to be working
- Boards need independence and should have a lead external director
- Training must get better

Earnings

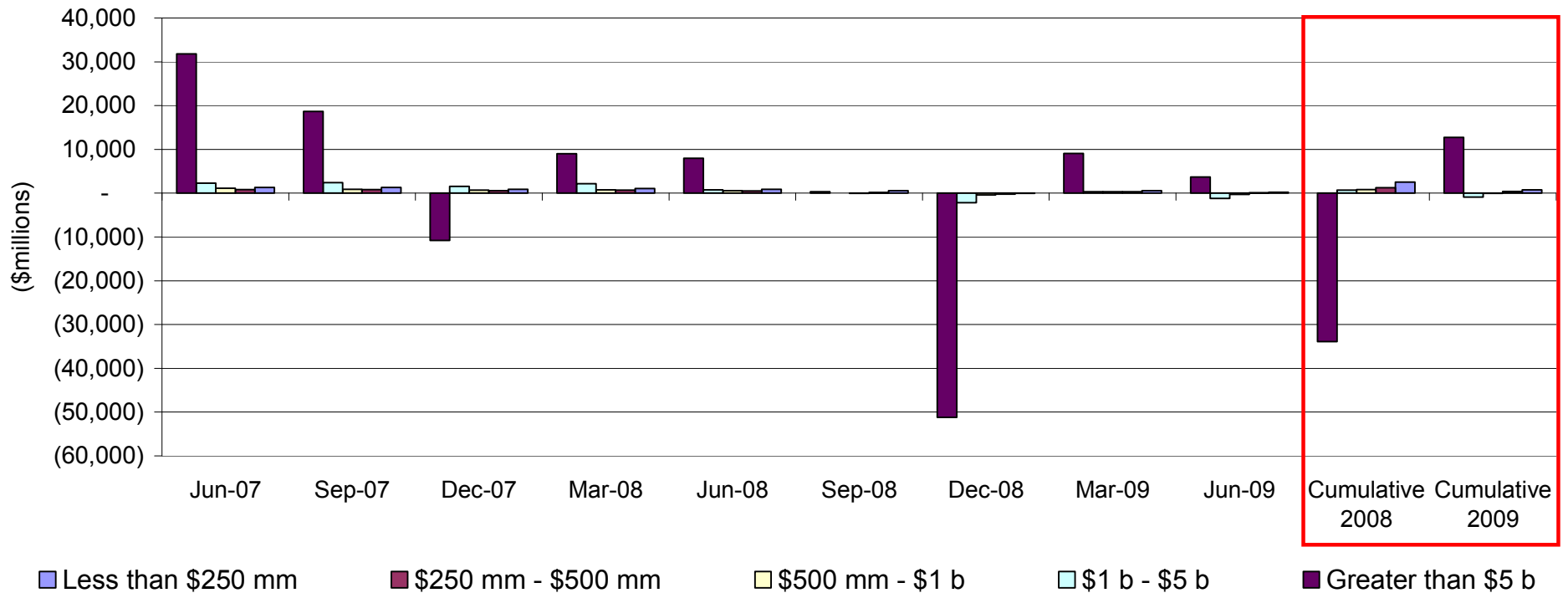
Across the banking industry, earnings began to falter in 2007 culminating in the industry's \$51.3 billion loss for the fourth quarter 2008. Earnings have rebounded in 2009 but continue to be anemic . . .



However looking at the earnings by asset size of institution, small community banks outperformed all other institutions in 2008 . . .



Total Quarterly Net Income By Asset Size of Institution



Some new earnings realities . . .

- Need to be profitable, but it is not about record earnings today
- It is OK to sacrifice some earnings to mitigate risk
- Grow only if its profitable
- Obtaining market share today will likely be a priority
- We must contain expenses

Liquidity

Maintaining a liquidity plan that addresses contingency funding needs is a necessity for any institution . . .

- Liquidity management is all about **managing cash flow and understanding your liquidity sources** and capacity.
 - Cash flows are often drastically different in different interest rate environments.

As of: Mar-09	Cash Flow Liquidity Analysis											
	Static Balance Sheet - Flat Rates											
	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10
Scheduled Cash Flow:												
Assets												
MBS	1,541,782	1,534,523	1,393,330	1,311,190	1,234,493	1,162,856	1,095,923	1,033,365	974,875	920,169	862,943	759,989
Investments	2,347,000	2,450,000	6,291,000	2,136,000	6,191,000	645,000	1,799,000	1,099,000	99,000	2,475,000	(0)	990,000
Total MBS & Investments	3,888,782	3,984,523	7,684,330	3,447,190	7,425,493	1,807,856	2,894,923	2,132,365	1,073,875	3,395,169	862,943	1,749,989
1-4 Family and Mixed Use Mortgages	1,247,838	862,706	843,072	823,923	805,248	787,034	769,269	751,940	735,038	718,551	702,468	686,779
Commercial Mortgages (Owner Occupied)	5,923,959	3,119,871	2,819,566	2,784,421	2,051,105	1,985,657	1,739,241	1,736,079	1,681,364	1,491,544	1,488,388	1,485,271
Construction, Land and Other Mortgages	16,007,310	7,460,741	3,580,592	1,923,960	1,419,078	1,299,146	1,156,243	769,951	451,799	453,588	376,315	344,997
Home Equity Loans	184,838	183,454	182,084	180,728	179,386	178,058	176,744	175,443	174,156	172,881	171,620	170,372
Consumer Loans	73,242	14,192	14,112	14,035	13,923	13,601	13,528	13,457	13,387	13,235	12,937	12,648
Commercial Loans	13,450,104	7,213,026	5,180,399	5,555,576	2,581,698	2,289,867	1,889,382	1,656,796	958,857	3,740,098	2,903,637	1,803,202
Loans, gross	36,887,291	18,853,989	12,619,825	11,282,643	7,050,439	6,553,364	5,744,407	5,103,667	4,014,601	6,589,897	5,655,366	4,503,269
Other Assets	-	-	-	-	-	-	-	-	-	-	-	-
Total Assets	40,776,073	22,838,512	20,304,155	14,729,833	14,475,932	8,361,220	8,639,330	7,236,032	5,088,476	9,985,066	6,518,309	6,253,258
Liabilities												
Certificates of Deposit	(24,683,111)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Brokered Deposits and CDARs	-	-	-	-	-	-	-	-	-	-	-	-
Total Deposits	(24,683,111)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Borrowings	(30,003,676)	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	-	-	-	-	-	-	-	-	-	-	-	-
Total Liabilities	(54,686,787)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Net Scheduled Inflows (Outflows)	(13,910,714)	(7,244,077)	10,132,107	10,045,811	1,316,019	(3,009,961)	7,063,867	4,242,032	3,140,384	3,855,929	(4,301,656)	(1,778,214)

Stress tests are needed!

Determine where the collateral is worth the most . . .

- Do a cost analysis based on borrowing costs and where assets can be pledged.
 - Every institution should know where the value of its collateral is highest and where the cheapest funding source is.
 - The sale of assets for liquidity purposes is generally a tertiary option for most institutions.
 - Underwater assets should be used as collateral for borrowings before an institution resorts to selling at a loss.

Collateral Status as of Mar-09												
	Book Value	Market Price	Market Value	Currently Pledged					Total Pledged	Coll Rate	Available to Pledge	Coll Rate
				FHLB	FRB	REPO	GUDPA	Other				
Securities	\$ 25,000	102.92%	\$ 25,730	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	97%	\$ 26,482	97%
Investments	15,000	101.22%	15,184	-	-	-	-	-	-	99%	15,369	99%
Residential 1-4	30,000	100.00%	30,000	-	-	-	-	-	-	90%	30,000	90%
Multifamily*	10,000	100.00%	10,000	-	-	-	-	-	-	60%	10,000	60%
Commercial Real Estate	45,000	100.00%	45,000	-	-	-	-	-	-	60%	45,000	60%
Construction Loans*	10,000	100.00%	10,000	-	-	-	-	-	-	45%	10,000	45%
HELOC	15,000	100.00%	15,000	-	-	-	-	-	-	60%	15,000	60%
Consumer Loans	5,000	100.00%	5,000	-	-	-	-	-	-	50%	5,000	50%
Commercial Loans*	20,000	100.00%	20,000	-	-	-	-	-	-	50%	20,000	50%
Total:	\$ 175,000	100.52%	\$ 175,914	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-	\$ 176,851	72%
Net Haircut										0.00%	28.24%	
Net Collateral Value				-	-	-	-	-	-	-	126,903	

Some new liquidity realities . . .

- Liquidity Stress Test Assumptions
- Cash flow assumptions:
 - From the dynamic model 1 (base case)
- Stress test scenarios:
 1. Base Case – liquidity projection for 12 months
 2. 20% Deposit Runoff
- Never there when you need it
- Sources can dry up quickly

Sensitivity to Risk

Managing interest rate risk while growing will control balance sheet sensitivity . . .

- Institutions should strive to fund their growth with **core deposits**, specifically demand deposits. The core deposit growth will not only improve profitability, but decrease interest rate risk.
- Borrowing rates are at historic lows. Institutions have the ability to lock in longer term funding for less than the cost of a time deposit and without the prepay risk.
- When investing or lending, institutions should focus on buying or originating **shorter term or variable rate assets** that will reprice to a higher rate as interest rates rise.

However, it is important to understand the regulatory constraints of growth. Breaching regulatory thresholds causes concerns among the regulators and can slow the growth of an institution . . .

- While 8.00% is a working expectation for core capital, regulators are expecting capital plans for any growth institution with less than 10.00%.
- Loan loss reserves are expected to be above 1.00% of total loans.
- Regulators have taken a hard line on the commercial real estate and construction lending guidance.
 - The regulatory threshold for Construction is 100.0% of Total Risk Based Capital
 - The regulatory threshold for Commercial Real Estate is 300.0% of Total Risk Based Capital. Regulators are starting to include owner occupied loans in the calculation.

- Loan concentrations of 30.0% or higher will draw additional scrutiny as well.

Loan Concentration Thresholds	
Tier 1 Core Capital	30,000
Total Growth Potential (8.00% Leverage Ratio)	375,000
Regulatory Thresholds:	
Total Construction (100% Total Risk Based Capital)	30,000
Total Commercial Real Estate (300% Total Risk Based Capital)	90,000
Total	120,000
Total Percent of Assets in CRE & Const.	32.00%

And, while available as liquidity management tools, do not rely on a wholesale or brokered deposit funding focus . . .

- Regulators will not permit a business plan that relies on wholesale funding or brokered deposits.
- The new FDIC insurance premium structure illustrates the regulatory concern in regards to wholesale funding.
 - An institution will incur additional FDIC assessment fees if:
 - Borrowings are measured above 25.00% of total deposits.
 - Brokered deposits are measured above 10.00% of total deposits.

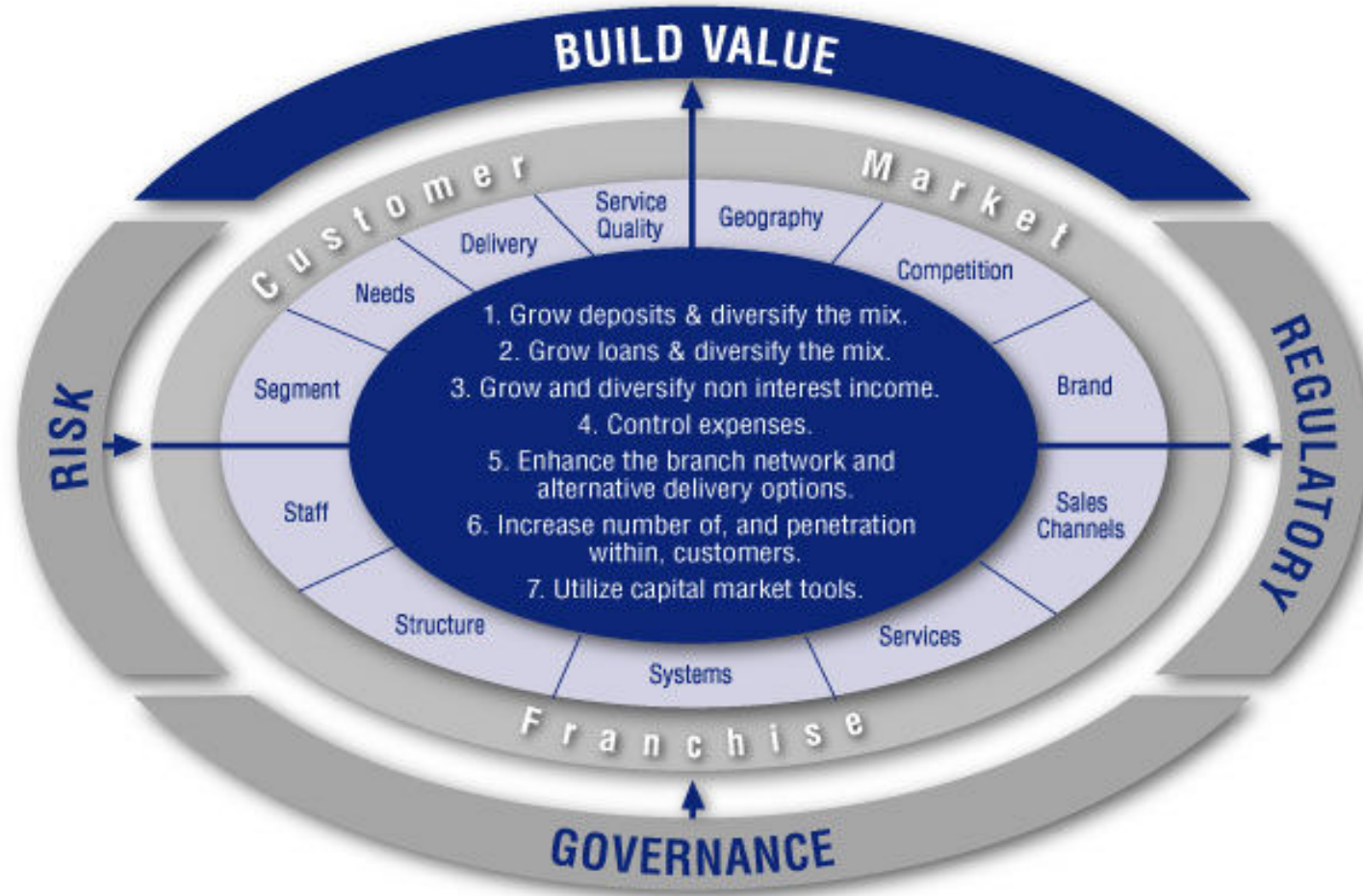
FDIC Assessment Schedule	Risk Category			
	I	II	III	IV
Annual Rates (bps)	12 - 16	22	32	45
Unsecured Debt Adjustment	-5 - 0	-5 - 0	-5 - 0	-5 - 0
Secured Liability Adjustment	0 - 8	0 - 11	0 - 16	0 - 22.5
Brokered Deposit Adjustment	0	0 - 10	0 - 10	0 - 10
Total Base Assessment Rate	7 - 24	17 - 43	27 - 58	40 - 77.5

- **Measured use** of borrowings or brokered deposits can enhance an institution's profitability, but **it should be used in moderation**.



Organic Growth Strategies

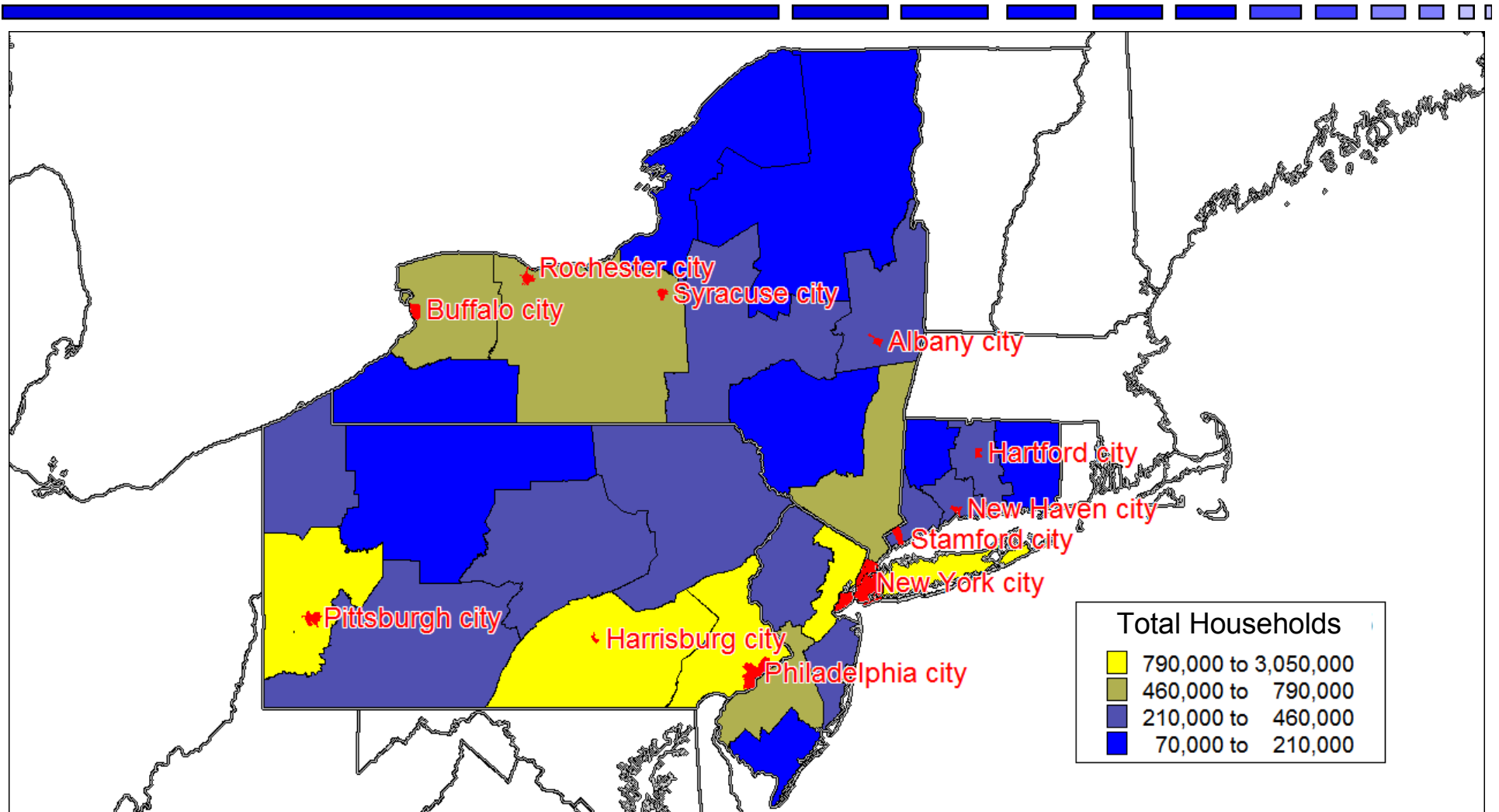
It all comes back to the seven ways to build value . . .



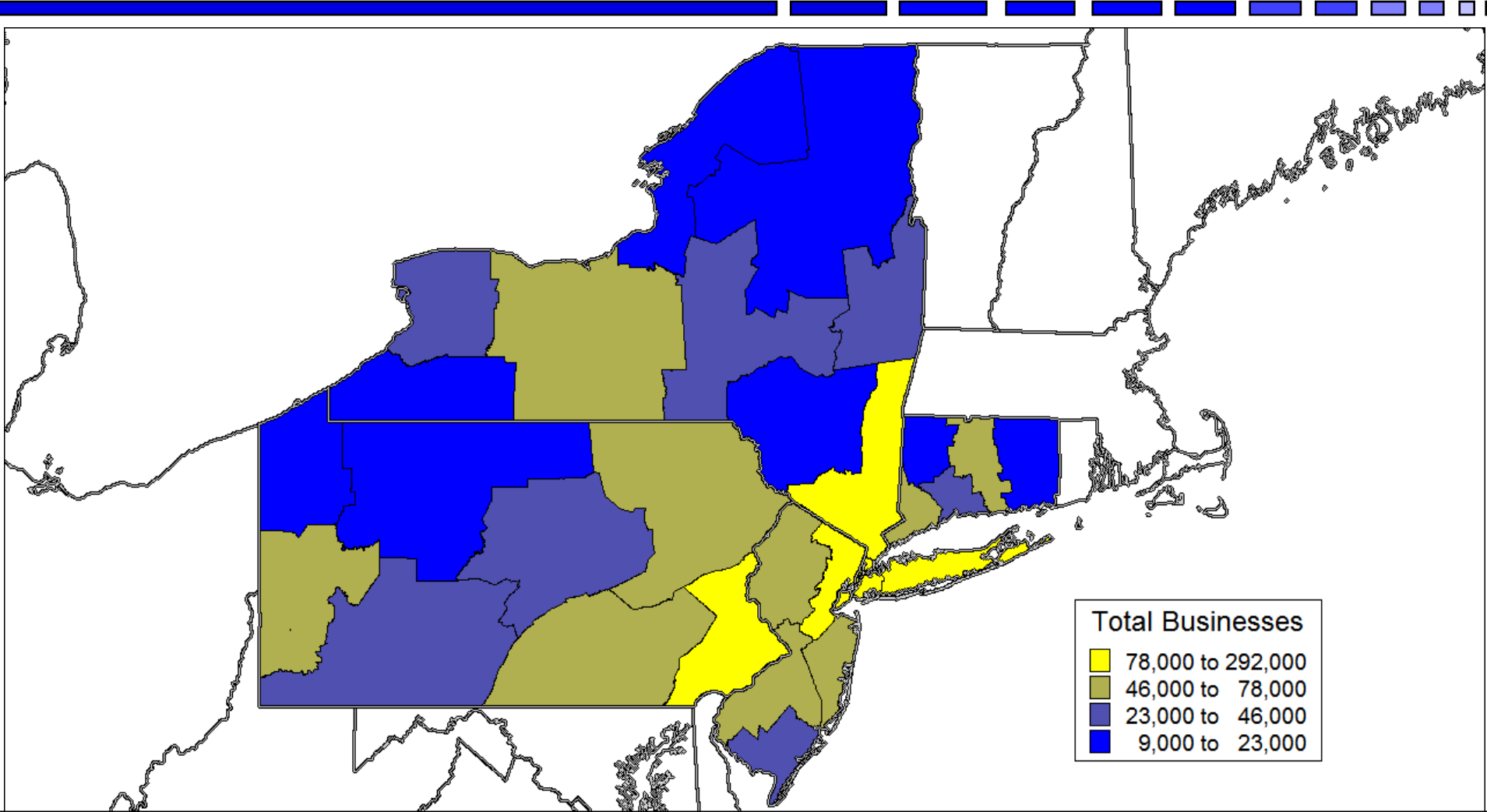
Executing an organic growth strategy requires detailed planning and an in depth understanding of the market area . . .

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- Information on households, populations and businesses can dictate market potential and determine which strategies will be successful.
 - A strategy must be tailored to an individual market, taking into account variables such as minority population, business density, median property value, per capital income and many others.

As an example New York, New Jersey, Connecticut and Pennsylvania were broken down into regions. There is considerable diversity in the regional markets in terms of demographic size and growth. Households are concentrated in the regions with larger metro areas . . .



And businesses are concentrated primarily in the more developed regions . . .



If expansion is necessary, infrastructure needs to be less costly and specifically targeted . . .

- Develop market specific facilities
 - Design branches to meet the specific needs of the market they serve
 - Establish a defining aspect so all branches are branded
- Flexible facility design – limit up-front costs and market exposure:
 - Modular facilities that are easily expandable
 - Portable branch FF&E
- Enter markets utilizing loan production offices
- Market ranking to determine best possible location



Geographic expansion can also be done wisely through the effective use of people expansion . . .

- Establish a Community Board made up of local movers and shakers with real teeth and measurable business development goals
 - The members of this board are expected to generate business through new loan and deposit accounts
 - Builds an affinity with the community through people
- Hire lending officers with ties to the local community and business development officers that are able to solicit deposits from businesses and residential customers.
- Determine the market loan potential to know if your loan officer should have \$8.0 million or \$30.0 million in annual production.
 - In the same market a construction lender may be wildly successful, however a C&I lender may struggle.
- Determine the market deposit potential to know if your business development officer should have \$5.0 million or \$15.0 million in annual production.
 - Know if it makes sense to target businesses or certain retail segments within a market.

Utilize the branch improvement process to improve the existing franchise . . .

- Increase penetration in current customers (“Cross Sell to increase Walletshare”).
- Learn to attract new customers (New Sell to increase “Market Share”).
- Develop a detailed profile of the bank’s existing branch markets.
- Identify the bank’s customers and their financial needs.
- Determine the Bank’s market share and position in existing markets.
- Identify growth opportunities on a market by market basis.
- Sell or close underperforming branches that strategically have no purpose





Acquisition Strategies

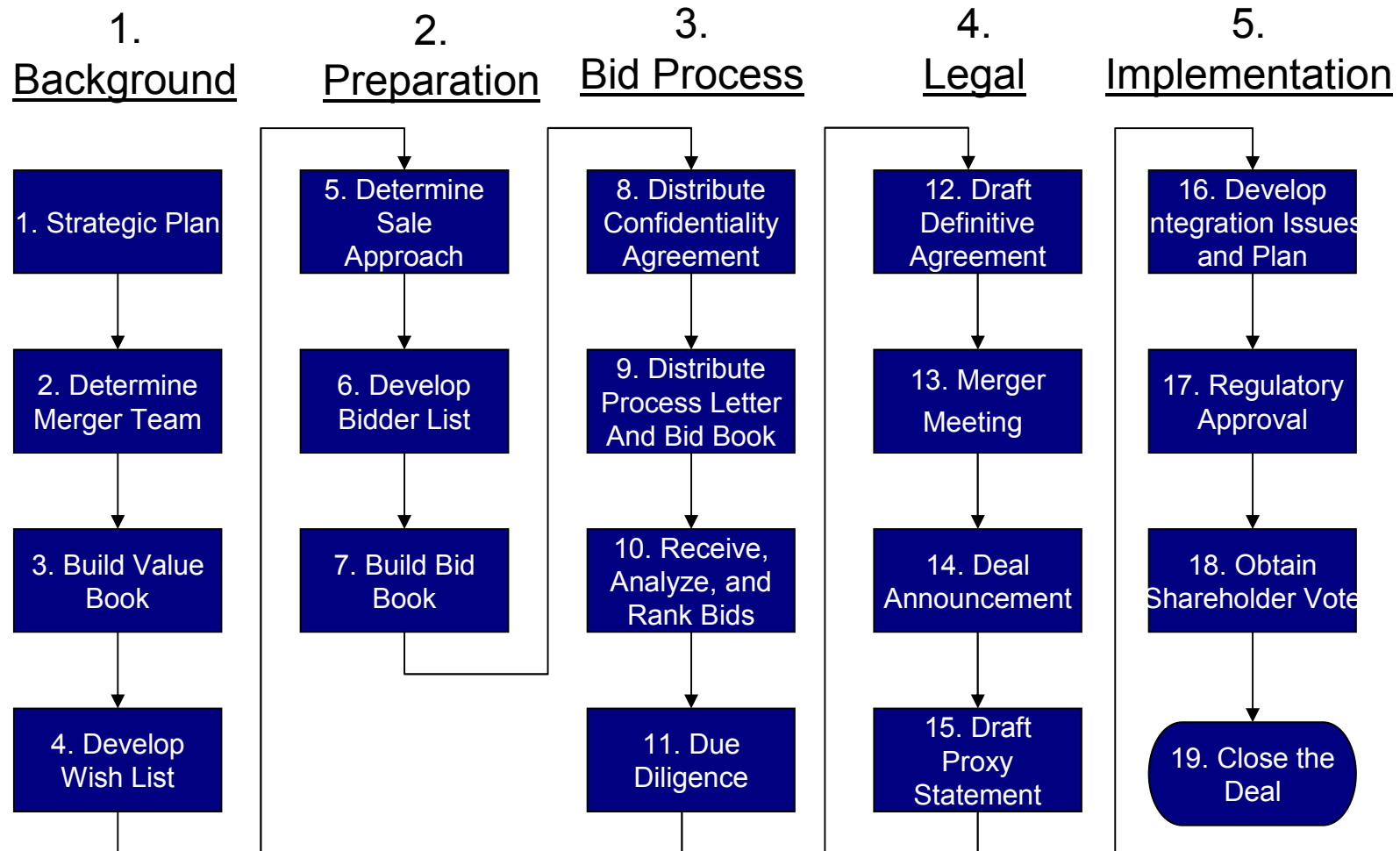
The community bank space, particularly in the Northeast, is experiencing challenges that provide a powerful opportunity to execute a roll-up strategy . . .

- **Access to capital:** Small community banks lack the ability to access the capital markets as efficiently as larger institutions and therefore cannot recapitalize themselves
- **High expense structure:** Community bank overhead levels are high due to the costs of operating in a regulated industry and the lack of economies of scale
- **Weak net interest margins:** Community banks, as a result of their need to grow and their smaller distribution channel, have a higher cost of funds and lower yield on assets
- **Inability to attract and retain top management:** Because small community banks lack scale, they cannot afford top management and do not have the depth of talented people to promote from within
- **Fragmented market:** The target market is fragmented, inefficient and poised for increased regulatory burden. There are too many small community banks in the Northeast
- **Historically low valuations:** Many institutions are trading for less than their tangible book value with financial stocks substantially underperforming the broader market during this crisis

The key return drivers of the consolidation strategy are . . .

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- **Improve the net interest margin:** Improve the net interest margin by both increasing asset yields and decreasing cost of funds.
 - **Acquire or build fee generating businesses:** Acquire or build fee income sources due to its capitalization and size.
 - **Gain economies of scale:** Gain economies of scale by leveraging its single back office and eliminating redundant operations.
 - **Lever off of existing relationship managers:** Retain key relationship managers and local brand identities in order to retain and strengthen community ties.
 - **Maximize valuation multiples:** Provide investor returns through valuation multiple expansion which will arise from both increasing asset size and return of normal market conditions.

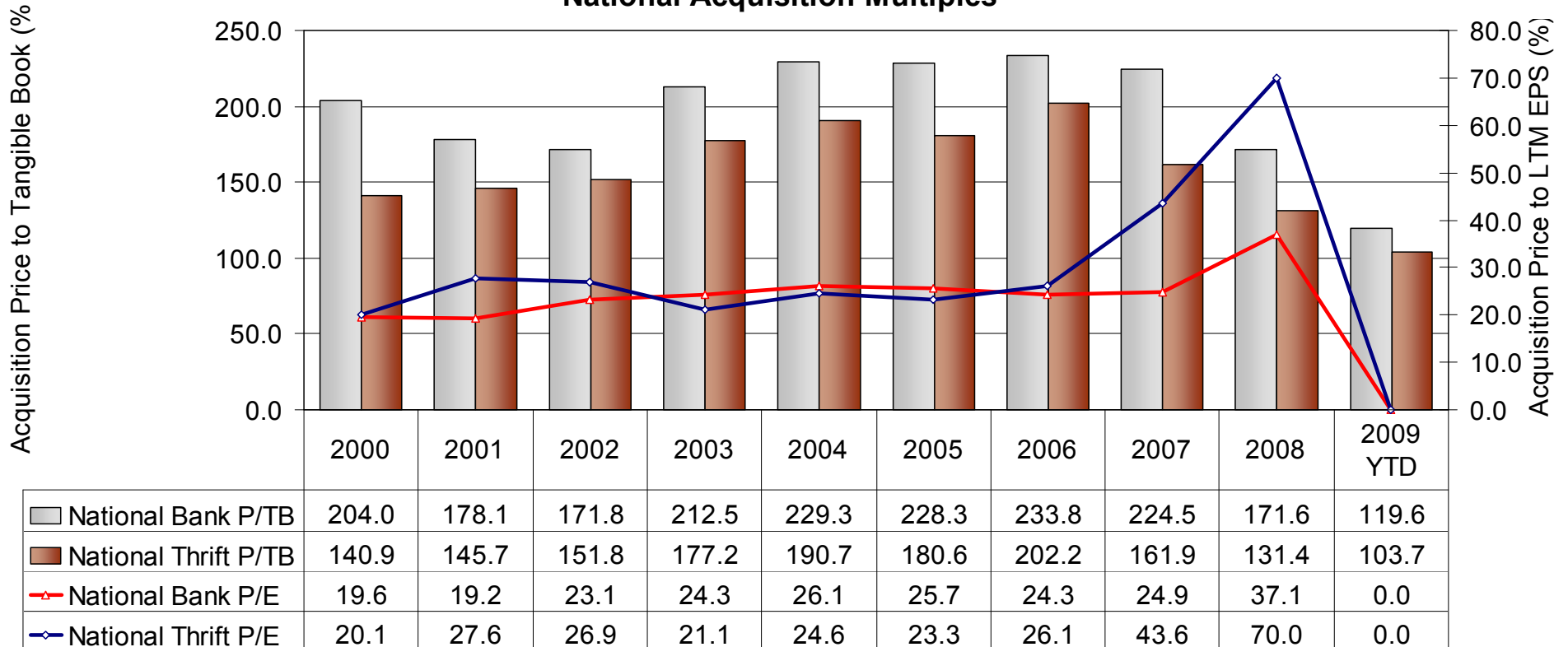
Each of the three acquisitions adds value in a unique way, however all acquisitions must follow the correct procedure . . .



Acquisition multiples are at historic lows, decreasing the incentive for sellers to sell . . .



National Acquisition Multiples



Separating deals involving healthy targets versus distressed targets, the acquisition multiples are much higher for healthy target institutions (defined as those with positive ROAA for the LTM). Healthy deals were prices at 142.85% TBVS and 18.9 x LTM EPS . . .



Healthy Deals

Buyer Name	Buyer State	Target Name	Target State	Target Region	Buyer: Total Assets (\$000)	Target: Total Assets (\$000)	Target: Total Equity (\$000)	Announce Date mm/dd/yyyy	Price/Tangible Book (%)	Price/LTM Earnings (x)	Target ROAA LTM	
Country Bancorporation	IA	Exchange State Bank	IA	Midwest	161,549	30,449	6,563	03/31/2009	100.00	6.42	2.20	
Central Bancorp, Inc.	CO	Farmers and Stockmens Bank of Clayton	NM	Southwest	NA	56,117	5,402	06/03/2009	167.22	8.12	1.46	
First Niagara Financial Group, Inc.	NY	Harleysville National Corporation	PA	Mid-Atlantic	9,587,977	5,646,195	473,713	07/26/2009	114.74	8.43	0.63	
Armed Forces Bank Holding Company	VA	2 Bank Subsidiaries			NA	884,958	110,602	03/11/2009	157.51	15.05	NA	
Community Exchange Bancshares	KY	Hindman Bancshares, Incorporated	KY	Midwest	NA	158,849	19,670	02/24/2009	132.19	18.15	0.97	
Foothills Bank	AZ	Yuma Community Bank	AZ	West	140,459	72,267	6,890	05/05/2009	185.64	18.32	0.75	
First American Financial Management Company	DE	Community Bank of Rowan	NC	Southeast	NA	146,645	10,615	07/15/2009	150.00	19.47	0.76	
Hulett Bancorp	WY	First National Bank of Ekalaka	MT	West	38,752	30,178	2,168	05/27/2009	155.63	20.20	1.11	
Merchants Bancorp, Incorporated	OH	CB Bancorp, Incorporated	OH	Midwest	418,271	110,988	10,767	03/25/2009	100.21	22.64	0.35	
BCB Bancorp, Inc.	NJ	Pamrapo Bancorp, Inc.	NJ	Mid-Atlantic	597,896	592,373	54,430	06/29/2009	86.13	25.00	0.40	
OceanFirst Financial Corp.	NJ	Central Jersey Bancorp	NJ	Mid-Atlantic	1,913,733	576,223	81,872	05/26/2009	135.70	26.00	0.54	
Sandhills Bancshares, Inc	TX	TransPecos Banks - Iraan	TX	Southwest	NA	23,726	2,512	05/20/2009	252.02	26.08	1.37	
									Median	142.85	18.90	

Distressed deals (where the target had a LTM ROAA of less than negative 1%) were priced at 45.82% of TBVS . . .

Distressed Deals

Buyer Name	Buyer State	Target Name	Target State	Target Region	Buyer: Total Assets (\$000)	Target: Total Assets (\$000)	Target: Total Equity (\$000)	Announce Date mm/dd/yyyy	Price/Tangible Book (%)	Price/LTM Earnings (x)	Target ROAA LTM
Capital Funding Bancorp, Inc	MD	AmericasBank Corp.	MD	Mid-Atlantic	NA	145,935	7,655	04/03/2009	3.54	NM	-1.81
Tall City Bancshares, Inc.	TX	Kent County State Bank	TX	Southwest	NA	14,856	1,963	03/13/2009	6.86	NM	-1.16
SP Acquisition Holdings, Inc.	NY	Frontier Financial Corporation	WA	West	NA	3,987,403	269,486	07/30/2009	9.05	NM	-2.18
Heart of Georgia Bancshares, Inc.	GA	Tattnall Bank	GA	Southeast	105,781	63,015	2,863	07/23/2009	21.54	NM	-2.39
First Business Bank, N.A.	CA	1st Pacific Bancorp	CA	West	105,209	450,769	22,344	07/16/2009	33.10	NM	-4.98
Southern Missouri Bancorp, Inc.	MO	Southern Bank of Commerce	AR	Southeast	453,257	28,385	1,563	04/13/2009	38.26	NM	-1.33
Carolina Trust Bank	NC	Carolina Commerce Bank	NC	Southeast	171,631	103,533	9,822	06/03/2009	53.37	NM	-1.06
NB&T Financial Group, Inc.	OH	Community National Corporation	OH	Midwest	529,400	100,143	8,755	06/30/2009	80.82	NM	-1.94
CB Bancshares Corp.	KS	Citizens Bank of Weir, Kansas	KS	Midwest	NA	8,357	598	02/23/2009	82.44	NM	-1.91
Global Consumer Acquisition Corporation	NY	Service1st Bank of Nevada	NV	West	NA	204,103	41,348	09/09/2009	100.00	NA	-3.52
Investor group	NY	1st Commerce Bank	NV	West	NA	45,390	5,673	07/13/2009	150.01	NM	-3.07
Cache Holdings, Inc.	OK	Healthcare Bancorp, Inc.	OK	Southwest	NA	56,324	4,459	06/23/2009	175.88	NM	-4.74
First Oklahoma Holdings, Inc.	OK	Glencoe State Bank	OK	Southwest	NA	9,979	1,668	07/10/2009	NA	NA	-8.81
Ladder Capital Finance Holdings, LLC	NY	FirstCity Bank of Commerce	FL	Southeast	NA	35,432	8,758	07/07/2009	NA	NA	-7.19
Alcar, LLC	NY	Darien Rowayton Bank	CT	New England	NA	118,243	3,526	06/29/2009	NA	NA	-5.87
Quontic Bank Acquisition Corporation	NY	Golden First Bank	NY	Mid-Atlantic	NA	27,391	3,315	05/12/2009	NA	NA	-4.83
Florida Traditions Bank	FL	Providence Bank	FL	Southeast	73,975	41,802	5,004	01/15/2009	NA	NA	-3.56
Access 1st Capital Bank	TX	Town Center Bank	TX	Southwest	71,834	51,471	5,470	06/01/2009	NA	NA	-3.27
Piedmont Bancorp, Inc.	GA	Republic Bank of Georgia	GA	Southeast	NA	156,851	14,472	03/18/2009	NA	NA	-3.21
Bancorp, Inc.	DE	American Home Bank	IL	Midwest	1,792,375	128,645	49,391	04/01/2009	NA	NA	-1.88
Klein Financial, Inc.	MN	Community Bank Plymouth	MN	Midwest	1,568,109	62,424	3,794	08/28/2009	NA	NA	-1.80
Liberty Financial Services, Inc.	LA	United Bank & Trust Company	LA	Southwest	366,502	25,378	1,574	02/02/2009	NA	NA	-1.78
Edgar County Banc Shares, Inc.	IL	First National Bank of Gilman	IL	Midwest	247,302	43,081	1,122	08/19/2009	NA	NA	-1.48
Golden Pacific Bancorp, Inc.	CA	Gold Country Financial Services, Inc.	CA	West	NA	100,935	9,708	08/06/2009	NA	NA	-1.29
MidAtlantic Bancorp, Inc.	VA	Greater Atlantic Financial Corp.	VA	Southeast	NA	218,631	-10,447	06/15/2009	NM	NM	-4.77
Piedmont Community Bank Holdings, Inc.	NC	VantageSouth Bank	NC	Southeast	NA	96,385	7,304	06/10/2009	NM	NM	-1.57
									Median	45.82	