Tall Trees Capital LLC

Bank Investing in the New Economy
The Due Diligence Model

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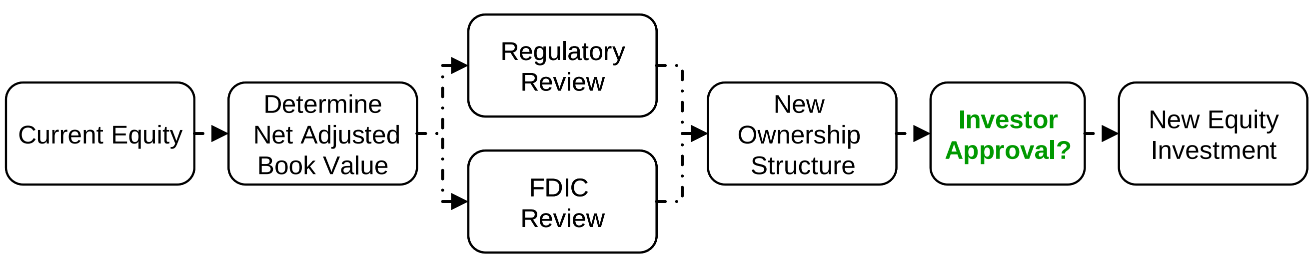
The Economy is in a recession. Recessions always present opportunities for Equity Investors if they can identify the sectors and institutions that will survive and have long-term viability. Banking will be one of those sectors to survive and the Government, though the Federal Reserve, will make sure the regulated banking sector has sustainability. Selecting the individual financial institution that will survive with sustained profitability will be one of the greatest challenges.

The banking system is in disarray because banks are now operating within the new financial reality that "Banks must be profitable." The Federal Reserve and the FDIC want banks to be healthy. Owners and executive managers must recognize the old paradigm of revenue at all cost is no longer the way to financial returns. Rather, today the agencies are looking at the strength of a bank's balance sheet – how much equity, how much leverage, how much risk? Thus, the challenge is how much equity does a bank need to maintain a solid balance sheet, and is it enough to return to the business of lending money and generate profits.

This new financial reality has also brought uncertainty. Because of this uncertainty, new investors in the banking sector must be careful to make sure their equity isn't used to pay for the sins of the legacy operating model. Thus, millions of dollars of new equity is on the sidelines because they can't get comfortable with the underlying value of a bank's assets and how the bank can become profitable. Empirically the data supports this fact – since January 2009, there have been very few non-forced mergers funded by the private sector.

Investors also need to be aware of the government's approval process for investment in banks. There are established rules on who can invest which includes obtaining government approval. The Regulators and the FDIC have set up a chain of minimum requirements that interested parties must adhere prior to extending approval on a new equity investment.



In the above process, the highlighted box raises the question of "Are you a qualified investor?" which is very important. The government retains the right to approve/disapprove investors in banks and thus only certain equity investors will qualify. When considering a bank investment, the playing field is not level – different investor profiles may get preferential treatment.

Consider the following regulations. If a Bank buys a Bank, than the percentage of ownership is not limited. If an investor with a background as a bank investor or bank operator buys a Bank, ownership may be limited, but they can have control. If a regulated Financial Service company buys a bank, the ownership amount is limited to 25%. If a non-financial service investor buys a bank, they are limited to 15% equity ownership, but could increase their voting control up to 40%. In addition, if a non-financial service investor, (i.e. an Equity Fund) buys a Bank, they may be precluded from buying another Bank. (However, if an Equity Fund invests in a bank Holding Company it may be able to consolidate other banks.)

As recent as 10 months ago, these rules were satisfactory and protected the Regulated US Banking Industry from questionable investors. Today, the Banking Industry is operating with limited equity and needs new equity from any source they can find.

Reducing **Risk to** Maximize Returns

A bank's ability to maximize profits is based upon its cost to borrow money. A *well-capitalized* bank, defined as having an equity balance of 8% of total assets, has the lowest cost of funds and the greatest margin spreads. (i.e., Borrow at the Federal Reserve Funds Rate of 0.25%, lend at 5 to 6%). If loan losses occur and underlying assets are devalued, banks are required to use their equity accounts to cover their loan loss provisions. When equity goes below 6% of assets, a bank's risk rating will be reduced to *adequately capitalized* or other lower classifications. A lower classification means a higher cost to borrow funds, smaller spreads and lower profits. Thus, new equity investors must be keenly aware of a bank's underlying asset values so that new equity is not used to fund losses from legacy loans.

Understand the Risks. Traditionally, bank valuations have been based on multiples of book value driven from their Return on Assets (ROA). With an average ROA for the banking industry of 1.18% in 2000, by 2005 it was still only 1.40%. Increasing bank valuations were therefore driven by increasing the assets of the bank, higher multiples of book value, higher ROA, or all of these.

The new valuation model for banks is focused on maximizing profits – that is, Revenue minus Expenses minus Provisions for Loan Losses. As a result, if substantial reserves must be added to the loan loss provision, a bank will incur losses. Thus, if loan loss provisions increase by 1.5% of assets, this could eliminate all profits in the average year.

To insure that new equity is not used to fund losses from previously originated loans, it is necessary to consider the key elements that have the greatest impact on a bank's profitability and investor risk. These include:

1. *Regulator*. Knowing the regulatory position of the bank is critical. When was the last regulatory review? If the regulators haven't been in, the bank may be facing regulatory sanctions. There are numerous examples of banks currently under FDIC mandates to raise capital, increase loan loss reserves and change lending practices. This information must be known prior to any new investment.

2. *Control Losses with an In-Depth Analysis.* To reduce risk and maximize the ROI, no new investment should take place without determining the net adjusted book value. The Due Diligence Model is the only way to adjust the net book value of the bank. Not only will at-risk assets be identified and re-valued, some assets may be sold or repositioned so losses are taken before new equity makes an investment. When the next audit of the bank's safety and soundness occurs, the at-risk assets will be removed from the balance sheet and the bank (and new investors) will not bear on-going losses from legacy assets.

3. *Maximize the Loan Spread to Increase Profits.* Once the Bank's balance sheet has been recapitalized and the bank returns to making loans in the current market environment, spreads of 600 basis points are achievable. Remember however, new loans may continue to be reviewed by the FDIC. The strategy for the bank to return to the market must be tempered by the realities of the Regulator.

Using the Due Diligence Model approach, an investor can determine the value of the new equity invested, focus on future profitable growth of the bank, and minimize the risk of paying for losses from legacy loans.

Protecting New Equity. How can new investors be sure the bank has accurately evaluated its Net Adjusted Book Value? You can't! Tall Trees Capital LLC has developed a model to evaluate a bank's at-risk loan portfolio and evaluate its compliance, documentation and profitability position. We perform a note-by-note analysis of at-risk assets and during our process identify assets that can be sold, repaired or repositioned. By writing down, or writing-off distressed assets, we can reduce the amount of money required in the reserve account, and free up equity for new and profitable loan originations and fees.

Our professionals have years of experience assisting companies seeking financing.	For more information on our Banking Services contact : Jim Wilber (630) 738-7646 Bernard Asher (847) 382-4401