THE CASE FOR COMMUNITY BANKS

It's Back: The Opportunity of a Lifetime

With crisis, there is always opportunity…

Remember what happened the last few times?

<u>1991-1997:</u>
Total Return: 827%
IRR: 35%

<u>2000-2004:</u>
Total Return: 222%
IRR: 17%

	IXBK - Nasdaq Bank Index Annual Return [1]
1987	-5.59%
1988	11.69%
1989	-11.37%
1990	-34.08%
1991	29.37%
1992	56.68%
1993	29.20%
1994	2.14%
1995	47.76%
1996	29.07%
1997	62.13%
1998	-10.55%
1999	-6.20%
2000	19.93%
2001	13.30%
2002	7.05%
2003	34.22%
2004	13.87%
2005	-1.93%
2006	13.82%
2007	-19.91%
2008	-21.49%
2009	-17.89%

Source: Bloomberg

<u>After Savings & Loan Crisis</u>
Total Return: 827%
IRR: 35%

<u>After Tech Bubble</u>
Total Return: 222%
IRR: 17%

Why Is This Happening Again?

"We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."

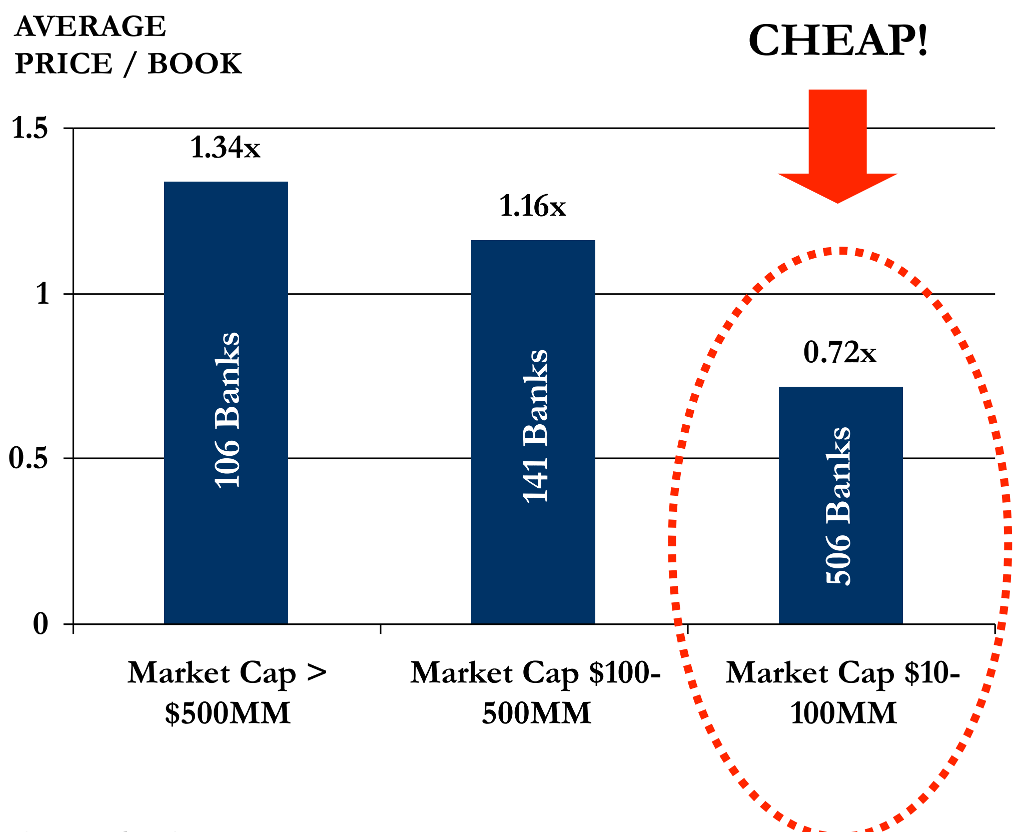
- Warren Buffett

- Subprime & Alt-A Fallout
- Collapse of Securitization Markets
- Derivative Exposure Uncertainty Drove Counterparty Risk Fears
- Liquidity Crisis & Inability to Access Capital
- Falling Asset Prices & Widespread Recession
- Bank Balance Sheet Exposures Called Into Question
- Regulatory Scrutiny & Capital Pressures
- Increase in Number of Failed Banking/Financial Institutions
- **FEAR DOMINATES IN FINANCIALS SECTOR**

Small Banks – Unloved & Cheap

Small Banks with Market Cap $10-100MM are cheapest with Price/Book 0.72x

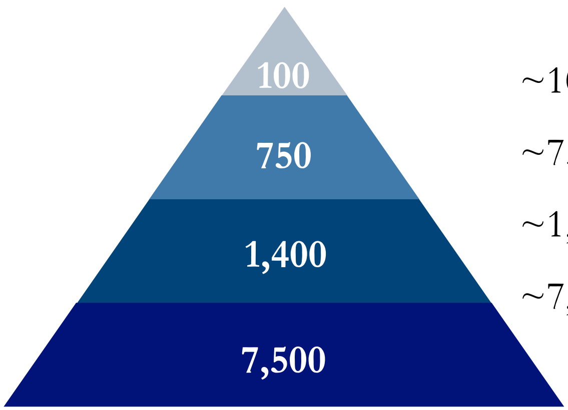
There are more publicly traded Small Banks, 506 total



Source: Bloomberg

Why So Unloved & Cheap? Reason #1

SMALL BANKS ARE UNDERFOLLOWED BY WALL STREET RESEARCH ANALYSTS



~100 US Banks: Public, Market Cap > $500MM

~750 US Banks: Public, Market Cap > $10MM

~1,400 US Banks: Public

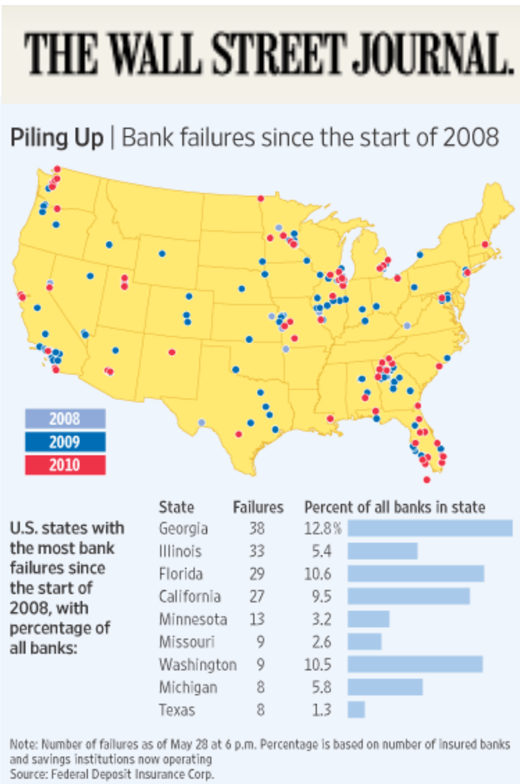
~7,500 US Banks: Public & Private

Over 90% banks are not covered by Research Analysts, and therefore UNDERFOLLOWED

Wall Street Research Departments are cost centers. Analysts only issue reports on companies that are likely to generate sales & trading commission, or investment banking revenues. Small/Micro-Cap Community Banks are not on Research Coverage Lists because they generate very little sales & trading commission, or investment banking revenues

Why So Unloved & Cheap? Reason #2

SMALL BANKS HAVE BEEN ABANDONED BY FEARFUL EXISTING INVESTORS



- Bank holding company restrictions limited shareholder concentration – small community bank shareholder bases were fragmented
- Existing investors & shareholders were often local wealthy private investors
  - Scared, fearful, and anxious as a result of repeated bank failure headlines
  - Lacked expertise to objectively evaluate bank holdings
- Indiscriminant and natural seller of small community banks
- "Baby Out With the Bathwater"

Why So Unloved & Cheap? Reason #3

SMALL BANKS HAVE BEEN OVERLOOKED BY NEW INVESTORS

- Large $$ amounts have been raised by the following types of entities, all with a similar purpose – purchase distressed bank assets in FDIC assisted transactions, distressed real estate and non-performing loan assets
  - Blind Pools
  - Private Equity Backed Banks
  - Distressed Real Estate Private Equity Funds
  - Distressed Credit/Loan Funds

- Examples include:
  - SJB Bank – Raised $1.1Bn
  - Bond Street Holdings – Raised $400MM, looking for another $350MM
  - North American Financial Holdings – Raised $900MM

- **Small community banks are considered too "illiquid" for these institutional investors of size, with lots of $$ to deploy and large deal bite size requirements**

The Case for Community Banks

- Incredibly cheap valuation in publicly traded community banks
- Identifiable reasons for why valuations are cheap (underfollowed, abandoned, and overlooked)
- Low entry price mitigates downside risk
- Strong tailwind created by the "visible hand" of US government & FDIC (low interest rates, steep yield curve, they don't want banks to fail)
- Survivor Banks will dominate the competitive landscape and benefit from…
- **…Multiple Sources of Upside Return:**
  - **Annual ROE (increases Book Value year after year)**
  - **Book Value Returns to Par (from discount to 1.0x)**
  - **Book Value Multiple Expansion (1.0-1.75x Historical Valuation)**
  - **Organic & Acquisition Growth (taking market share away from weak competitors, further increasing book value)**

SEE PAGE 17 FOR DETAILS

Sources of Upside Return (5 Years)

Over the next 5 Years, Sources of Upside Return include:

ROE Growth:	128%
P/B 0.75x to 1.0x	32%
P/B 1.0x to 1.75x	120%
Org./Acq. Growth	???

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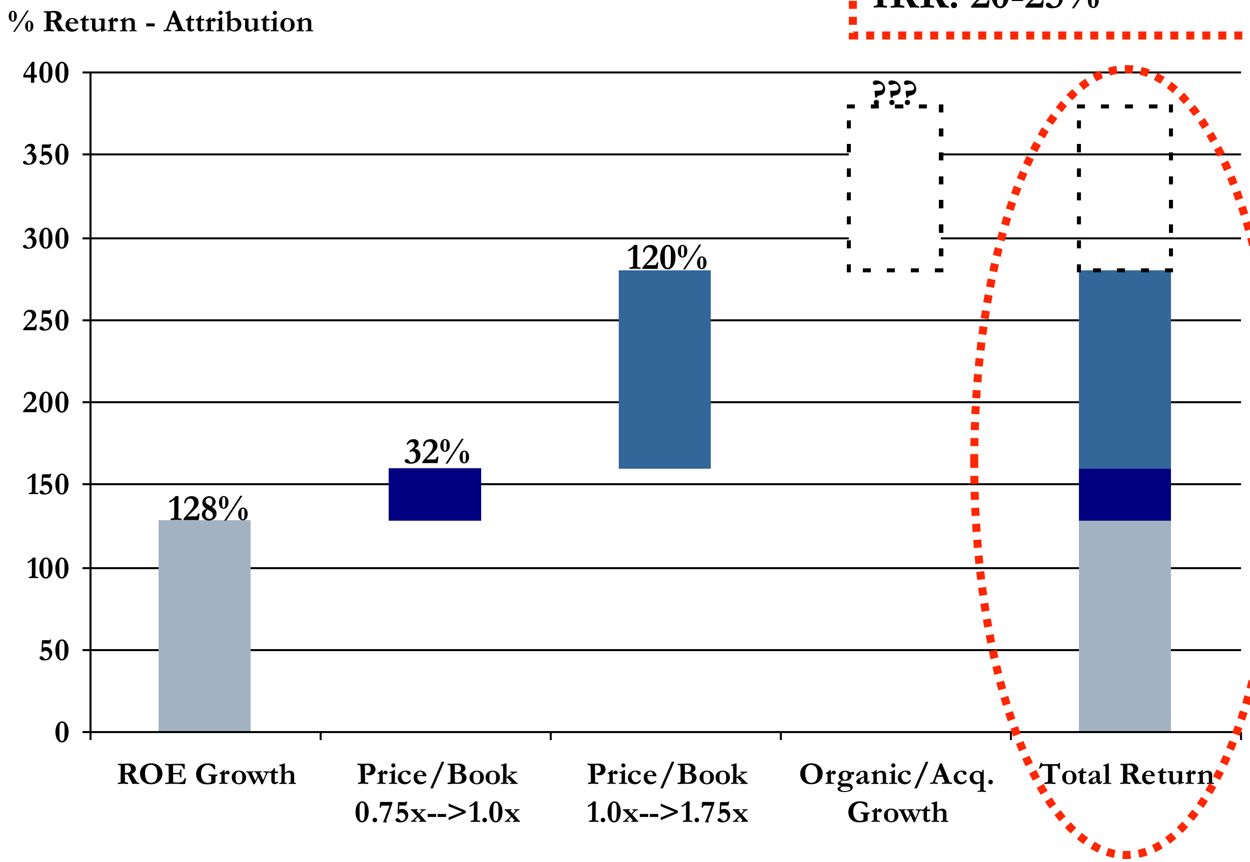
% Total Return	279%+
% IRR	20-25%+

5-Year Projected…
Total Return: 279%+
IRR: 20-25%



Our Value-Add: Separating the Wheat from the Chaff

Not all micro/small-cap community banks are created equal…

See Examples (Right): BEWARE OF ZOMBIE BANKS!

Similar valuation (P/B Multiple), but some are zombies, while others are healthy

Our investment process selects banks that are both healthy AND cheap

	Price/ Book (x)	Tier 1 Capital Ratio	% Non-Perform. Assets	
Zombie Bank 1	0.32x	12.43%	7.86%	Zombies
Zombie Bank 2	0.41x	7.17%	12.99%	
Healthy Bank 1	0.47x	32.61%	0.09%	Healthy
Healthy Bank 2	0.39x	15.78%	3.04%	

Similar valuation, but some are <u>healthy</u> and some are <u>zombies</u>!

The Investment Process

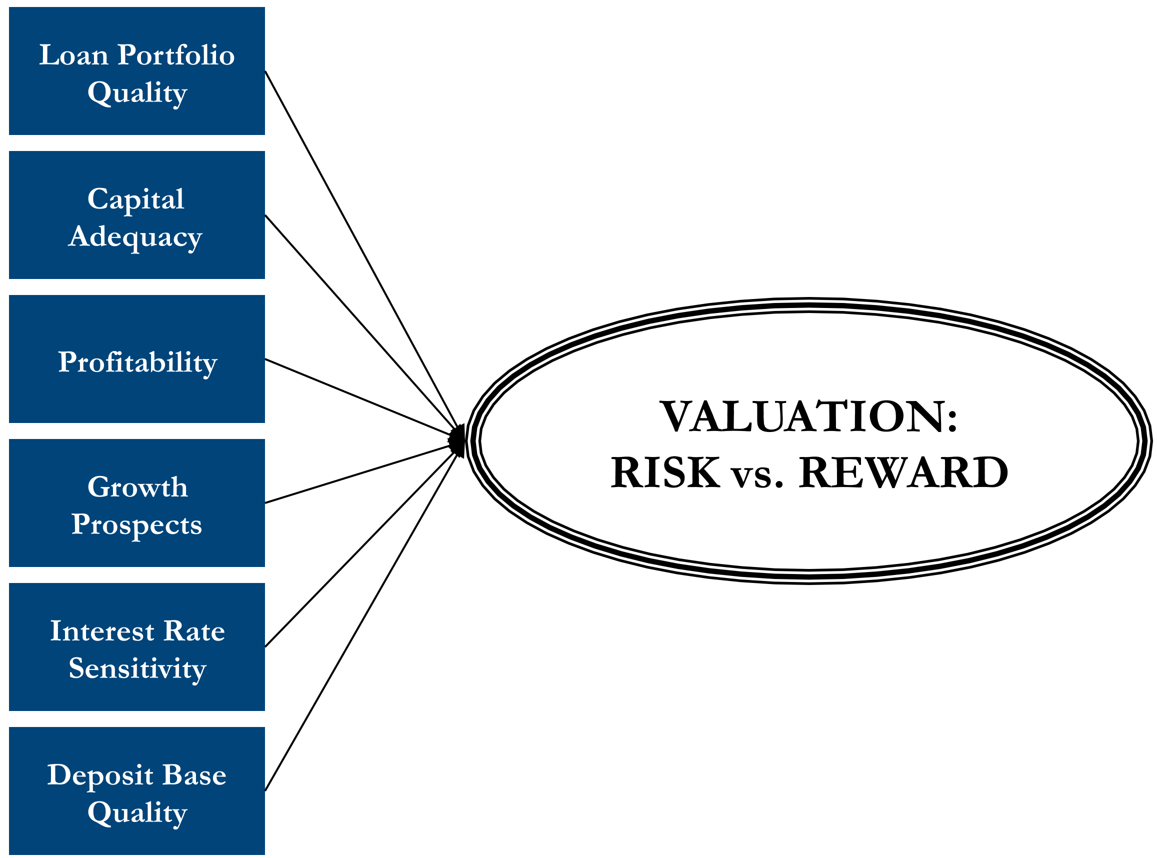
Fundamental, value-oriented investing: find the high-quality small/micro-cap survivor banks trading at a discount to book value

Conduct quantitative screen with info from FDIC database (proprietary formula)

Next step: analyze qualitative variables, while taking valuation into account

Valuation determines risk/reward profile – a low purchase price is the best risk mitigant!

FUNDAMENTAL ANALYSIS:

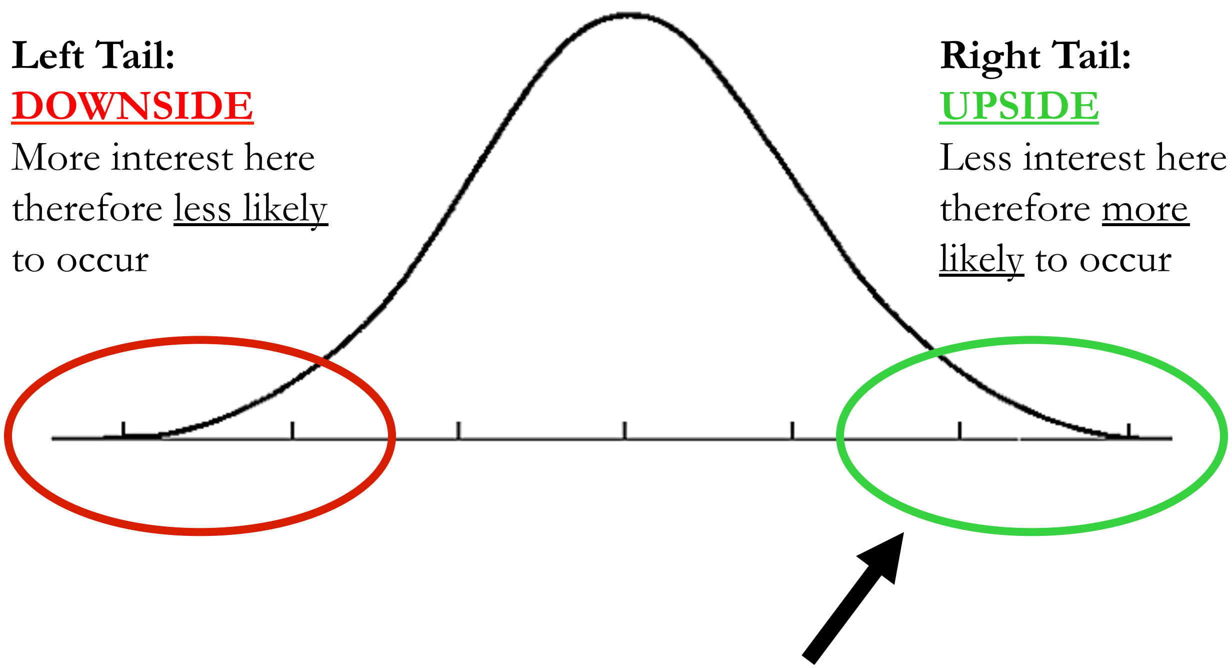


A Contrarian Thesis: The "Right-Tail" Allocation

Not very many people focused on, or allocating to "right-tail" events (rare occurrences that provide asymmetric upside to portfolio)

Most people are still fearful that "left-tail" events will occur again (e.g., Subprime, Financial Market Meltdown, Greece, Libya, Monetary Policy)

Left Tail:
DOWNSIDE
More interest here therefore less likely to occur

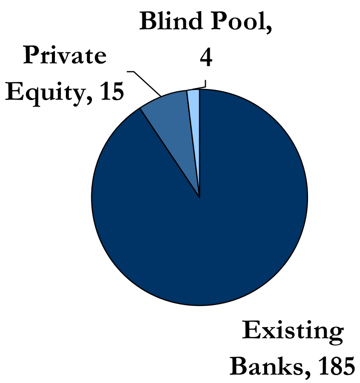


Right Tail:
UPSIDE
Less interest here therefore more likely to occur

SMALL-CAP / COMMUNITY BANK RECOVERY!!!

A Better Model for Accessing Distressed Assets

Number of FDIC Transactions Granted to Type of Purchaser



Source: SNL Financial

- Large $$ amounts have been raised by Blind Pools, Private Equity, Distressed Real Estate and Credit/Loan Funds in preparation to purchased distressed assets from the FDIC
- In reality, these vehicles were not best suited to take advantage of the current opportunity set
  - FDIC has preferred to give distressed assets to existing banks, not new money investor vehicles (see Chart at Left)
  - Banks have been reluctant to sell assets at a discount to distressed real estate and credit/loan funds
- **SMALL COMMUNITY BANKS ARE THE BEST-PRICED AND MOST EFFECTIVE VEHICLE TO ACCESS & BENEFIT FROM DISRESSED ASSETS**

APPENDIX

Historical Price/Book Value Multiple

Price/ Book multiples today are near historic lows – similar to what we observed in the early 1990s (RTC Era)

Valuations went as high as 3.0x-4.0x Price / Book for an entire decade, 1996-2006

Historical Price/Book Multiple (x)

Source: SNL Financial

Historical Net Interest Margin

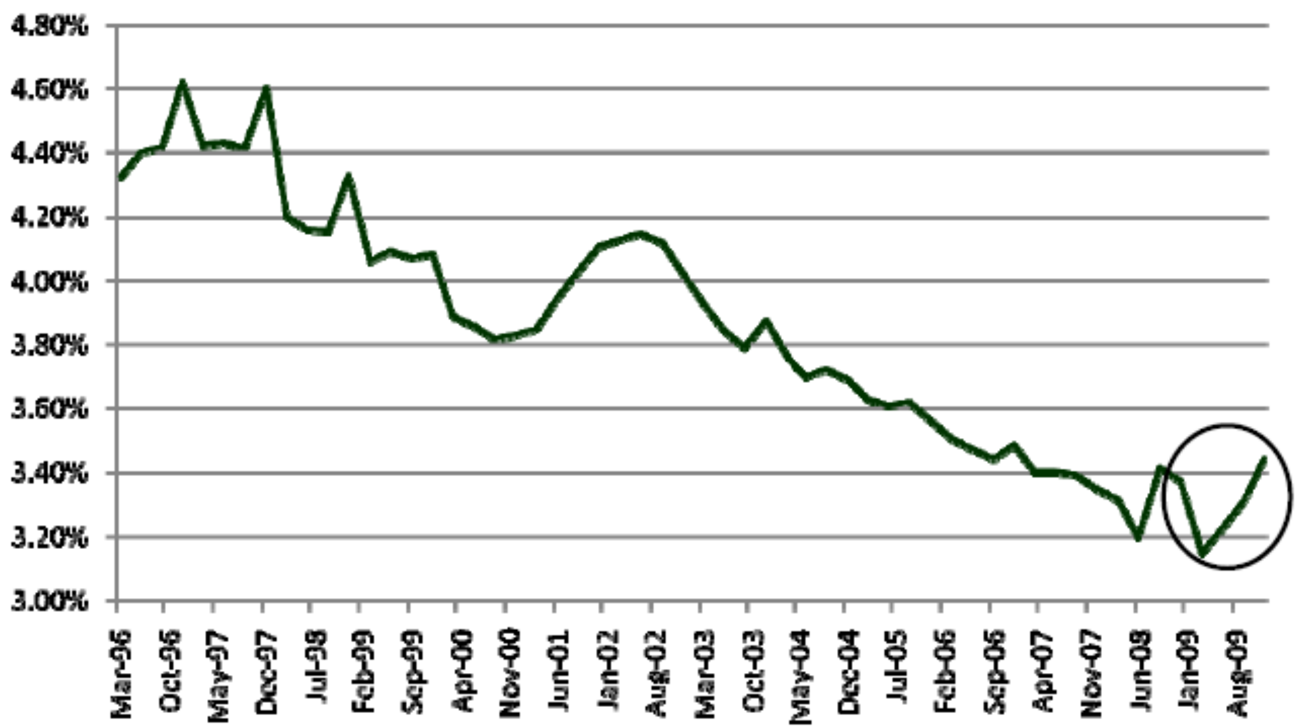
Loose industry lending standards gradually eroded interest rate spreads over the last decade – as loan supply outpaced loan demand

Over the last year, we have noticed a rebound in net interest margins due to:

(1) Tightening underwriting standards

(2) Loan demand outpacing loan supply

Historical
Net Interest Margin (%)



Source: SNL Financial

Compounding Math: Sources of Upside Return [1]

1st Source of Return

Year	1	2	3	4	5
1. ROE GROWTH					
Beginning Book Value per Share	**$10.00**	**$10.50**	**$11.03**	**$11.58**	**$12.16**
ROE % - Annual	5%	5%	5%	5%	5%
Increase in Book Value	$0.50	$0.53	$0.55	$0.58	$0.61
Ending Book Value per Share	**$10.50**	**$11.03**	**$11.58**	**$12.16**	**$12.76**

Ending Price / Book Multiple	0.80x
Implied Ending Price	$10.21
% Total Return	128%
% IRR	5%

2nd Source of Return

Year	1	2	3	4	5
2. PRICE / BOOK MULTIPLE: 0.75x --> 1.00x					
Ending Book Value per Share	**$10.50**	**$11.03**	**$11.58**	**$12.16**	**$12.76**

Ending Price / Book Multiple	1.00x
Implied Ending Price	$12.76
% Total Return	160%
% IRR	10%

3rd Source of Return

Year	1	2	3	4	5
3. PRICE / BOOK MULTIPLE: 1.00x --> 1.75x					
Ending Book Value per Share	**$10.50**	**$11.03**	**$11.58**	**$12.16**	**$12.76**

Ending Price / Book Multiple	1.75x
Implied Ending Price	$22.33
% Total Return	279%
% IRR	23%

4th Source of Return

4. Organic / Acquisition Growth

% Return Contribution – How Much Extra?

1. Assumes At Purchase: $8.00 Price, $10 Book Value, and 0.80x P/B Multiple

Case Study 1: $58MM Market Cap Bank

Loan Portfolio Quality

- Prudent loan underwriting philosophy through bubble and excess pre-2007
- Lending did not expand until after 2007 despite efforts by regulators urging Bank to increase loans ($159MM at 4Q08 to $329MM at 4Q10) with 2 FDIC Transactions
- Low Construction and Land exposure – only 4.7% of total loans
- Balance loan portfolio: 20% Residential Real Estate, 5.0% Construction & Land, 25% Commercial & Industrial, 47% Commercial Real Estate

Capital Adequacy

- **16.3% Tier 1 Equity Ratio** (FDIC considers 8% Very Well Capitalized)
- Current Equity Ratio can withstand a large amount of future loan losses – ensures bank's survival through downturn
- Large amounts of future loan losses unlikely due to loan portfolio vintage (low loan volume growth during bubble and excess pre-2007) and FDIC loss sharing
- Large equity sponsor (Hovde Financial) owns 72% of Bank – provides ability to raise capital quickly if necessary (current share buyback plan at $2,500/share)

Profitability

- **LTM Net Interest Margin ~6.3%**
- **Ann. Net Interest Margin ~8.5%**
- Low cost deposits base – only 9% time deposits
- Efficiency Ratio (a measure of cost) only 61%
- **Annual ROE ~10% (on current loan portfolio)**
- Additional profits available from future market share growth and acquisitions

Growth Prospects

- Bank has already **completed 2 FDIC-Assisted Transactions** post 2008
  - **Book Value 1Q09: $39.4MM**
  - **Book Value 4Q10: $73.3MM**
- Southern California competitors paralyzed – unique opportunity to gain market share and expand footprint
- Management team (affiliated with Hovde Financial) has knowledge and resources to evaluate opportunities

Interest Rate Sensitivity

- Bank assets contain large floating rate exposure – interest income will benefit from higher rates
  - 72% loan portfolio is Floating (47% Commercial RE, 25% C&I)
  - 20% of Asset Base is cash balance which is Floating
- Deposit base contains fairly low cost deposits (mainly demand and savings) and should not experience large negative impact as rates rise

Case Study 1: $58MM Market Cap Bank (cont' d) [1]

Current Price: $2,500
Current BV: $3,185
P/B Multiple = 0.78x

Assumes 5% ROE (conservative, this bank has been achieving 8-10% ROE)

Over 5 years…

Total Return	~285%+
IRR	~23%+

Year	1	2	3	4	5
1. ROE GROWTH					
Beginning Book Value per Share	**$3,185.00**	**$3,344.25**	**$3,511.46**	**$3,687.04**	**$3,871.39**
ROE % - Annual	5.0%	5.0%	5.0%	5.0%	5.0%
Increase in Book Value	$159.25	$167.21	$175.57	$184.35	$193.57
Ending Book Value per Share	**$3,344.25**	**$3,511.46**	**$3,687.04**	**$3,871.39**	**$4,064.96**

Ending Price / Book Multiple	0.78x
Implied Ending Price	$3,190.70
% Total Return	128%
% IRR	5%

Year	1	2	3	4	5
2. PRICE / BOOK MULTIPLE: 0.71x --> 1,00x					
Ending Book Value per Share	**$3,344.25**	**$3,511.46**	**$3,687.04**	**$3,871.39**	**$4,064.96**

Ending Price / Book Multiple	1.00x
Implied Ending Price	$4,064.96
% Total Return	163%
% IRR	10%

Year	1	2	3	4	5
3. PRICE / BOOK MULTIPLE: 1.00x --> 1.75x					
Ending Book Value per Share	**$3,344.25**	**$3,511.46**	**$3,687.04**	**$3,871.39**	**$4,064.96**

Ending Price / Book Multiple	1.75x
Implied Ending Price	$7,113.67
% Total Return	285%
% IRR	23%

4. Organic / Acquisition Growth

% Return Contribution – How Much Extra?

1. Assumes At Purchase: $2,500 Price, $3,185 Book Value, and 0.78x P/B Multiple