ACQUIRE OR BE ACQUIRED

EXPLORING YOUR GROWTH OPTIONS

Employee Stock Ownership Plans for Banks and Bank Holding Companies

The Tax-Exempt Stock Market

Presenters:

W. William Gust, J.D., LLM
President of Corporate Capital Resources, LLC

Michael A. Coffey
Managing VP of Corporate Capital Resources, LLC

Date: January 30, 2012

Corporate Capital Resources LLC

Overview of Today's Presentation

1. ESOP Basics
2. ESOP Pros and Cons
3. ESOP Structures
4. Valuation Issues
5. Stories from the Trenches
6. Q & A

Central Theme

1. An ESOP is not THE answer, but may be a component of a larger strategy.

2. A well-designed ESOP should be integrated with a broad spectrum of business goals besides just capitalization and employee benefits – e.g. coordination with major shareholder estate plans, governance, techniques to reduce the number of shareholders, etc.

Introduction – Some Questions

1. Is there such a thing as board-controlled, "friendly" capitalization?
2. Is there another market for your stock, besides inside or outside investors, your competitors or the public markets?
3. Is there a way to purchase bank stock with tax-deductible dollars?
4. Can a tax-deductible private stock market purchase stock with less dilution to existing shareholders than that from investment capital?
5. Can Tier 1 capital be created with tax-deductible earnings and acceptable dilution?
6. Can sellers of bank shares ever reinvest sales proceeds without taxation?
7. Can a Bank make acquisitions with tax-deductible dollars?
8. And if this can be done, who benefits and how?

Corporate Capital Resources LLC

ESOP Basics

1. ESOPs are a qualified retirement plan under IRC Section 401(a) mandated to invest primarily in employer securities (bank holding company shares)
2. ESOPs must own the highest and best class of employer securities with respect to voting, dividend and liquidation rights
   - Coincides with regulators' desire to see common equity ownership
3. Employees are not the stock owners
4. The legal owners of the stock are the Trustees
5. ESOP shares are voted in most instances by the Trustees
   - Vote pass-through for closely-held Bank ESOP participants in limited cases.
   - Public company ESOP vote pass-through to participants in all cases subject to shareholder vote.
6. ESOPs can borrow money to buy stock with deductible P+I payments
7. Level of ESOP stock ownership is subject to Bank Change of Control Act; Reg W may also come into play.

ESOP Benefits

1. Stock and/or cash contributions are tax-deductible to the sponsoring company

2. ESOP contributions may be used, when approved by the Plan Trustees, to purchase shares from the company and its shareholders

3. For C Corporations

   - "Reasonable" dividends paid are deductible by the sponsor when used to buy stock or service ESOP stock acquisition debt

4. For S Corporations

   - Earnings on shares paid to an ESOP are untaxed

ESOP Benefits

Can enhance ability to build and/or maintain capital

- Capital has become one of the foremost issues for banks
- Conventional sources of capital
  a) After-tax earnings
    - ESOP bank has potential tax savings
      I. ESOP bank's tier 1 capital can be improved with pre-tax dollars
      II. Allows for either a faster build-up or a higher level of capitalization
  b) Outside investors
    - ESOP provides certain advantages relative to raising external capital
      I. Ability to improve capital while maintaining control
      II. Possibly less dilution of shareholder value using ESOP

Corporate Capital Resources LLC

ESOP Benefits

Impact of ESOP on Capitalization

	Bank Today		
	Total Common Equity Capital	30,000	
	Less unrealized gains	(2,000)	
A	Tier 1 Capital	28,000	
	Allowable ALLL	3,500	
B	Total Capital	31,500	
C	Leverage Assets	350,000	
D	Risk weighted assets	280,000	
			Well Capitalized Ratios
A / C	Leverage Ratio	8.00%	**5.0%**
A / D	Tier 1 Risk Weighted Ratio	10.00%	**6.0%**
B / D	Total Risk Weighted Ratio	11.25%	**10.0%**

	Assumptions	
E	Net Income (without ESOP)	2,000
F	Net Income (with ESOP)	1,400
G	Pre-Tax ESOP Contribution	1,000

Ratios without ESOP		Calculation
Leverage Ratio	8.57%	(A + E) / C
Tier 1 Risk Weighted	10.71%	(A + E) / D
Total Risk Weighted	**11.96%**	(B + E) / D
FUNDING PHASE		
Ratios with ESOP		
Leverage Ratio	8.40%	(A + F) / C
Tier 1 Risk Weighted	10.50%	(A + F) / D
Total Risk Weighted	**11.75%**	(B + F) / D
AFTER STOCK SALE TO ESOP		
Ratios with ESOP		
Leverage Ratio	8.69%	(A + F + G) / C
Tier 1 Risk Weighted	10.86%	(A + F + G) / D
Total Risk Weighted	**12.11%**	(B + F + G) / D

Corporate Capital Resources LLC

ESOP Benefits

ESOP has certain benefits relative to raising external capital

1. Potential for better pricing
    - In 2009 - 2011, a majority of transactions to raise capital occurred at discounts from the last trading price prior to the announcement (average of approximately 10 to 15%)
    - Could see further pricing decline from a surge in demand as more banks attempt to attract outside investors
        1. Would create a buyers' market
        2. May further reduce prices for sellers and increase shareholder dilution
        3. Loss of value to current shareholders
2. Maintain control
    - Control and/or other restrictions are often demanded by outside investor groups when used to raise Bank capital
3. Shareholders could suffer less dilution
    - If stock is acquired by the ESOP over time, improved cash flows may result in better retained earnings
    - ESOPs stock contributions provide a tax-deduction for the non-cash item (much like depreciation) without loss of control

ESOP Benefits

1. Create an internal stock market
   - ESOP provides an additional source of liquidity for investors
   - Transaction activity promotes confidence in stock pricing

2. Provide an employee benefit
   - Benefit is tied to long-term stock performance

3. Allocations of benefits in participant populations can be skewed using formulas which reward loyal, long-term employees and still meet the requirements of non-discrimination
   - Smaller banks have seen highly compensated executives receive 25% to 45% of all allocations in the ESOP.

Corporate Capital Resources LLC

Benefits for TARP Banks

1. Banks using TARP capital face the following challenges
   - Paying escalating after-tax dividends over time
   - Ultimately redeeming the TARP securities with after-tax dollars
   - Bringing in outside investment capital
     1. Outside investors will often exact a high price in terms of shareholder dilution
2. A minority-interest ESOP is not governed by TARP regulations
3. An ESOP can provide a potential source to repay TARP obligations through a combination of the following
   - Tax-deductible contributions used or accumulated to purchase stock
   - Tax-deductible dividends paid on ESOP stock

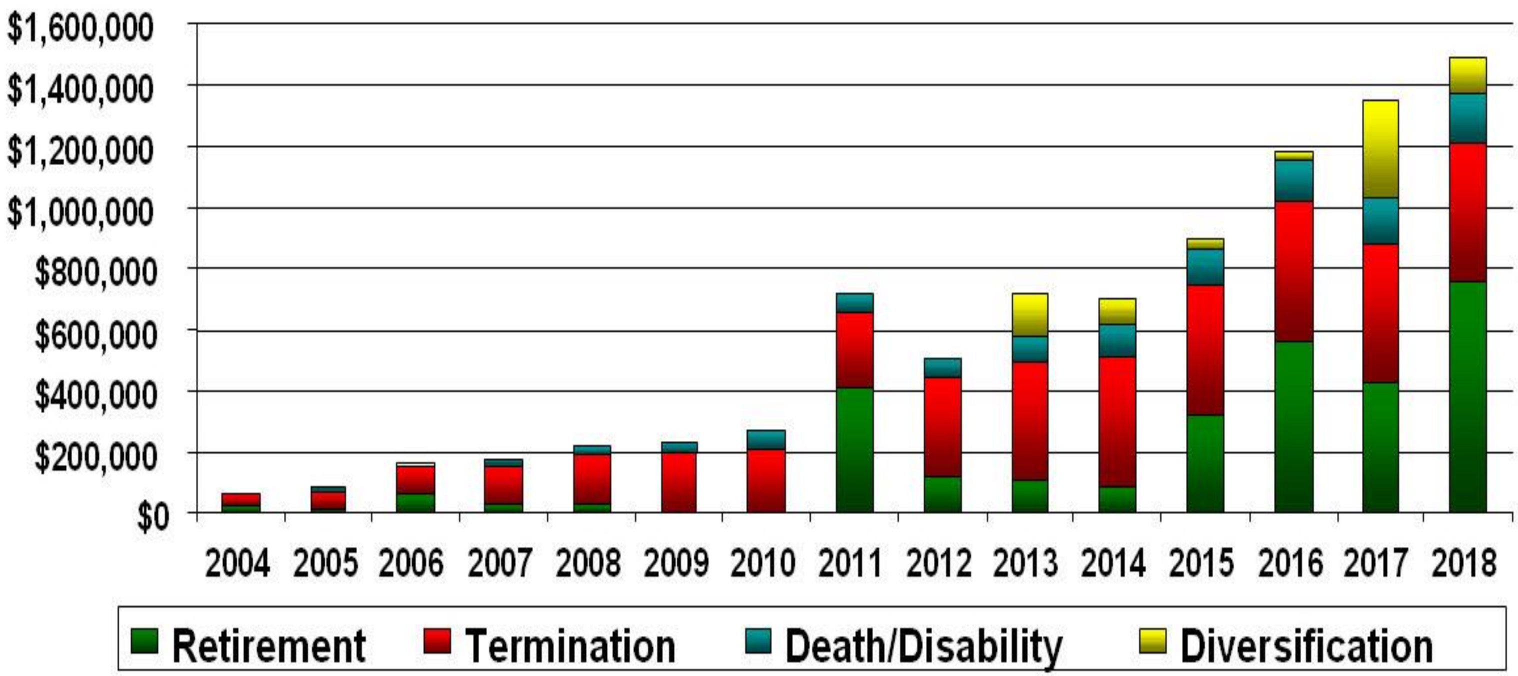
ESOP Negatives

1. Repurchase obligation
   - Stock in the ESOP must ultimately be repurchased by the sponsoring corporation or the plan.
   - Represents a long-term, emerging obligation.
   - While the obligation is typically not booked on the balance sheet and does not impair capital, it is a real obligation and will require funding
   - Can be managed using prudent funding and key executive plans
2. Fiduciary Roles
   - Directors and ESOP trustee(s) are fiduciaries
   - Personally liable for operating the plan for the exclusive benefit of the plan participants
   - Care must be taken to document the fiduciary prudence and carry the appropriate fiduciary liability insurance for both the BOD and Trustee(s)
3. Complexities
   - Added requirement to understand <u>stock flow</u> management

ESOP Negatives

1. The repurchase obligation

- ESOP participants generally receive cash (not stock) for their vested retirement plan payouts
- Can be managed using prudent funding, appropriate administrative rules for payouts to former participants, coordination with key executive plan funding and other techniques



Structures

Simple Annual Tax-Deductible Stock Contributions

The corporation receives a tax-deduction for the value of the newly issued shares contributed to the ESOP.

C Corporation

Annual Tax-Deductible Contributions; 25% of Pay Limit

Possible Deductible Dividends Paid on ESOP Shares with Dividend Paying Security.

ESOP Tax-Exempt Employee Trust Retirement Plan

Participating Employee Stock Accounts
Long-Term Emerging Non-GAAP Obligation

The contributions are discretionary each year and deductible, if within IRC 404 limits and paid by the filing of the corporate returns.

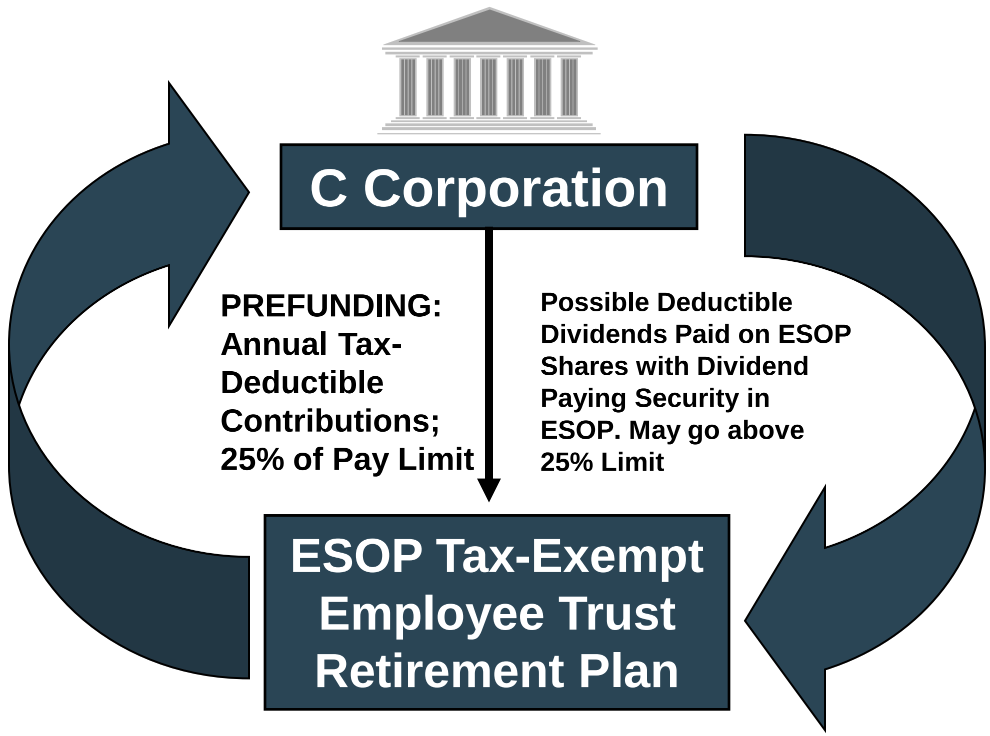
ESOP Stock Contribution Example of Cash Flow

	(Before) Profit Sharing	(After) ESOP Stock Bonus Plan
Pre-Tax Earnings	$500,000	$500,000
Contribution	$(200,000) Cash	(200,000) Stock
Net Pre-Tax	300,000	300,000
Taxes	(120,000)	(120,000)
Net After-Taxes	180,000	180,000
Add back Non-Cash Item		
Non-Cash Contribution	0	200,000
Cash Flow	$180,000	$380,000

Structures

Sale of Newly Issued Shares to Pre-Funded ESOP

The corporation receives the value of the shares tax-free from the capital stock sale.



The corporation issues and sells new shares to the ESOP.

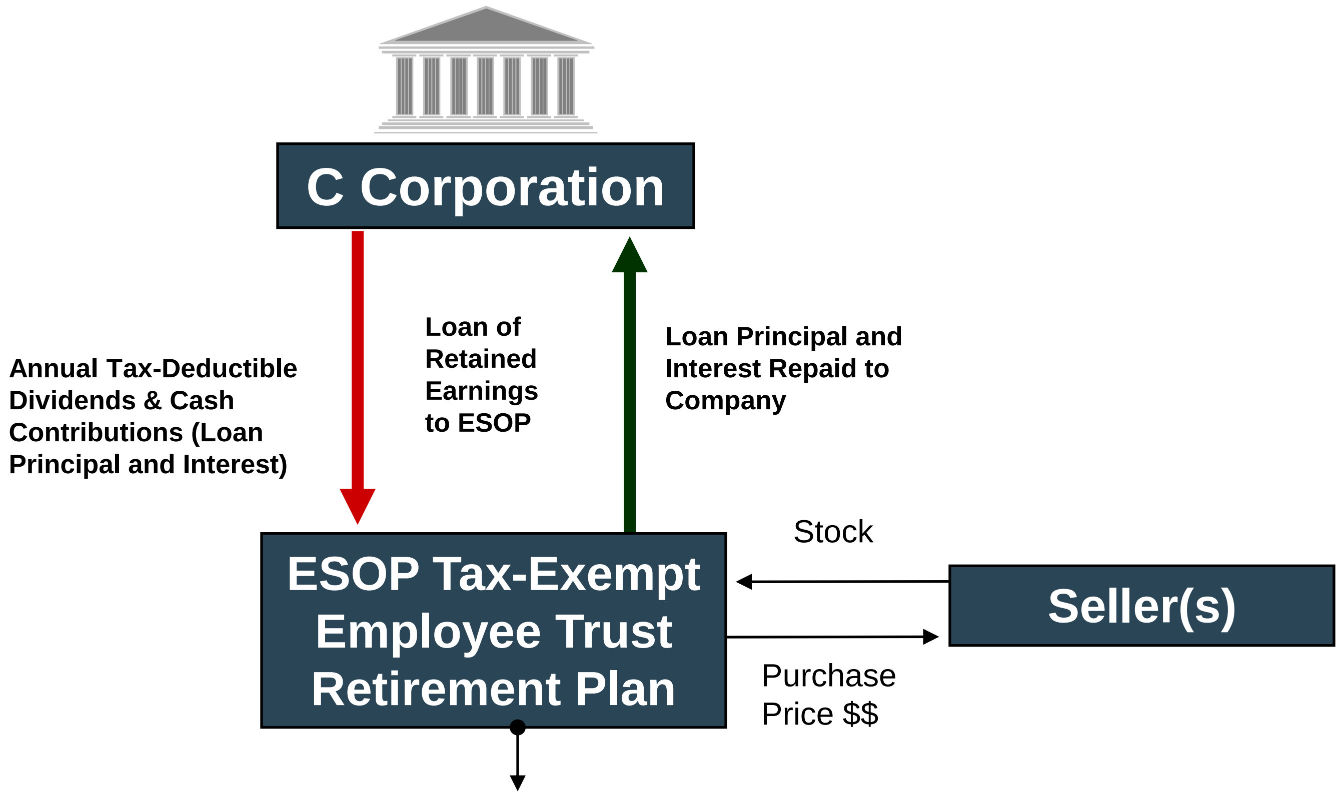
Participating Employee Stock Accounts
Long-Term Emerging Non-GAAP Obligation

Structures

Stock Purchase with Holding Company Financing

This is the only type of ESOP loan which does not require an outside lender for the transaction; however the after-tax retained earnings must be accumulated first.

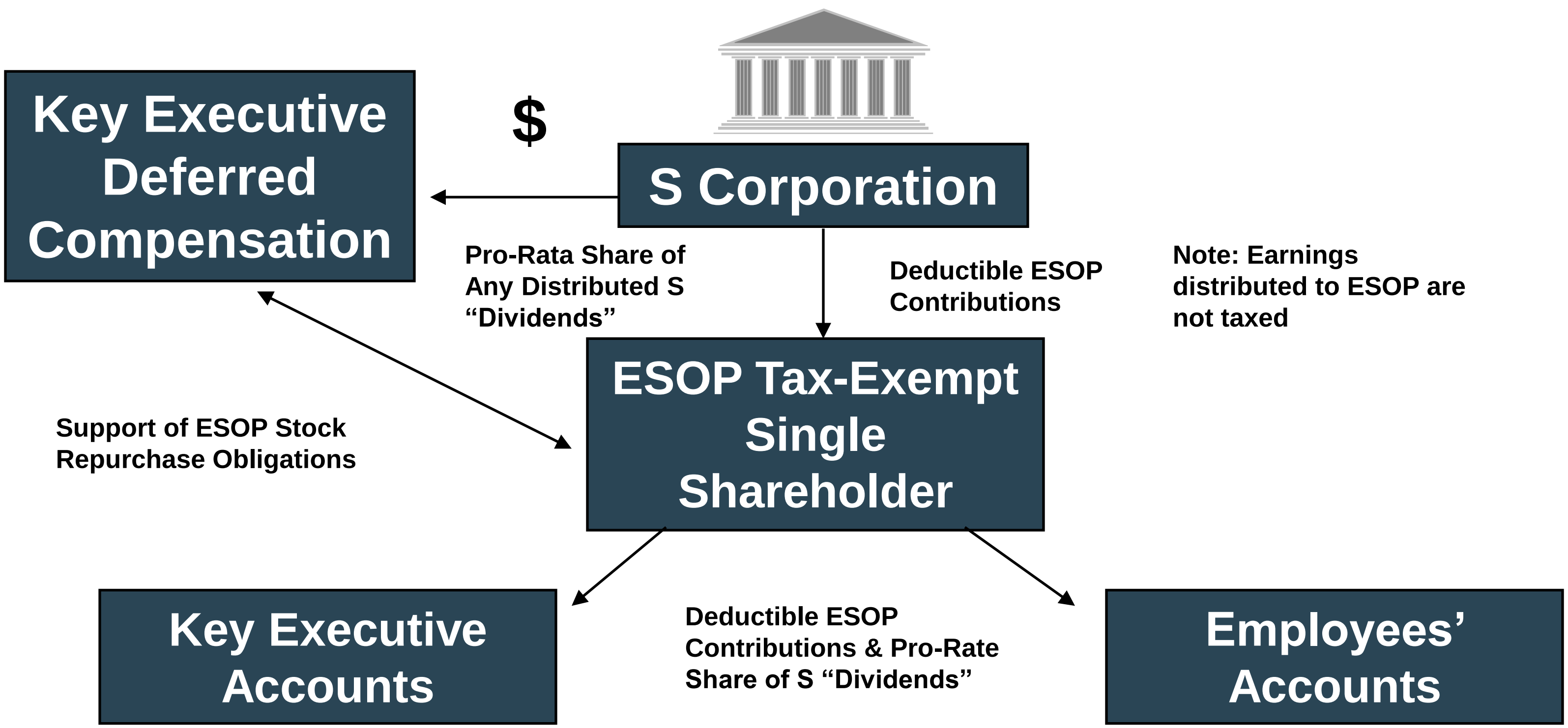
The corporation repays the loan to itself with tax-deductible dollars.



Participating Employee Stock Accounts Create a Long Term ESOP Stock Repurchase Obligation

Structures

S Corporation ESOP



Structures

Additional Considerations for TARP Banks

1. Begin creating some of the requisite liquidity with discretionary, tax-deductible contributions to the ESOP accumulating untaxed dollars for future stock purchase.
2. Deductible contributions must not impair capital.
3. Measure actuarial profile of current and probable future plan participants
   - Design the ESOP provisions for minimal payouts in early cash accumulation years
4. Possible strategies
   - Recapitalize TARP preferred shares as voting stock appropriate for an ESOP
     1. Some leverage may be available and consideration should be given to a convertible preferred security
   - Use accumulated untaxed cash in ESOP to “go public” internally
     1. A later sale of newly issued shares to the ESOP restores the cash to the balance sheet, which buys out the TARP preferred security.

Structures

Additional Considerations for TARP Banks

1. Future dividends paid on any preferred shares owned by the ESOP should be deductible in the amount of 5% of value in years 3-5 and 9% of value after 5 years
2. Dividends paid on ESOP shares and used to finance the acquisition of the shares are tax-deductible
3. Could start the buydown process, which will continue each year until the preferred is fully redeemed in a series of transactions
4. Other hybrid combinations of cash and stock may work better
   - Final decision should be based on studies of taxes, capital requirements, employee benefits, and other variables feeding into the structure

Valuation Issues
Some Parties Involved in Implementation

1. Design and Transaction Quarterback
2. Trustee(s), Either Internal or Outside Fiduciary
3. Plan Administrator
4. Plan Sponsor
5. Administrative Committee
6. Attorney or Plan Designer
7. Fund Manager
8. Independent Appraiser for the Trustee(s)

Valuation Issues
Role of Independent Valuation Firm

1. Independent appraiser exists to assist fiduciary
   - Employee Retirement Security Act of 1975 (ERISA) requires that shares held by ESOP be appraised by an independent third party
   - Initial valuation for purchase/issuance of ESOP shares
   - Annual valuation for plan administration purposes
   - Periodic valuations for subsequent transactions
2. Transaction Role
   - Analyze impact of proposed transaction on bank and ESOP
   - Assist fiduciary in negotiation and structuring
   - Provide fairness opinion
     1. Analyze whether transaction is fair, from a financial point of view, to the ESOP participants

Valuation Issues
Regulatory Guidance

1. Primary regulator of ESOPs is the Department of Labor (DOL)
    - Authority drawn from ERISA
2. Secondarily Internal Revenue Service has authority to review activities of plan
3. Depending upon trading volume, there are specific rules issued by the DOL & IRS to govern the valuation process for ESOP shares
4. ESOP and valuation community have taken steps to define standards of appraisal practice

Short Stories from the Trenches

1. What an advisor said about an ESOP buying shares – and why it missed a key strategy.
2. What happened when a company was sold without considering an ESOP.
3. Why a TARP bank started an ESOP and doubled the contributions after two years.

Corporate Capital Resources LLC

Thank You

W. William Gust, J.D., LLM
President
Corporate Capital Resources, LLC
Bill_Gust@ ccrva.com
»540.345.4190

Michael A. Coffey
Managing Vice President
Corporate Capital Resources, LLC
Michael_Coffey@ccrva.com
»540.345.4190