



June 18, 2014.... John Donnelly speaks at the Michigan Bankers Association Annual Convention on Mackinac Island

On June 18, John Donnelly spoke to a group of bankers at the MBA annual convention. The presentation was entitled “The Importance of Good Shareholder Relations” and the topics covered included Factors Affecting Stock Price; Market Making; Capital Management and How to Build Franchise Value



*June 18, 2014*

THE IMPORTANCE OF GOOD SHAREHOLDER RELATIONS

*John C. Donnelly*

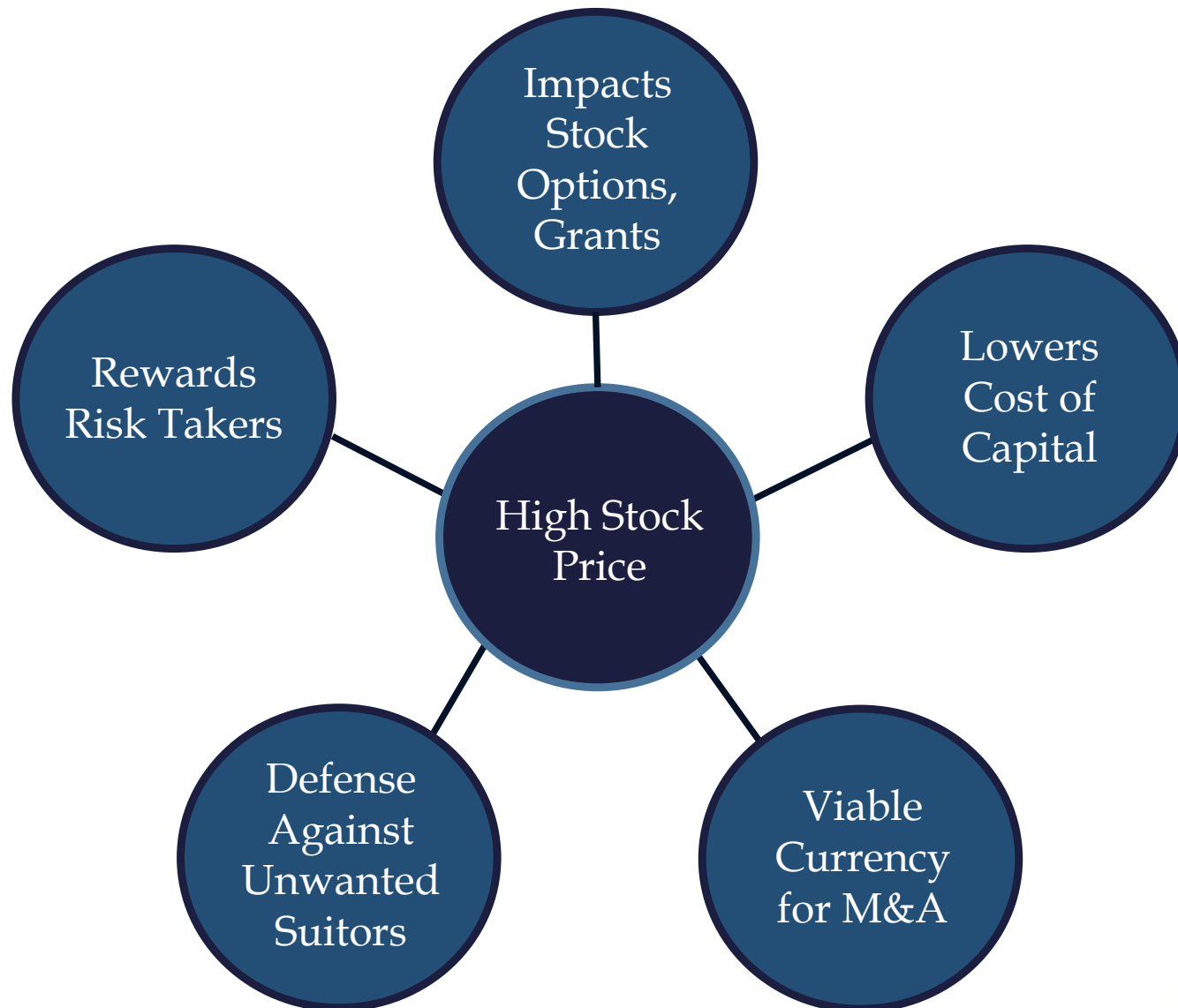


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## FACTORS AFFECTING STOCK PRICE

## Why Stock Price is so Important



## Why Stock Price is so Important - Management Stock Options, Grants

- Boards should structure management compensation around stock performance
- Without stock incentives, management is essentially “working for a paycheck”
- Relationship should exist between annual salary and stock ownership (3 to 1)
- Directors should consider taking director fees in stock
- Investors respond favorably to stock-based compensation

## Why Stock Price is so Important - Lowers Cost of Capital

- A higher stock price will lower dilution to current owners and to tangible book value if a Bank chooses to raise capital – an illustrative example is as follows:
  - Bank A & Bank B both have \$40 million of shareholders' equity and 4,000,000 shares outstanding. Both wish to raise \$10 million in capital.
  - Bank A trades @ 140% of tangible book value OR \$14.00/share
  - Bank B trades @ 75% of tangible book value OR \$7.50/share

	Bank A	Bank B
Shareholders' Equity	\$40,000,000	\$40,000,000
Shares Outstanding - Pre-offering	4,000,000	4,000,000
BV/Share	\$10.00	\$10.00
Market Price	\$14.00	\$7.50
Capital Raise	\$10,000,000	\$10,000,000
New Shares Issued	714,285	1,333,333
Shareholders' Equity - Pro Forma	\$50,000,000	\$50,000,000
Shares Outstanding - Pro Forma	4,714,285	5,333,333
BV/Share - Pro Forma	\$10.61	\$9.38
Accretion (Dilution)	6.06%	-6.25%
Original Shareholder Ownership	84.85%	75.00%

## Why Stock Price is so Important - Viable M&A Currency

- The Price/BV of the acquirer is directly correlated to its ability to pay for an acquisition
- An illiquid stock will also discourage would-be sellers to “accept” the acquirer’s currency
- Higher Price/BV is a market indicator that the street “likes” the acquirer’s currency
- High Price/BV will give an institution a distinct advantage in M&A



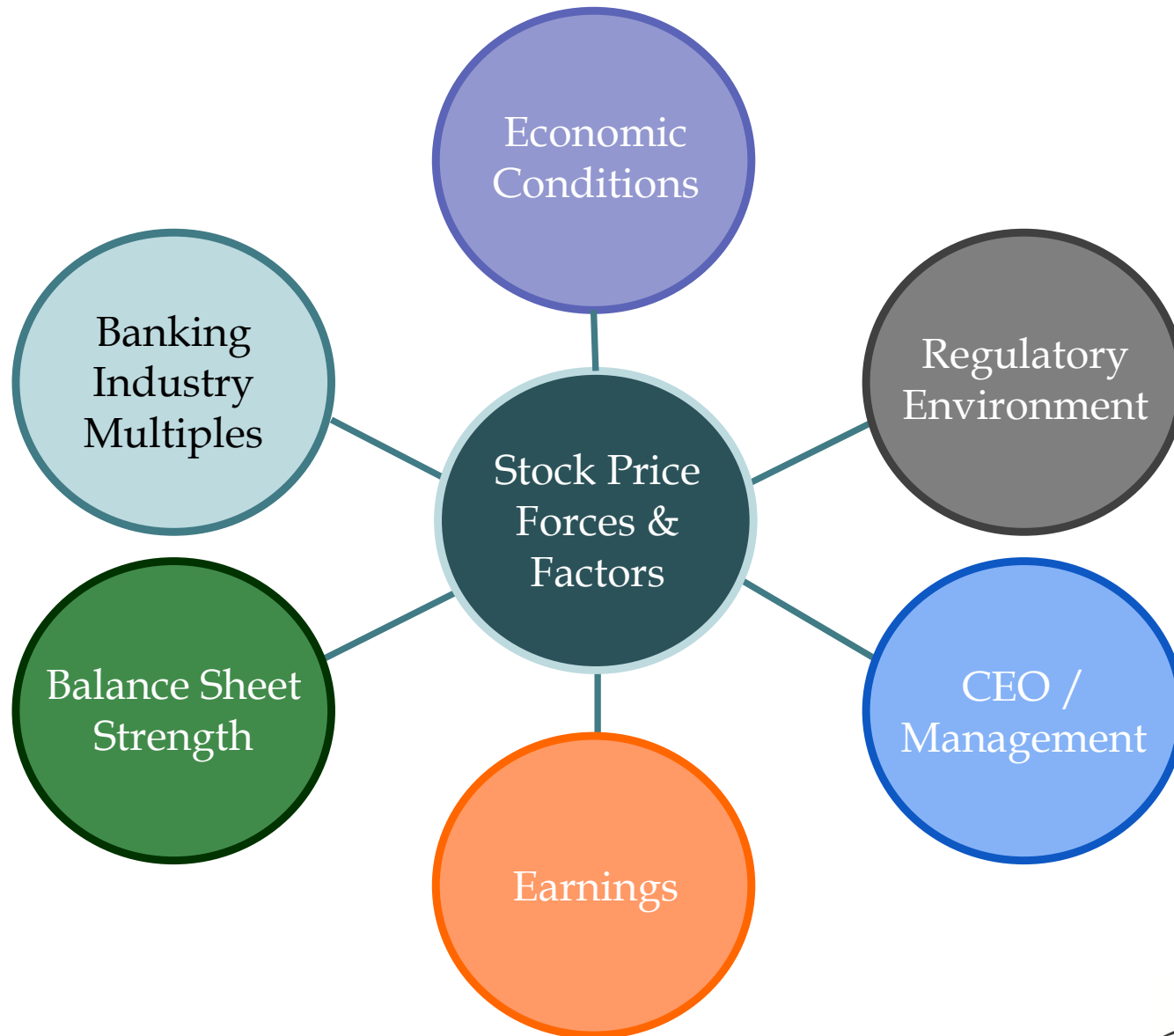
## Why Stock Price is so Important - Defense Against Unwanted Suitors

- Low stock prices makes the stock subject to unwanted investors
- Buyers can purchase up to 4.99% without a public filing
- Noticing one 13-d filer may attract other unwanted investors
- Low stock prices may also invite a strategic acquirer to lob an offer in “over the transom”

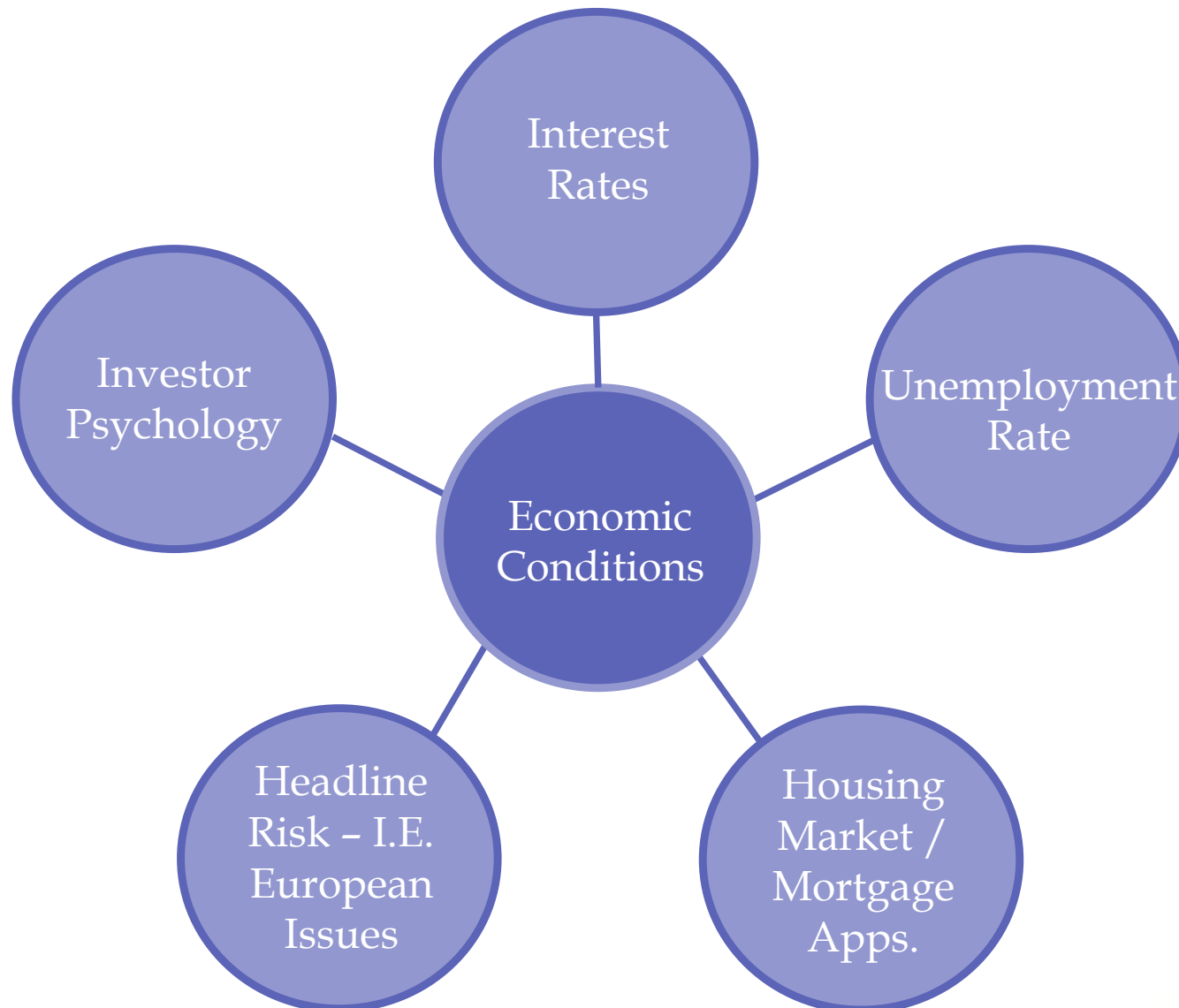
## Why Stock Price is so Important - Rewards Risk Takers

- Banks need to generate a return that exceeds their **cost of capital**
- What is cost of capital?
  - Cost of capital is a return an investor would expect to compensate them for:
    - Alternative risk-free rate (I.E. Treasury Bonds), plus
    - + Equity risk premium, plus
    - + Size risk premium, plus
    - + Industry risk premium
    - = Cost of capital
- The cost of capital is generally 12% - 15% in the banking industry today

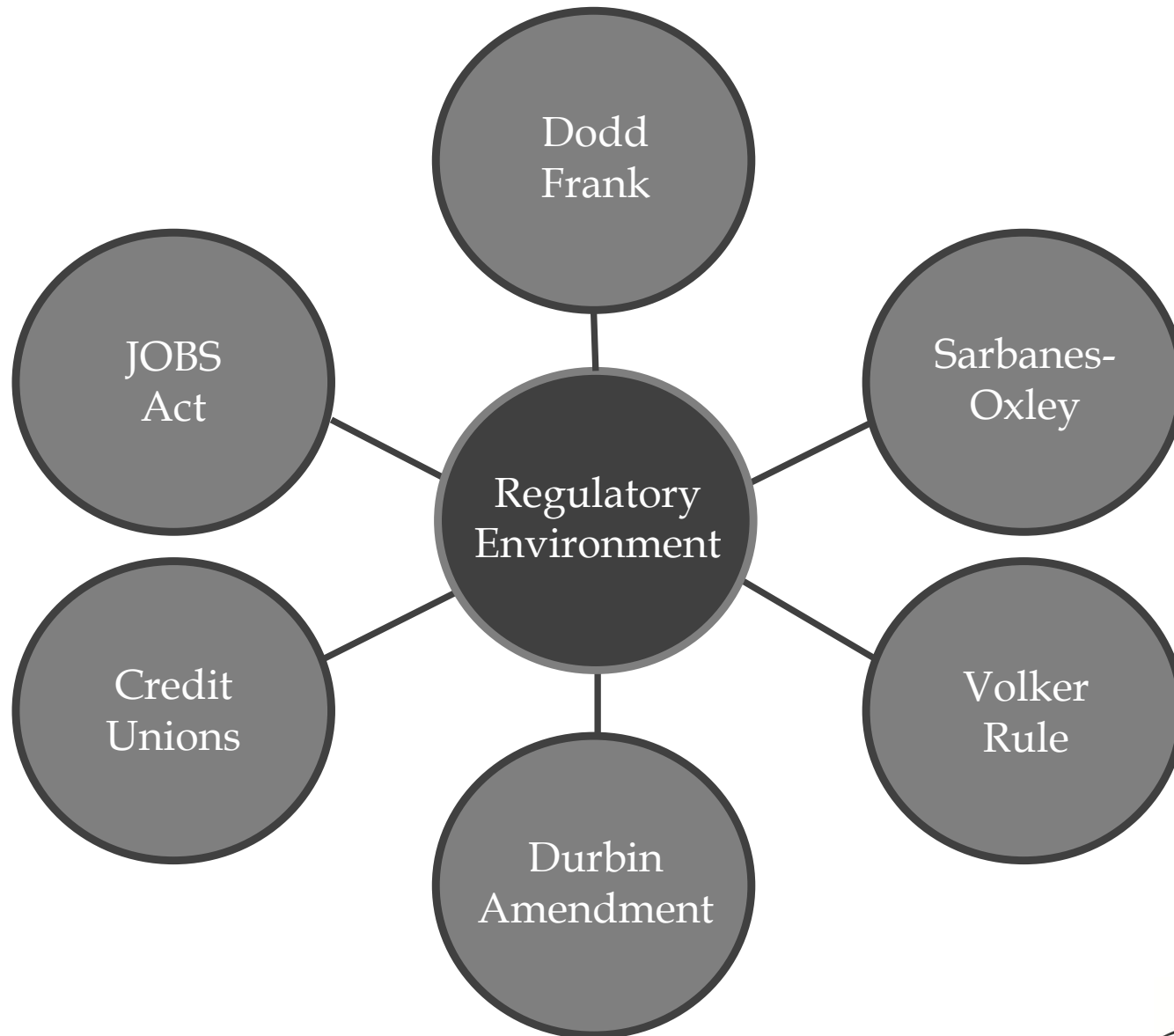
## Factors Impacting Bank Stock Pricing



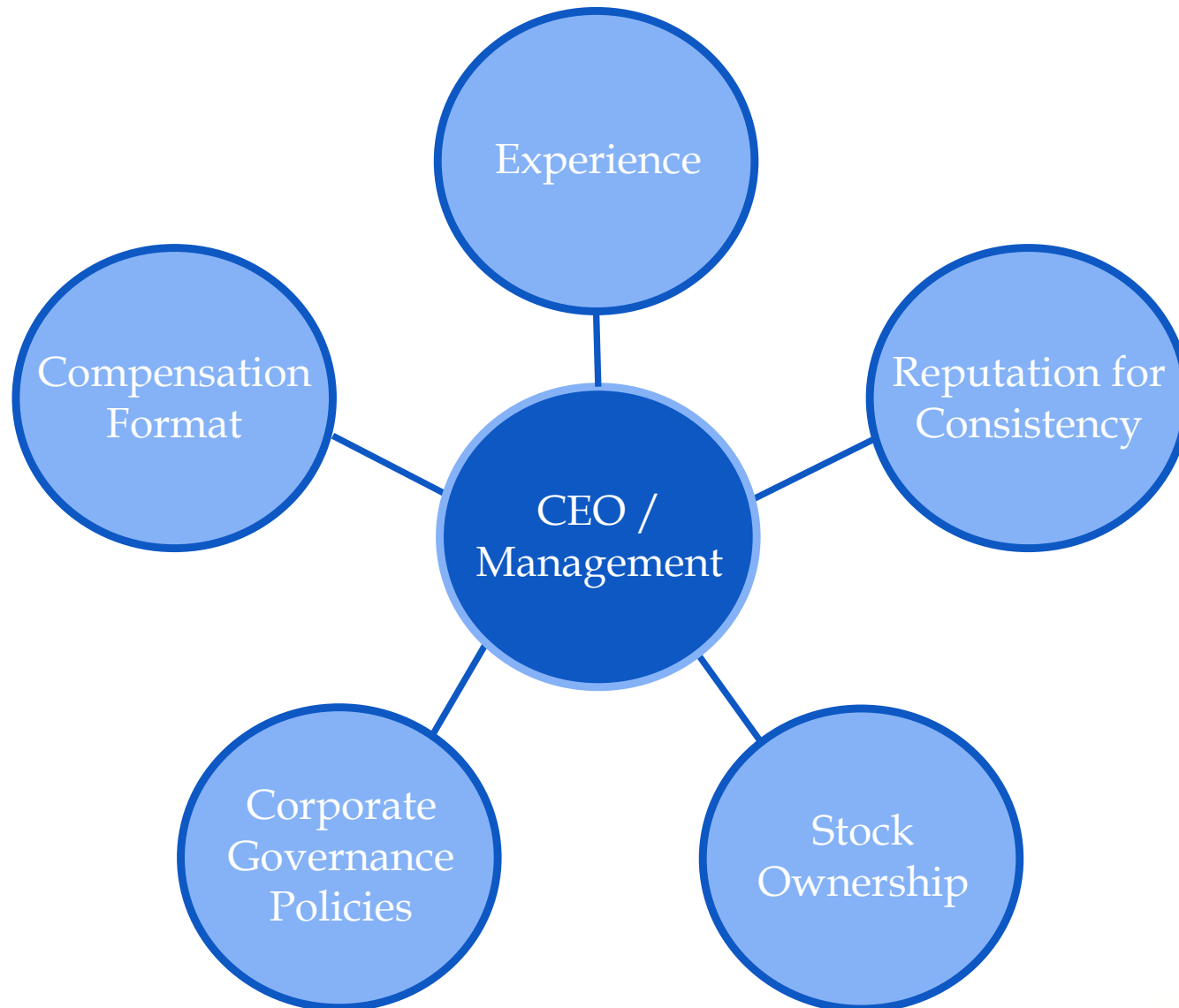
## Factors Impacting Bank Stock Pricing - Economic Conditions



## Factors Impacting Bank Stock Pricing - Regulatory Environment



## Factors Impacting Bank Stock Pricing - CEO/Management



## Factors Impacting Bank Stock Pricing - Earnings



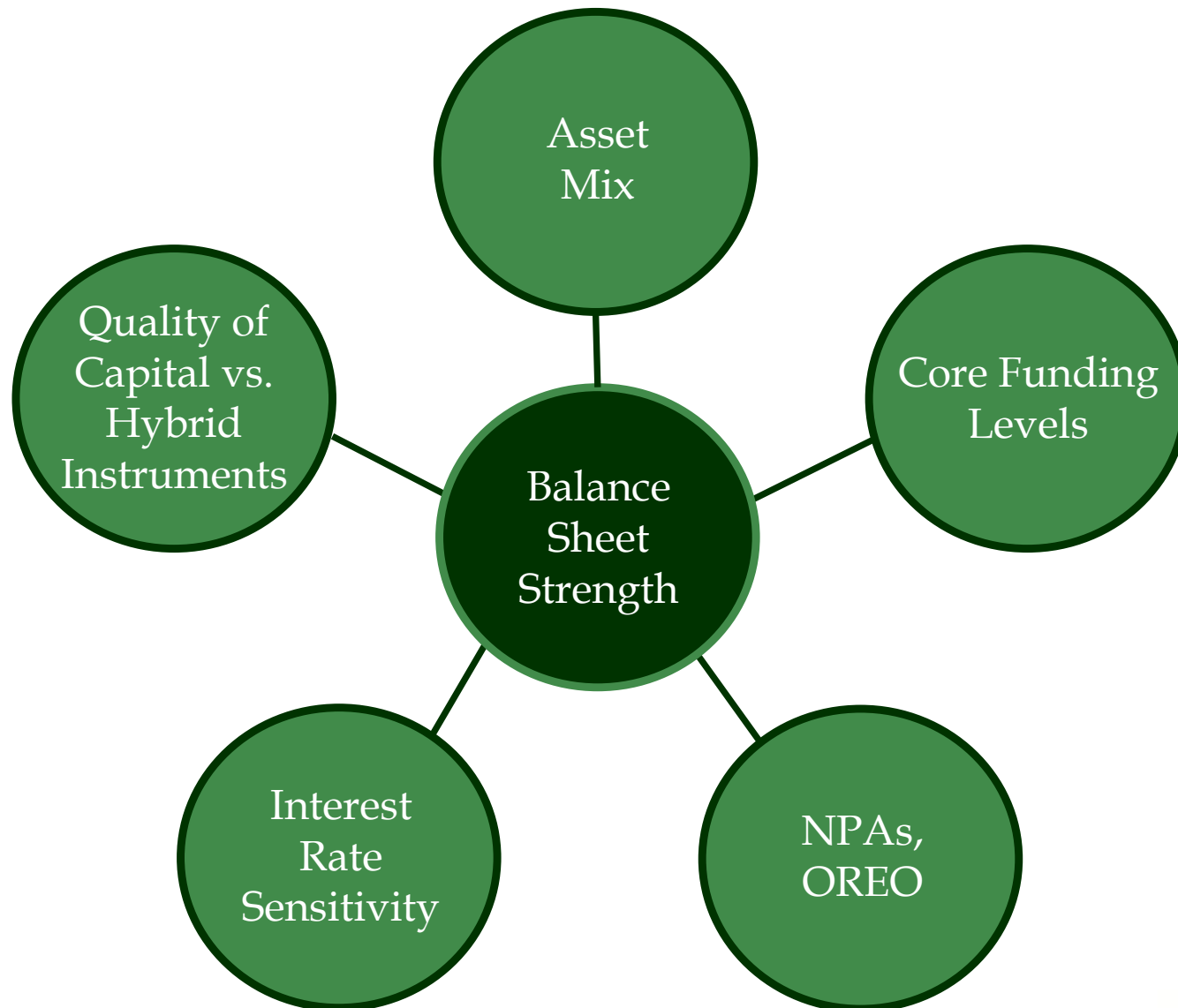
## Financial Performance Trends

- Lower Net Interest Margins +
- Higher Operating Costs (= Higher Efficiency Ratio) +
- Lower Fee Income (Debit, OD) +
- Higher Credit Costs (= Lower Profitability, = **Lower Stock Price**)

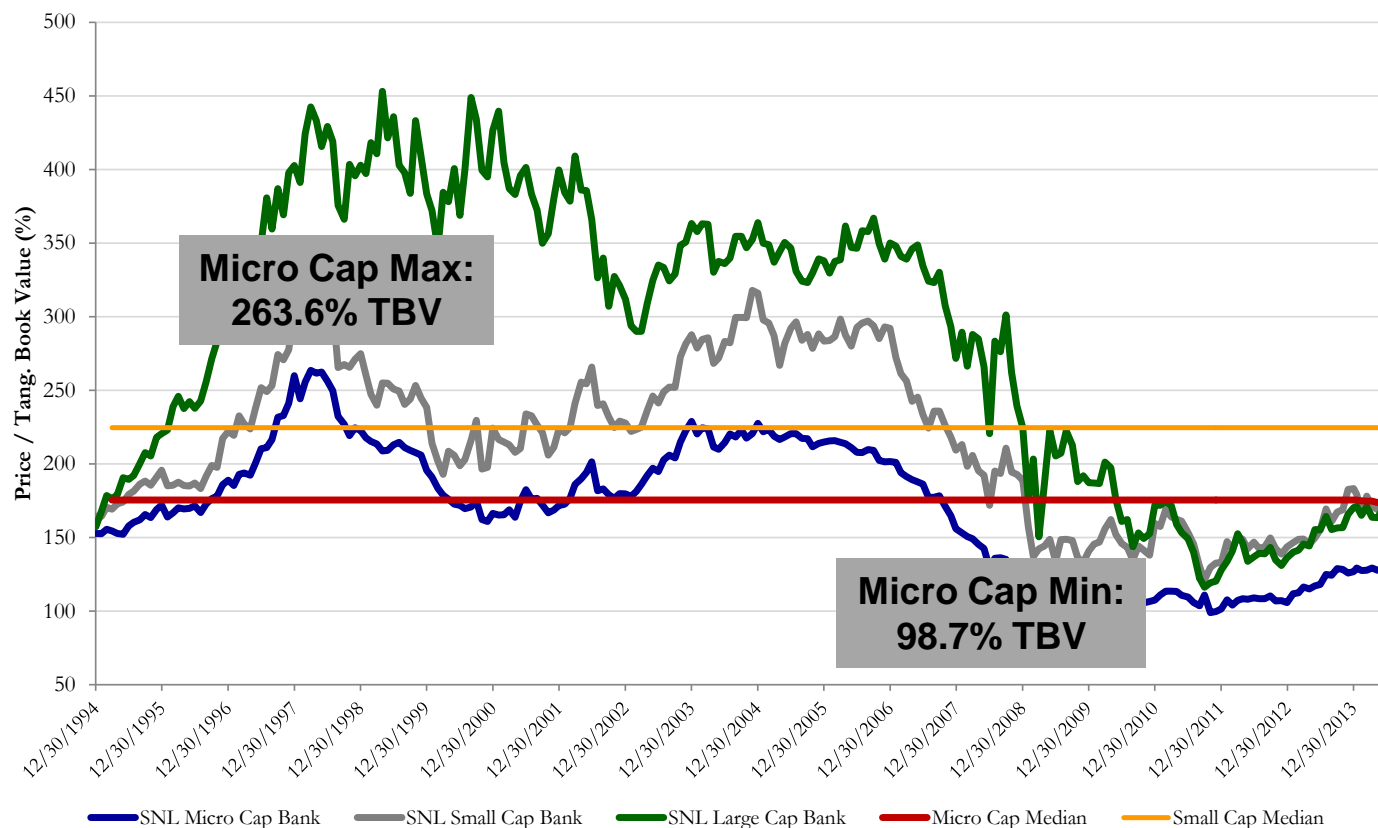
There appears to be a permanent “squeeze” on the bank profitability model which is reflected in soft stock prices



## Factors Impacting Bank Stock Pricing - Balance Sheet Strength



## Valuation Multiples of Bank Stocks

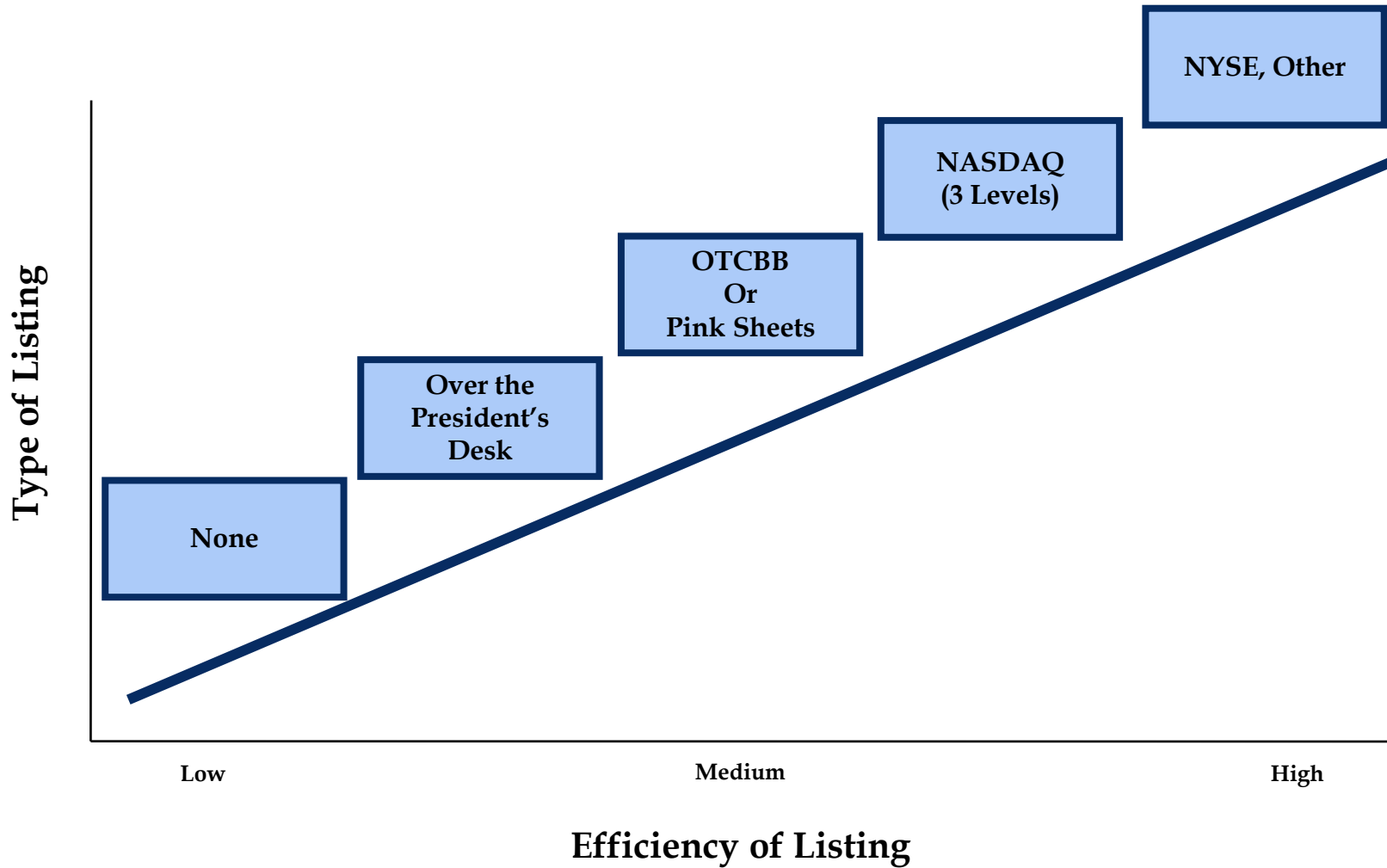


**“Micro Cap” bank stocks are being valued near the lowest levels they have been in over 15 years**



## MARKET MAKING

## Forms of Market Making



## Forms of Market Making - Over the President's Desk

- Pros:
  - Easy
  - No brokerage fee
  - Buyer/ Seller usually disclosed
  - Valuation methods vary
  
- Cons:
  - May impose fiduciary duty on President
  - Inefficient
  - May exclude some from process

## Forms of Market Making - OTCBB

### ➤ Pros

- Minimal listing requirement – bank must be current with reports to their appropriate regulatory authorities
- Inexpensive
- Facilitated by FINRA
- No minimum bid
- No financial requirement

### ➤ Cons

- Must be sponsored by brokerage firm – Form 211
- Prices may not reflect true value of bank
- Bank authorization not required
- “Trader” mentality versus buy to own

## Forms of Market Making – The NASDAQ Stock Market

- Minimum Financial Requirements
- Stringent Corporate Governance
- Expensive
- Three Levels
  - NASDAQ Capital Market (Formerly SmallCap Market)
  - NASDAQ Global Market (Formerly National Market)
  - NASDAQ Global Select Market (Highest Standards)

## Forms of Market Making - The NASDAQ Stock Market

### ➤ Pros

- Broader Market Exposure
- Efficient
- Creates “Published” Closing Price
- Attracts Other Market Makers

### ➤ Cons

- Expensive
- High Corporate Governance Standards
- May Not Achieve Volume Goals
- Shareholder Vote Needed for Dilutive Capital Offerings



## Shareholder Relations

*Shareholder Relations are Very Important – Love ‘em or Hate ‘em*

Communication is important to differentiate your stock from the others

## Shareholder Relations - How Do Banks Attract Investors?

- Strong webpage and Investor Relations portal
- Dedicated IR personnel in house (CEO, CFO)
- Regular Communications
- Robust Annual Meeting (yes, dinner & drinks!)

## Shareholder Relations – A Strong Webpage

- **Case Study – Walt Disney Company (NYSE: DIS)**
  - ✓ Full access to annual reports, 10-Q, 10-K, Proxy
  - ✓ Press releases
  - ✓ List of Board members, with biographies (pictures a plus)
  - ✓ Board committees
  - ✓ Articles of Incorporation; By-Laws
  - ✓ Stock ownership by insiders
  - ✓ Dividend rate, history
  - ✓ Transfer agent, CUSIP#
  - ✓ Change of address form

## Shareholder Relations Survey

Symbol	Market	Webpage Portal	Company Background	Annual Report	Quarterly Report	Investor Presentations	Press Releases	Officers/Directors	Quote History	Market Capitalization (\$mm)
* BBBI	OTCQB	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	11.7
CTDN	OTCQB	Yes	Yes	Yes	No	No	No	No	No	21.3
CYFL	OTCQB	No	Yes	Yes	Yes	No	No	Yes	Yes	25.2
* COFS	OTCQB	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	59.4
CEFC	OTCQB	No	No	No	No	No	Yes	No	No	26.3
CBNC	OTCQB	Yes	No	Yes	Yes	No	Yes	Yes	Yes	23.5
* CBMI	OTCQB	No	Yes	No	No	No	No	Yes	No	16.5
EFIN	OTCQB	Yes	No	Yes	Yes	No	Yes	Yes	Yes	18.0
HCBN	OTCQB	No	Yes	No	No	No	No	No	No	20.8
* MFNC	NASDAQ	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	69.6
* SOMC	OTCQB	Yes	No	Yes	Yes	No	Yes	Yes	Yes	44.4
* UBMI	OTCQB	Yes	No	Yes	Yes	No	Yes	Yes	Yes	159.5
UNIB	OTCQB	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	38.9
WSSH	OTCQB	No	No	No	No	No	Yes	No	No	29.3

\* Utilizes third party to manage webpage

## Financial Disclosures – Hot Buttons

Balance Sheet	P & L	Credit
BV/Share	Pre, Pre ROAA	Classifieds/Equity + ALLL
TBV/Share	Pre, Pre ROAE	NPA's/Assets
Goodwill	NIM	Reserves/NPA's
CRE/Capital	Efficiency Ratio	Cum. NCO/Peak NPA's
TCE/Assets	Fee Income/Total Income	Texas Ratio

Don't make analysts ask "Where's Waldo?"

## Investor Presentation

- Financial Overview (with items just discussed)
- What is our Market?
- What are our Growth Plans?
- Organic vs. Acquisition Strategy
- What is our Core Deposit Strategy?
- What do we want to be when we Grow up?

The Investment Presentation can make or break whether someone will buy your stock

## Market Makers

- Market Makers are the “matchmakers” in the market
- “Trading” Firms versus “Full Service” Firms
- OTCBB versus NASDAQ
- Trading for a “Tic” versus “Long-Term” Investors

### Some Market Makers:

- Boenning & Scattergood
- FIG Group
- KBW – a Stifel Nicolaus Co.
- Raymond James
- Monroe Securities, Inc.
- Sterne Agee

**Communication with your market maker will give them a better chance of bidding up the price of your stock.**

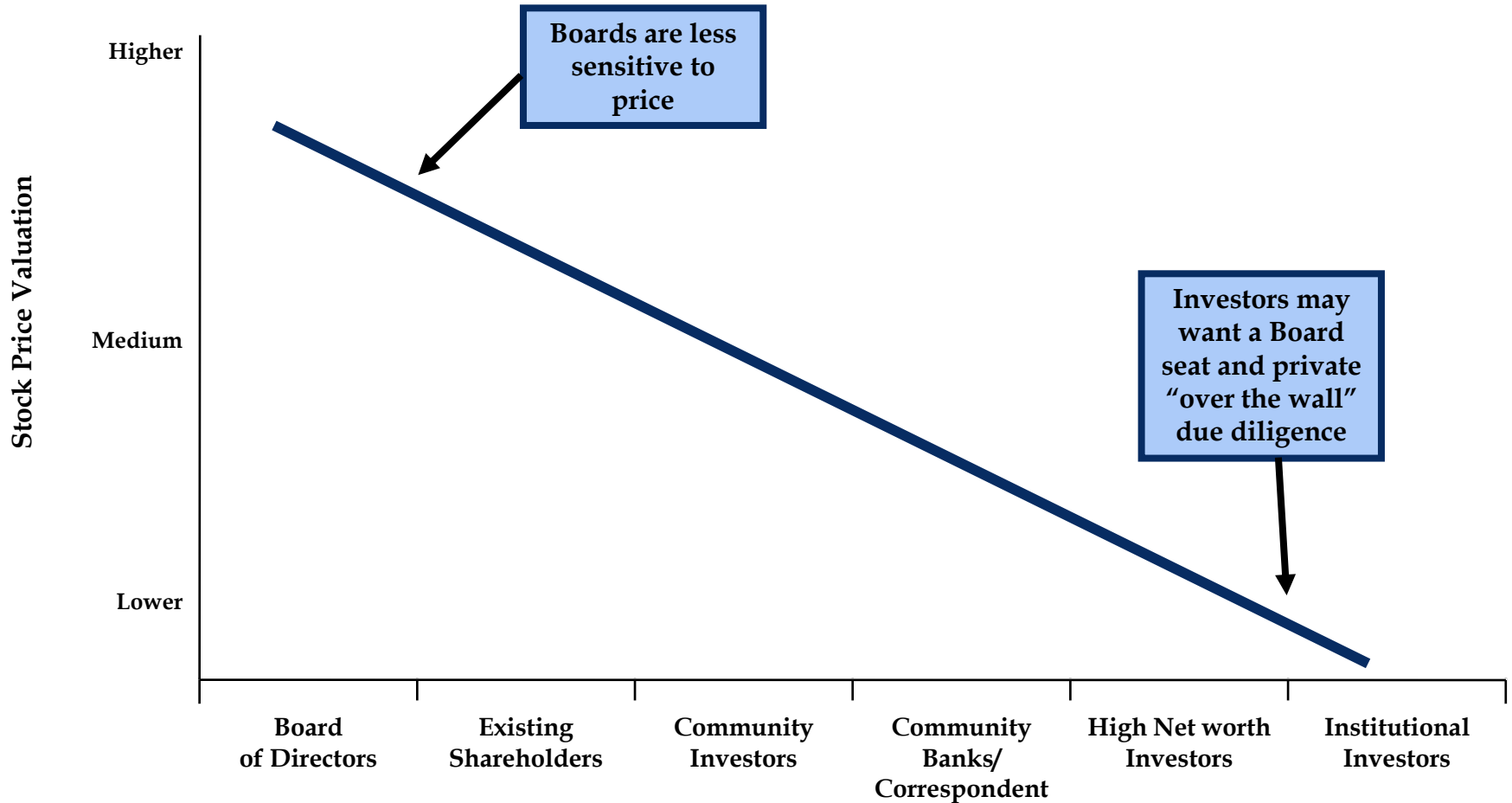
## General Characteristics of Your Market Maker

- Market maker hundreds of stocks
- Exclusive focus on community banks
- Make markets in many MI banks
- Small volume can dramatically alter the price
- You can control the following with your market maker:
  - Disclosure - uncertainty = discount
  - Story - speak or visit with market makers as why your bank is different
  - Shareholder Posture - manage bank with good governance for shareholder returns

**You may only have 15 minutes to get your 15 minutes of fame**



## Common Stock - Pricing Mix





## CAPITAL MANAGEMENT

## Shareholder Objectives vs. Regulator Objectives

## Shareholder Objectives

## Regulator Objectives

Maximize Earnings



Conservative Lending

Maximize ROE



“Well capitalized” ratios

Pay Cash Dividends



Preserve capital

Grow Assets



Reduce reliance on real estate lending

Maximize Shareholder Value

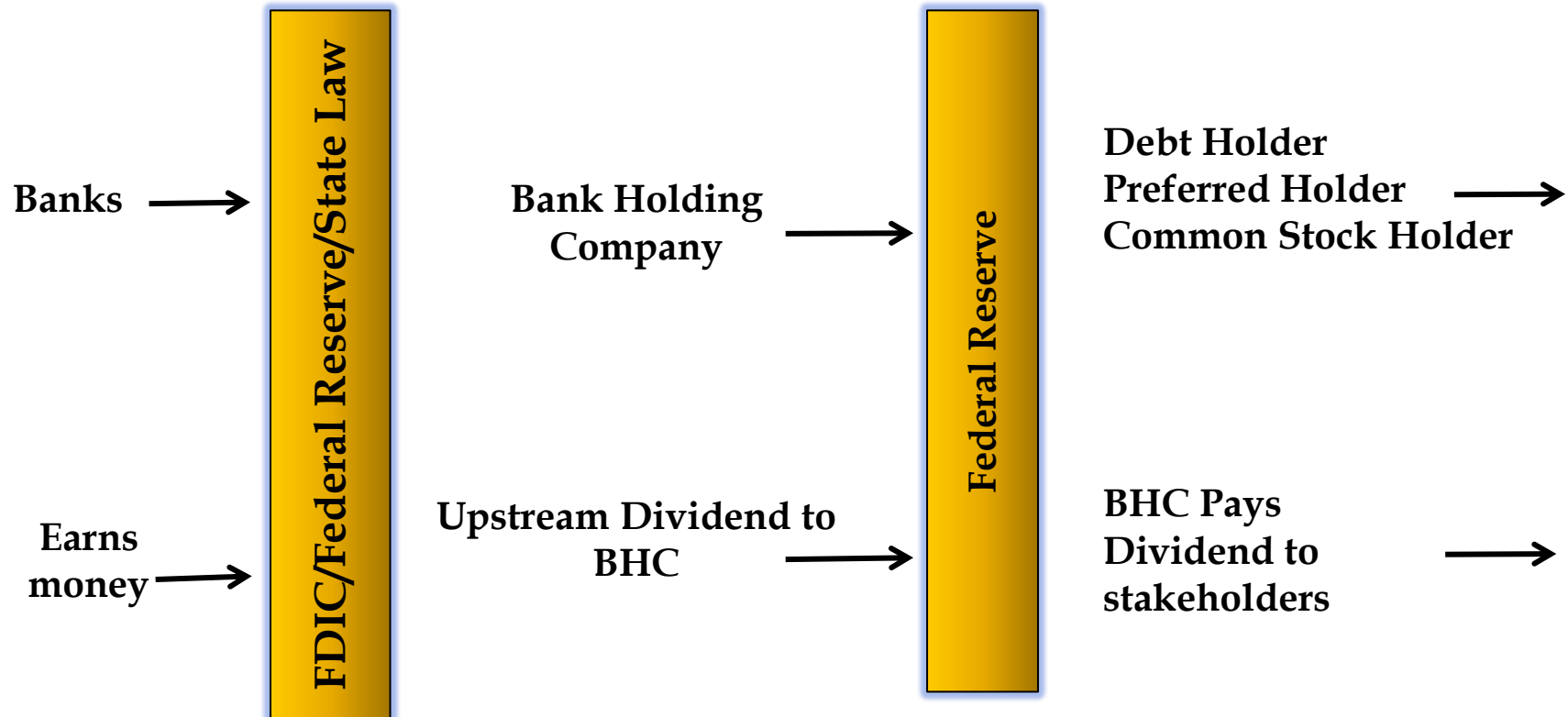


Run a safe and sound organization

## Dividends: Why They Are Important



## The Road to Shareholder Dividends



## Limitations on Bank Dividends to Shareholders

Federal Reserve directives (member banks):

Dividends cannot exceed:

Net Income – current calendar year +  
Retained “net” earnings for the preceding  
two calendar years

Undivided profits

Must have positive undivided profits

Recent Fed Rule SR 09-4 that monitors  
Dividends



*Note: Must be current on Trust Preferred, TARP, or SBLF to pay common dividend*

## High Performer – Pays Dividends

### Bank Pays and Dividend

	Year 1	Year 2	Year 3	Year 4	Year 5	Exit @ Year 5
Beginning Net Worth	10,000	11,125	12,377	13,769	15,318	
Net Income - ROE =	15.0% 1,500	1,669	1,856	2,065	2,298	
Less: Dividend	25% 375	417	464	516	574	
Ending Net Worth	11,125	12,377	13,769	15,318	17,041	
Dividend	375	417	464	516	574	
Discount Rate	12.0%					
Time Convention	1.0	2.0	3.0	4.0	5.0	
Discount Factor	0.8929	0.7972	0.7118	0.6355	0.5674	

PV of Dividends	335	333	330	328	326	
Total PV of Dividends	1,652					

Terminal BV	1.50					25,562
Discount Factor						0.5674
PV of Terminal BV						14,504

Total PV of Dividends	1,652
PV of Terminal BV	14,504
<b>Equity Value</b>	<b>16,156</b>

## High Performer - No Dividend

### Bank Pays No Dividend

		<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Exit @ Year 5</u>
Beginning Net Worth		10,000	11,500	13,225	15,209	17,490	
Net Income - ROE =	15%	1,500	1,725	1,984	2,281	2,624	
Less: Dividend	0%	-	-	-	-	-	
Ending Net Worth		11,500	13,225	15,209	17,490	20,114	
Dividend		-	-	-	-	-	
Discount Rate	12.0%						
Discount Rate		1.0	2.0	3.0	4.0	5.0	
Discount Rate		0.8929	0.7972	0.7118	0.6355	0.5674	

PV of Dividends		-	-	-	-	-	
Total PV of Dividends		-					
Terminal BV	1.50						30,170
Discount Factor							0.5674
PV of Terminal BV							17,119
Total PV of Dividends		-					
PV of Terminal BV		17,119					
Equity Value		17,119					



## Michigan Dividend Review - All Public Banks

37 Public Banks surveyed

21 Currently paying a dividend YTD

Mean Payout Ratio is:	22%	2013
	20%	2012
	26%	2011
	26%	2010

Median yield of 1.84%

Highest yield - Commercial National 6.44%

### MI Banks paying dividend:

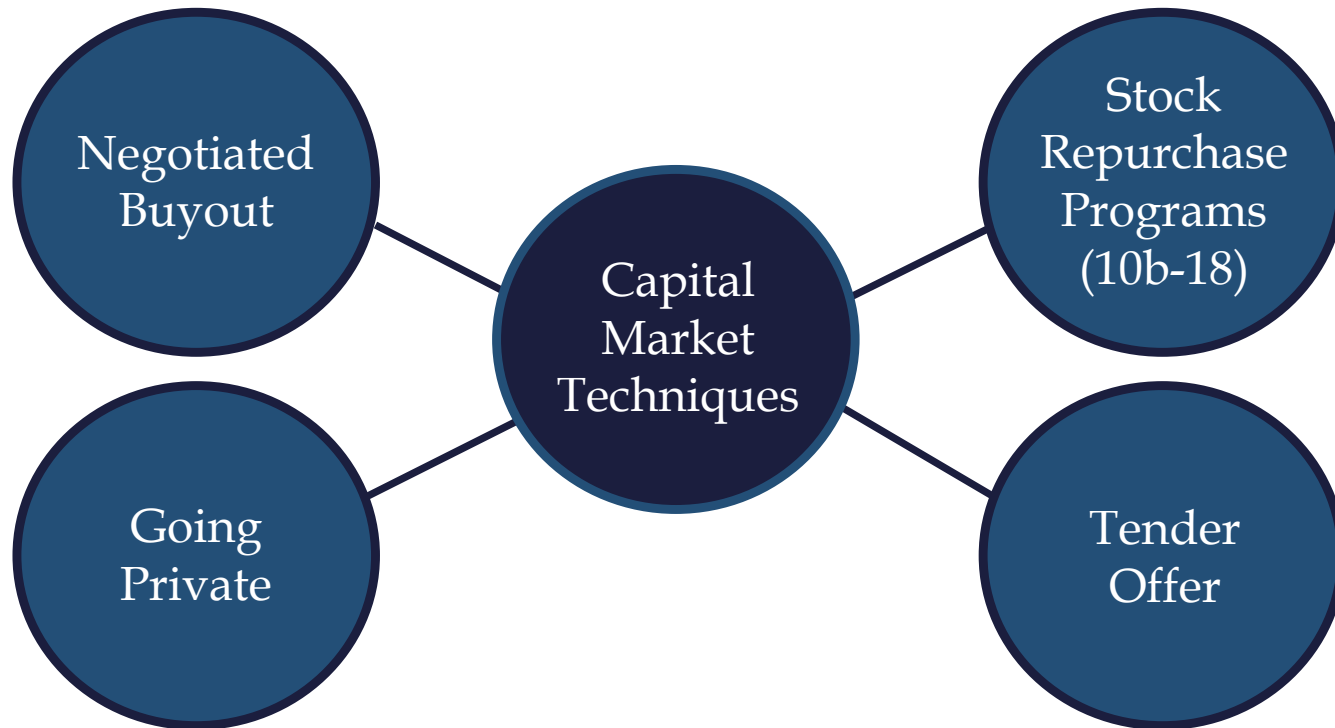
- 4.4% median LTM Gross Loan Growth
- 9.5% median Tangible Common Equity/Tangible Assets

## Michigan Dividend Paying Only - Peer Analysis

### MI Banks paying dividend:

- 35% median Payout Ratio in 2013
- 1.2% median Yield
- 4.4% median LTM Gross Loan Growth
- 9.5% median Tangible Common Equity/Tangible Assets

## Other Capital Management Techniques



## Open Market Purchases - Reasons

- Dividend Reinvestment
- Stock Options
- Accumulate stock for future acquisition
- Send signal to market stock is undervalued

## Open Market Purchases

Governed by rule 10b-18 of Securities Act

- Single day volume lesser of 25% of 4 week Average Daily Trade Volume or issuer's daily 10b-18 purchases for last 3 months.
- Only one broker on any given day
- Can't be first trade of the day or within 30 minutes of closing
- Cannot exceed highest independent bid or last transaction price whichever is higher – some exceptions permissible
- Hard to manage what can be bought

## Tender Offer Buyback

- If buyer is public, must file TO with SEC (per 13d and 14d(1))
- Shareholders not mandated to sell
- Buyer may set minimum
- Private Companies have more flexibility
- Fixed price or “Dutch Auction”

## Privately Negotiated Buyout

- Aging legacy shareholders (or their heirs) may desire liquidity
- If negotiated, buyer can justify “liquidity” and “minority” discount
- Alleviates possible pressure to sell bank
- Purchase can be financed with BHC debt
- Should enhance ROE, EPS

## Those That Should Consider Going Private

- Low Market Capitalization
- Little or no analyst coverage
- Thinly traded on OTCBB
- Reduced risk of shareholder litigation
- Public shares undervalued
- Threshold is 2,000 shareholders



## Reasons To Go Private

- There may be no need for public capital
- SEC reporting costs
- High compliance cost with Sarbanes Oxley
- Less need to manage short term earnings
- Possible Subchapter S status eligibility

## Going Private Techniques

- “Freeze Out” Merger
- Reverse Stock Split
- Tender Offer

## JOBS Act

- Jumpstart Our Business Startups Act
  
- Some major provisions:
  - Increased the number of shareholders from 500 to 2,000 to be an SEC company
  - Reg. A (in-state) offerings increased from \$5 mm to \$50 mm
  - General solicitations permissible to accredited investors
  - New public companies exempt from SOX 404(b) for 5 years



## HOW TO BUILD FRANCHISE VALUE

## Current Investor Sentiment

### Must Haves

- Strong management team
- Healthy balance sheet
- Core earnings
- Market opportunities / ability to grow
- Strong capital

### Desires

- M&A opportunities
- Investment liquidity
- Growing market area
- Improving margins
- Core deposits

### Dislikes

- Declining asset quality
- C&D / Investor CRE loans
- Brokered deposits
- "Fill the hole" capital

## Performance Affects Valuations

(\$ in 000s)

Median Results	# of Banks	% of Banks with TARP	Performance Analysis			Valuation Metrics	
			LTM ROAA	LTM Net Interest Margin	LTM Efficiency Ratio	P / BV	P / TBV
National Banks <sup>(1)</sup>	697	9.18%	0.73%	3.62%	72.60%	101.89%	108.51%
Midwest <sup>(2)</sup>	158	6.96%	0.77%	3.48%	72.26%	99.34%	106.23%
Michigan <sup>(3)</sup>	26	0.00%	0.78%	3.56%	74.83%	96.26%	100.65%

Footnotes:

- <sup>(1)</sup> Public community bank stocks nationally with less than \$5 billion in assets and avg. daily trading volume greater than 0 over the past month.
- <sup>(2)</sup> Public community bank stocks in the Midwest with less than \$5 billion in assets and avg. daily trading volume greater than 0 over the past month.
- <sup>(3)</sup> Public community bank stocks in Michigan with less than \$5 billion in assets and avg. daily trading volume greater than 0 over the past month.

**Based on the median, Michigan banks have experienced similar earnings, but trade at a slight discount to their Midwest and National peers**

## Relevant Community Bank Performance Metrics by Size

Summary of Trading Multiples for Micro vs. Small Cap Banks  
 Median Results for Respective Comparable Sets  
 (\$ in 000s)

Median Results	# of Banks	% of Banks with TARP	Balance Sheet		Performance Analysis				Valuation Metrics	
			Assets	Deposits	LTM ROAA	LTM ROAE	LTM Net Interest Margin	LTM Efficiency Ratio	Price / Book Value	Price / Tang. Book Value
Small Cap <sup>(1)</sup>	162	3.09%	\$1,814,279	\$1,562,059	0.91%	8.87%	3.70%	65.24%	126.07%	142.27%
Micro Cap <sup>(2)</sup>	246	4.88%	513,175	423,180	0.79%	7.82%	3.57%	71.24%	101.35%	106.69%

Footnotes:

<sup>(1)</sup> Small cap comparable group set includes all public banks with assets between \$1 and \$5 billion, NPAs/assets less than 5%, and tang. equity greater than 6%

<sup>(2)</sup> Micro cap comparable group set includes all public banks with assets between \$250 million and \$1 billion, NPAs/assets less than 5%, and tang. equity greater than 6%

**Smaller banks trade at significantly lower valuations than larger banks. Gaining scale generally leads to improved profitability and higher valuations**

## Large Disconnect between Public Market and M&A Markets Valuations

The chart below shows the difference between current valuations in the publicly traded market and the M&A market for banks with less than \$1.0 billion in assets that have sold since 2013:

	Assets (\$000s)	NPAs / Assets (%)	Valuation Metrics		
			Price / Book Value (%)	Price / Tang. Book Value (%)	Price / LTM EPS (x)
Comparable Company Median	\$513,175	1.49%	101.35%	106.69%	12.75x
Comparable Acquisition Median	\$144,480	1.54%	115.42%	120.38%	19.52x

Low valuations and/or no access to reasonably priced capital has led some banks to merge. The median one-day trading premium for all M&A transactions since 2013 for banks with less than \$1.0 billion in assets is 36%.



## How do Community Banks Close the Valuation Gap?

A. Obtain scale (> \$1 billion in assets) that allows banks to absorb the increasing costs of banking and produce adequate shareholder returns (through organic growth opportunities or partnering with another institution)

OR

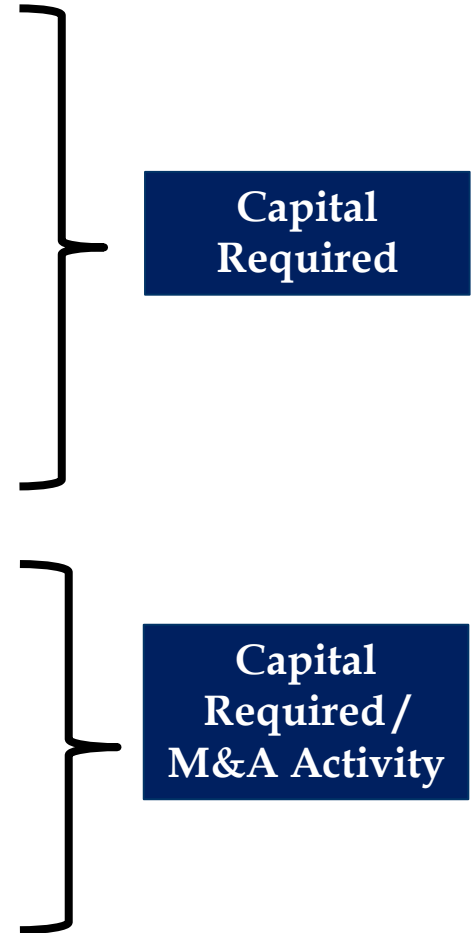
B. Prove to investors that your bank can operate with consistently high levels of profitability at a smaller asset size (< \$500 million in assets)

**The investment community believes that most banks will have to choose option A and are investing in larger banks or banks with clear growth strategies to become a bank with scale (> \$1 billion in assets)**

## How Do Community Banks Close The Valuation Gap?

**Potential growth activities to achieve scale and close “the gap”:**

- Open new branches
- Increase asset size through:
  - Increasing core deposit base
  - Hire additional lending teams
  - Purchase in-market loan participations
- Increase non-interest income activities
- Buy branches
  
- Traditional acquisition
- “Merger of Equals”
- Sell to a larger institution



## Characteristics of a Possible Target

- Liquidity needed by shareholders
- CEO succession issues
- Capital needs with limited access to capital markets
- Regulatory scrutiny (MOU, written agreement, etc.)
- In deferral/default of BHC senior debt, trust preferred, TARP

## Merger of Equals Concept

- Merger of equals creates scale, efficiency
  
- Often contemplated on a “book-to book” valuation basis based on the “true” book values of each partner
  
- Merger of equals challenges:
  - Social/cultural issues
  - Fair value “mark to market” accounting
  - Regulatory approval

Many believe the “cost of banking” will induce more merger of equals

## Summary

- Stock price is the lifeblood of a bank
- Communication with investors is critical to efficient markets
- Capital management techniques can increase stock prices
- Core deposits and fee income will enhance shareholder value
- Scale generally leads to higher valuations

**Bankers are facing one of the most challenging environments ever to make money**



Q & A



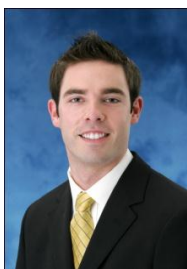
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### **John C. Donnelly - Managing Director**

Mr. Donnelly is a Managing Director for Donnelly Penman & Partners (DP&P). DP&P is an investment banking firm specializing in raising capital and advising on mergers and acquisitions in the banking industry. Mr. Donnelly is also the founder and Managing Member of the Donnelly Penman Financial Services Fund, LP (the "Fund") which invests in community banks throughout the country. Prior to co-founding DP&P in 2000, Mr. Donnelly was a Managing Director in the investment banking department of Raymond James & Associates, Inc. where he focused on the financial services industries. Mr. Donnelly joined Raymond James in 1999 effective with its acquisition of Roney & Co., a Midwest based investment banking and brokerage firm. Mr. Donnelly joined Roney in 1993 where he held the positions of Managing Director and head of the Financial Institutions group and also served on the Executive Committee. From 1983 to 1993, Mr. Donnelly held the positions of Senior Vice President and Director of Corporate Finance at First of Michigan Corporation (now Oppenheimer). Prior to that, he was employed in various credit and lending positions at both Manufacturer's National Bank (now Comerica, Inc.) and Michigan National Bank (now Bank of America). Mr. Donnelly is a Trustee of the Beaumont Health System and is a former director of Premara Financial, Inc. and Carolina Premier Bank in Charlotte, North Carolina.

Mr. Donnelly graduated from Georgetown University and holds a M.B.A. degree from the University of Detroit Mercy. Mr. Donnelly also has Series 7, 24, 27, 55 and 63 licenses with FINRA.

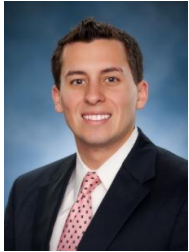


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### **Andrew C. Christians, CFA - Senior Vice President**

Joining DP&P in 2006, Mr. Christians specializes in mergers and acquisitions (buy side and sell side), business valuations, financial advisory, strategic analysis, and raising capital for financial institutions. Mr. Christians has also rendered sell-side and valuation services for the automotive, manufacturing, and service industries. Additionally, Mr. Christians has been the Portfolio Manager for the Donnelly Penman Financial Services Fund (\$28 million private equity fund dedicated to investing in community bank equities across the nation) since March 2009, in addition to managing accounting, investor relation, and administrative activities. He also sits on the Advisory Board and Investment Committee for the Fund. Prior to joining DP&P, Mr. Christians was an Analyst in Stout Risius Ross' Transaction Advisory Group. At Stout Risius Ross, he specialized in performing financial opinions and consulting services primarily related to mergers and acquisitions, goodwill impairment analyses, and corporate strategic planning. Mr. Christians has earned the right to use the Chartered Financial Analyst (CFA) designation and graduated from the University of Michigan's Ross School of Business with a B.B.A. degree with concentrations in Finance and Accounting.



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**Gregory H. Cunningham - Senior Associate**

Mr. Cunningham joined DP&P in 2011. At DP&P, Mr. Cunningham specializes in merger and acquisition transactions, valuations, financial advisory, fairness opinions, and due diligence services for financial institutions. Additionally, he provides financial advisory and strategic analysis for the automotive, manufacturing, distribution, and service industries. Prior to joining DP&P, Mr. Cunningham was a Turnaround Consultant at Kenneth J. Dalto & Associates, where he provided advisory services to middle market companies requiring debt restructuring and refinancing, as well as corporate finance. Mr. Cunningham graduated from Western Michigan University's Haworth College of Business with a B.B.A. degree with a major in Finance and minor in Accounting. Additionally, Mr. Cunningham is pursuing a M.B.A. from the University of Detroit Mercy.