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INDUSTRY  
UPDATE

Financial Markets Turmoil

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## MCCOLL PARTNERS SECTOR SPOTLIGHT

## Financial Markets Turmoil

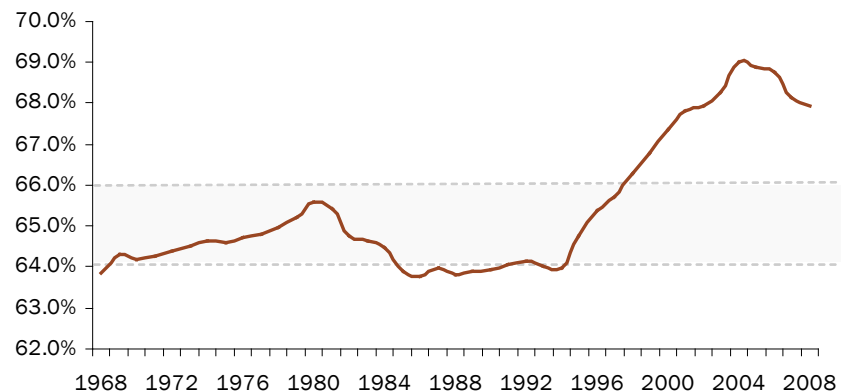
We are pleased to provide you with this market update on behalf of McColl Partners' Financial Institutions Group. The recent events in the financial markets have been stunning, and have compelled us to produce the following newsletter. We have attempted to make sense of what has taken place, while also providing some thoughts and advice on what lies ahead. As always, we appreciate any feedback and welcome any further questions.

## CURRENT STATE OF AFFAIRS

The American economy is currently in a state of turmoil. In recent years, the rapid and sustained increase in the demand for housing, reinforced by low interest rates, the explosion of sub-prime and related lending, and a flourishing secondary market turned a housing boom into a housing bubble. Aggressive speculators built ahead of the demand and financing sources evaporated almost overnight. As a result, prices began to fall, and the bubble eventually burst. Since the beginning of the housing implosion in the summer of 2007, residential construction and housing prices have declined steadily, resulting in decreased economic growth and job creation across the country. Simultaneously, masses of defaulting sub-prime mortgages—which have infiltrated the credit markets via collateralized debt obligations and other exotic investment vehicles—have triggered a wave of rolling problems in the financial markets. Many financial institutions found themselves owning securities worth less than their expected value or whose values could not be easily determined. The results have been devastating, with big losses for some and a panicky flight from risk by investors. Uncertainty about the future tightness of credit markets has resulted in even lower investor confidence, and it appears as though financial institutions will incur significant additional losses before the situation improves.

Everyone seems to be asking the same question: how long will the current financial crisis last? While we do not know precisely, Figure 1 suggests that the last decade has been a period marked by “free credit,” weak loan structure, and low pricing that has led to unprecedented levels of homeownership. The U.S. Census Bureau estimates that as of June 2008, there were approximately 112 million households in the United States. For the homeownership rate to return to historical levels of 64% to 66%, the number of owned homes would need to decline by 2 to 4 million units. The reversal of this abnormally high level of homeownership will likely take years, not quarters, to correct.

Figure 1: Historical Average Homeownership Rates



Source: Federal Reserve.

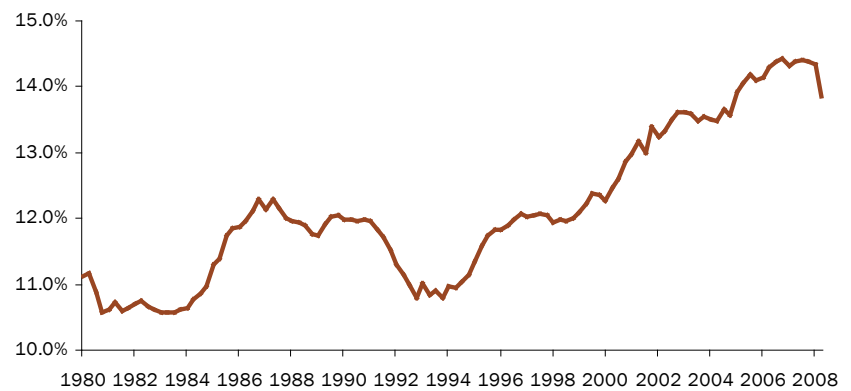
Note: Shaded area indicates long-term historical average of approximately 64% - 66%.

As shown in Figure 2, relative consumer debt levels have grown rapidly over the last fifteen years, indicating that consumer demand for consumption has increased much faster than consumer income. In the fourth quarter of 2007, the household debt service ratio (“DSR”), an estimate of the ratio of debt payment to disposable personal income, reached an all-time high level of 14.4%, compared to 10.8% in the fourth quarter of 1993.

## IMPLICATIONS FOR COMMUNITY BANKS

In recent decades, countless regional and community banks have been able to stay independent thanks to a robust economy. As the dust settles from the current financial crisis, obvious winners and losers will emerge. Weaker banks will become takeover targets while their healthier counterparts will drive the force of consolidation. Surviving banks will revert back to the basics through sound lending with proper structure and pricing, and new forms of regulation will most certainly appear. As the industry landscape undergoes major changes in the coming months, the strongest community banks will be those who stay ahead of the curve.

Figure 2: Household Debt and Financial Obligations as a Percentage of Income



Source: Federal Reserve.

## PAULSON'S RESPONSE

The speed and magnitude of recent developments has been unprecedented. The latest Paulson/Bernanke initiative, a \$250 billion capital injection into the American financial sector, as part of the \$700 billion Troubled Asset Relief Program (“TARP”), is undoubtedly bold, but may be exactly what is needed in this time of crisis. Although government ownership of banks is not desired, extraordinary times call for extraordinary measures. The TARP’s Capital Purchase Program will provide valuable capital to financial institutions across the country, a move that is necessary to restore confidence in the financial system and encourage lending. While the details are still being finalized, the benefits of raising capital seem to outweigh the proposed conditions for eligibility. As it is highly unlikely that the government will invest in all banks, there will be some banks that will need to pursue other alternatives. However, on the whole, we believe this proposal provides a fair rate to both banks and taxpayers, and is the beginning of a viable solution to the current crisis. **If given the opportunity, we strongly encourage participation.**

## 2009 OUTLOOK

The events of recent weeks and months were stunning, but should have been expected. For some time now, Americans have lived well beyond their means as unlimited “free credit” has been widely available. Now, we must endure the deleveraging of America. The recently passed TARP is the first step toward improvement as it will help stabilize the market and prevent an even greater set of rolling failures. However, the plan will not solve the multitude of problems in the financial markets. Rather, the rebound from this recession will be slow and difficult as the market will take years to correct itself from a decade of “free credit.” Nonperforming assets will continue to rise as the toll of the housing crisis spreads to credit cards, home equity lines, and commercial real estate.

## McCOLL PARTNERS' ADVICE

For the past fifteen months, our advice has been to focus on preserving capital (avoiding the temptation to buy back stock at reduced prices), maintaining strong asset quality, and retaining core funding. These should continue to be the areas of focus and will be more important than loan growth and net income growth in 2009 and 2010. Specifically, our thoughts are as follows:

I. **Capital is King** – If your bank qualifies for assistance, request the maximum capital injection of 3% of risk-weighted assets from the TARP Capital Purchase Program.

II. **Focus on Asset Quality** – Consider liquidating underperforming assets which would otherwise require time and resources to monitor.

III. **Look to your Funding** – An inability to receive funding could be detrimental to the survival of your bank. Focus on building core deposits, transaction accounts, and other stable sources of liquidity. Wholesale funds or “indifferent money” may not be available when you need it most.

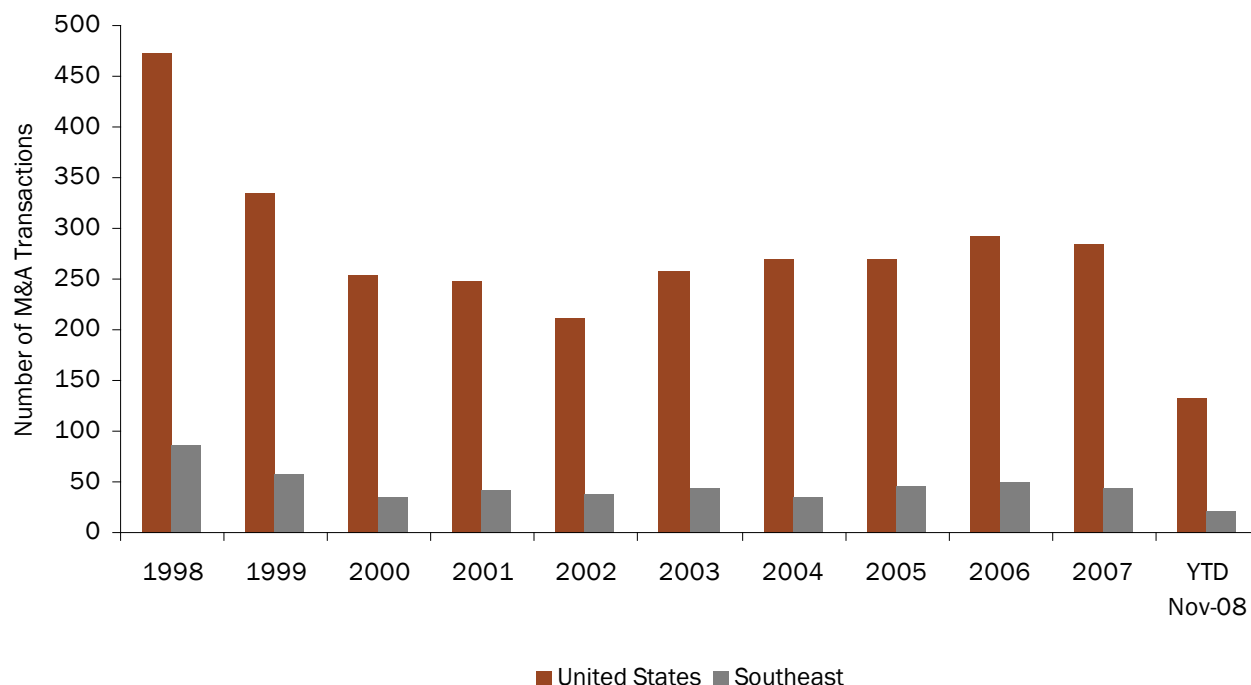
IV. **Diversify your Portfolio** – With extensive knowledge of local economies and property values, community banks typically have higher quality real estate loans than larger players in the industry. Many large banks and investment banks have never even seen their real estate collateral. However, diversification will be increasingly important as a highly concentrated portfolio may be perceived as risky, thus hindering your ability to receive funding.

V. **Anticipate and Embrace Consolidation** – Given the number of struggling banks and the current need for capital, consolidation is inevitable. Do not underestimate your vulnerability or allow market forces to limit your opportunities. Be prepared and proactive to make strategic moves that will best benefit your shareholders.

VI. **Expect Lower Transaction Multiples** – Transaction multiples may never again reach the record highs of recent years. If considering a sale or divestiture, do not wait until it is too late. In some markets, there are more sellers than quality buyers. Sellers will be selling for lower values, but since most will receive stock, they will also be investing in a new currency at lower values. If considering a purchase, be prepared now. Acquisition opportunities are seller driven, not based on when a buyer is ready. While risk is more prevalent today, history suggests that the best acquisitions are made during periods of uncertainty, not when the market is frothy.

VII. **Prepare for Additional Regulation** – Policy makers will almost certainly increase regulatory measures on financial institutions. Rising costs associated with the regulation will put pressure on capital ratios. Work to tackle regulatory matters head on, as it will only improve your relationships with supervisory organizations.

### Historical M&A Activity



Source: SNL Financial.

### Selected Southeast Transactions


Target/Acquiror	Target State	Date Announced	Deal Value	Deal Value/ Earnings	Price/ Tangible Book Value	Deal Value/ Book Value	Premium/ Core Deposits
<b>Hampton Roads Bankshares, Inc.</b> Gateway Financial Holdings	VA	Sep-08	\$86.5	7.5 x	96.3 %	61.5 %	(2.0) %
<b>First Bkshrs Stevenson, Inc.</b> F&M Bancorporation	AL	Sep-08	13.3	13.9	NA	NA	9.5
<b>Yadkin Valley Financial</b> American Community Bancshares	NC	Sep-08	94.4	23.7	206.1	167.5	19.9
<b>Hamilton State Bancshares</b> Jefferson State Bank	GA	Aug-08	NA	NA	NA	NA	NA
<b>First Community Bancshares, Inc.</b> Coddle Creek Financial Corp.	NC	Jul-08	33.0	57.0	163.3	163.3	13.8
<b>BanIndependent, Inc.</b> Citizens Bancorp of Lawrence	AL	Jun-08	NA	NA	NA	NA	NA
<b>First Citizens Bancorp.</b> Community Bankshares Inc.	SC	Jun-08	95.9	35.9	196.3	172.4	13.4
<b>Caja Madrid</b> City National Bancshares Inc.	FL	Apr-08	927.0	25.1	NA	NA	43.5
<b>Village Bank &amp; Trust Financial Corp.</b> River City Bank	VA	Mar-08	20.3	NM	130.5	130.5	5.6
<b>First Citizens Bancorp.</b> Merchants & Farmers Bank	GA	Mar-08	36.8	12.3	NA	NA	17.7
<b>1st United Bancorp, Inc.</b> Citrus Financial Services Inc.	FL	Feb-08	6.0	NM	NA	NA	(17.1)
<b>Central Bancorp, Inc.</b> Jones County Bank	GA	Feb-08	1.4	NM	NA	NA	24.3
<b>Hampton Roads Bankshares, Inc.</b> Shore Financial Corp.	VA	Jan-08	55.8	20.1	201.0	198.4	16.8
<b>Median</b>			<b>\$36.8</b>	<b>21.9 x</b>	<b>179.8 %</b>	<b>165.4 %</b>	<b>13.8 %</b>
<b>Mean</b>			<b>\$124.6</b>	<b>24.4 x</b>	<b>165.6 %</b>	<b>148.9 %</b>	<b>13.2 %</b>

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McColl Partners provides investment banking services to owners and management of middle-market businesses and financial institutions by combining experienced, dedicated professionals, unparalleled access to decision makers, and focused industry expertise.

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AMERICAN COMMUNITY BANK  
has agreed to be acquired by



McColl Partners acted as financial advisor to American Community Bancshares, Inc.



FIFTH THIRD BANK  
has acquired



McColl Partners acted as financial advisor to Fifth Third Bancorp.



Carolina National Bank  
has been acquired by



McColl Partners acted as financial advisor to Carolina National Corporation.

McColl Partners' Financial Institutions Group combines robust knowledge of diverse and dynamic capital markets with innovative approaches to traditional investment banking. From mergers and acquisitions to strategic advisory, McColl Partners professionals work with each client to develop tailored solutions.

For more information on how McColl Partners can assist your company, please contact:

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