nine months before your merger -

planning for a healthy merger “baby”

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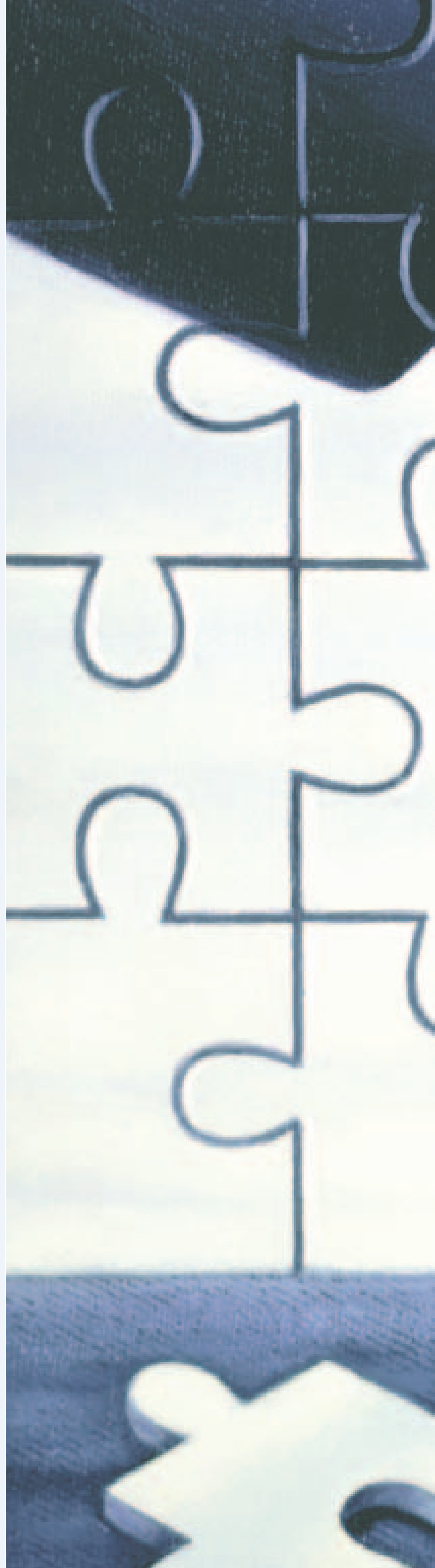
In today’s competitive business climate there is no substitute for planning. Few community bankers are willing to make a loan on a business project without evidence of a carefully thought out business plan, regardless of the value of the collateral or guarantee. In this light, it is surprisingly common to see experienced community bankers enter into negotiations on what might be the most important business transaction of their careers — the merger or sale of their financial institution — without a significant amount of advance planning.

Set forth below are several issues that community bankers should think about prior to entering into merger discussions. Since some of these issues are complex and may require restructuring or other actions by the institution, we recommend that boards of directors review them, if possible, at least a year prior to the initiation of merger discussions.

Merger Pricing

Most community bankers are aware that bank merger pricing is commonly expressed in terms of financial ratios such as price/earnings (“P/E”), price/book value (“P/B”), price/core deposits, etc. However, too often community bankers consider only industry average pricing ratios without taking into account other factors that influence pricing decisions. We believe that a review of these other factors would enable acquiring and selling institutions to have a better understanding of how to price their merger transactions. Those factors typically include the following:

- Impact of the deal on the buyer’s future P/E and other ratios
- Buyer’s stock price (including applicable pricing ratios)
- Transaction structure
- Form of consideration (cash vs. stock vs. mixed)
- Taxation of the transaction
- Differences in financial performance among the buyer, the seller, and any peer group used to develop pricing expectations
- Non-financial factors
  - Geography
  - Roll-up strategy
  - Buyer’s negotiation style
- The buyer’s size and availability of other targets



Financial Impact on the Acquiring Institution. Any discussion of the merger value of a particular institution should begin, not with average industry pricing ratios, but rather with an analysis of the value of the selling institution to a particular buying institution. Accordingly, while the selling institution may have an "intrinsic" value based on a peer group average of say two times book value, if there is no buyer willing to pay such price, then two times book value is simply not its true value.

The most critical pricing issue for buying institutions is financial "dilution." Financial dilution generally results when the book value per share and/or earnings per share of the combined institution after a merger is lower than that of the buying institution before the transaction. In fact, many experienced acquirors establish guidelines for maximum acceptable dilution. For instance, some institutions will not implement any merger in which their earnings per share is projected to decline by more than a specific percentage (e.g., 1 percent) for more than a specific period (say 12 to 18 months) following closing. Similarly, a common "red line" for book value dilution is that all such dilution must be earned back within a three- to five-year period following closing.

The amount of dilution experienced by a buyer on transactions involving a stock sale depends in part on the P/E of its stock. Acquiring institutions with shares carrying a high P/E may experience little or no dilution since, by issuing stock, they are in essence trading a relatively low amount of earnings in exchange for the seller's earnings. It should be noted that financial dilution is often a more critical issue for publicly owned buyers as opposed to privately owned buyers as public institutions tend to have shorter performance horizons than private institutions.

Adjustments to Historical Pricing Ratios. From the point of view of an acquiring institution considering a merger, the truly relevant financial ratios are not the historical financial ratios but rather the projected ratios of the combined institutions. Unfortunately, future financial ratios are notoriously difficult to estimate and are subject to many contingencies. For instance, a projected P/E ratio is subject to many significant contingencies including future economic conditions, cost savings, operating synergies and employee issues. Similarly, a projected P/B ratio is generally dependent on the amount of goodwill and other intangibles arising from the relevant transaction and is very difficult to estimate at the time of the merger agreement. Finally, a projected price/core deposit ratio is subject to estimates regarding deposit decay, changes in interest rates, etc., which, while based on historical experience, are difficult to predict at the time of the merger agreement.

A selling institution should be aware of the importance of these projected financial ratios to the buyer and be prepared to engage in discussions with the buyer on their calculation. In this way, the seller may be able to negotiate a more favorable transaction price. In contrast, the historical pricing ratios are less likely to be utilized by the buyer in pricing a transaction; rather, they are more likely to be used to explain and justify it to interested third parties (such as stockholders.)

Transaction Structure. A key issue relating to merger pricing is transaction structure. For instance, from both the buying and selling institution's standpoint, a merger in exchange for stock consideration is viewed much differently than a merger for cash consideration, even if the pricing ratios are identical. From the point of view of the seller, stock consideration is generally tax deferred whereas cash received is generally taxable on the date of closing. Moreover, the receipt of stock as a merger consideration creates an investment decision on the part of the selling institution regarding the subject stock whereas the receipt of cash is simply a sale for an easily quantifiable price. In particular, a seller receiving stock as a part of the purchase price should focus as much on the upside and downside potential of the buyer's stock as on the current value of such stock. This should involve a thorough analysis of the buyer's historical operations as well as an analysis of its

stock pricing ratios in comparison to its peers.

Taxation. Another important structural issue is the taxation of the transaction. For instance, an acquiring institution may be willing to pay a higher price for a selling institution if the transaction is structured so that there is tax-deductible goodwill, which is available to reduce tax expense.

Financial Model. We believe that the best way for a potential acquiror to analyze the price it can pay for a target institution is to create, either on its own or with the assistance of a financial advisor, a financial model to analyze the impact of a merger with the target institution on its earnings and capital. For the same reason, we believe that an institution wishing to assess its value in a merger transaction should create a similar financial model to analyze the price that possible merger partners would likely be willing to pay for it in a merger transaction. In most cases, this technique can predict far more accu-

rately an institution's merger price than can the application of average pricing ratios.

Non-Financial Factors. There are a number of non-quantative factors that may have a significant influence on pricing. These factors include the attractiveness of the seller's market as well as the availability of alternative mergers or other investments. Also, transaction pricing is sometimes driven by non-financial issues such as the desire of a non-banking company to enter the banking industry. While these factors usually cannot be modeled, they should be considered by all parties in their deliberations on transaction pricing.

Employee Benefits

We generally recommend that a board of directors considering a merger review its institution's employee benefits arrangements at least a year before entering into merger discussions. There are many reasons for this. First, once an institution enters into merger discussions, it may be difficult from a fiduciary duty standpoint to justify the granting of additional benefits to employees, particularly where they may be severed in connection with the transaction. (In contrast, when no merger discussions are ongoing, the courts and bank regulators generally take a hands-off attitude to employee benefits on the theory that they are within the discretion of the board of directors.)

A second reason for reviewing employee benefits prior to implementing a merger process is that certain benefits support the merger process while other benefits can create tax and other problems and should be avoided or restructured. (For instance, we generally recommend that all boards that believe that a merger is possible over the next 12 months analyze whether their institutions have any executive compensation arrangements that could trigger employee and bank "golden parachute" tax penalties under Section 280G of the Internal Revenue Code.) Finally, by implementing a benefits review prior to commencing a merger process, a board of directors may identify inadequacies or problems in the benefits area that should be remedied prior to the beginning of merger discussions. If an institution does not review its benefits until it has begun merger discussions, it may already be too late.

Employment Protection

Of course, any discussion regarding the possibility of a merger can create concern among executives and rank-and-file employees. Accordingly, a board of directors considering the implementation of a merger should review its institution's employee protections to ensure they are adequate to protect key employees and maintain overall employee morale. Also, a board of directors may identify a particular employee who needs special protection in the event of a merger.

Among the measures that may be undertaken to strengthen employment protection are employment contracts, special severance agreements, health insurance arrangements, and (narrow or broad) severance programs. Like other employee benefits, if a board waits until the commencement of merger negotiations to address its employment protection program, it may already be too late.

Needless to say, in addressing the needs of employees, a board should also consider the needs of stockholders. Accordingly, if a merger is anticipated, employee benefits should be structured in a way to support the merger. For instance, bonus payments may be designed so that they only accrue if the employee stays with the institution during the transition period.

Merger Procedures

The procedures utilized to prepare for a merger transaction — identify possible merger partners, evaluate merger offers and negotiate the merger agreement — are critical to the success of the transaction. For instance, from the legal standpoint, the courts and the regulatory agencies generally do not independently evaluate the adequacy of the price or other terms of a merger transaction; rather they focus on the reasonableness of the merger procedures. The theory underlying this "business judgment rule" is that courts and regulatory agencies are not as well positioned as boards to evaluate complex business decisions and that, as a result, they should defer to board decisions, provided it can be shown that the board used adequate diligence in making the subject decision.

From a financial standpoint, the merger procedures are crucial, particularly for the selling institution. For instance, if a selling institution negotiates only with one or two other parties that have not been identified as being able/willing to pay a high merger price, it could fail to obtain the most favorable transaction for its stockholders. Conversely, if a selling institution seeks to open negotiations with too many institutions in an unstructured manner, it may not be taken seriously by potential acquirors.

It is generally permissible for institutions seeking merger partners to speak with as many or few other parties as they believe will yield the most attractive transaction. Accordingly, some institutions sell themselves in private (or occasionally public) "auctions" in which up to 20 to 25 potential buyers are invited to submit "indications of interest;" some institutions conduct only limited auctions in which the selling institution talks with two or three potential buyers; and some institutions negotiate "private" deals in which the institution talks with only one potential buyer. However, regardless of the procedures utilized, it is extremely important that the selling institution design its merger procedures (and document such procedures) with the goal of obtaining a transaction that is in the best interests of the institution and its stockholders. (In particular, since privately negotiated transactions arguably are less likely to yield the highest price, they may require more documentation showing that the transaction pricing was in the best interests of stockholders.)

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Commitments

Since the value of a selling institution is a function more than anything else of the financial impact of the merger on the acquiring institution, a key factor to be considered by the acquiring institution is the existence of any long-term commitments on the part of the selling institution that could have an adverse impact on the value of the resulting institution. Among the commitments that may cause concern to a potential acquiror are: (i) data processing or other service provider contracts with expensive termination provisions, (ii) wholesale financial leverage that is expensive to unwind, and (iii) capital market and hedging instruments with prepayment penalties. Based on the above, if a board believes it may consider a merger within the next year, it should use caution in entering into new long-term commitments.

Merger Agreement Issues

When two community institutions become serious about merger discussions, they typically commence negotiations in a formal merger agreement. Prior to the commencement of negotiations, both the buying and selling institution should have a good idea of the provisions they would like to see in a merger agreement. These terms may include director and officer protection (indemnification, D&O insurance, board seats, etc.), employee matters (organization chart, benefits issues, severance arrangements, etc.), contingencies (loan losses, environmental issues, etc.) and termination provisions. In addition, because there will be a period of three to five months following the execution of the merger agreement before closing (to provide time for regulatory processing and stockholder approval), the selling institution will want to negotiate merger covenants which are flexible enough so that it can maintain reasonable profitability should the transaction terminate prior to closing.

We generally recommend that boards of directors develop a 10 to 12 item merger agreement "wish list" prior to the commencement of merger agreement negotiations. This procedure has several advantages. First, it enables management to negotiate key issues during the time it has the most leverage. (The selling institution's leverage generally is at its height at the beginning of merger negotiations — when there is not yet an agreement on all of the major issues — and dwindles as negotiations proceed.) Second, the identification of key issues prior to negotiation of a merger agreement will result in smoother, quicker and more cost effective negotiations. Finally, the identification of key issues prior to the negotiation of a merger agreement can assist the parties in identifying irrevocable differences before the expenditure of an inordinate amount of time and money.

Central Role of Business Plan

We believe that one of the first steps to planning a merger transaction is to bring the institution's business plan up-to-date and, if possible, extend its financial projections to two or three years. This can achieve several purposes. First, an updated business plan can serve as a platform to evaluate potential revenue enhancements and costs savings, which in turn can enhance the parties' ability to accurately value the selling institution. Second, the preparation and review of an updated business plan can provide legal support by demonstrating due diligence for a board of directors' decision with respect to a merger.

While in the process of updating its business plan, the board should assemble a potential merger team consisting of the institution's senior management (including its CEO and financial team), experienced legal counsel and an experienced financial advisor. The board should then use this team to walk through each of the issues set forth above to prepare for possible merger discussions. As a part of this exercise, the board may want to analyze a hypothetical merger with a potential merger partner to assess critical issues on a "dry run" basis.

Community financial institution mergers are an area where an ounce of prevention is certainly worth a pound of cure. By thinking about possible merger issues well before commencing merger discussions, both buying and selling institutions can position themselves to obtain the best possible transaction for the institutions, their stockholders and their employees, customers and community. In this way, when the merger "baby" is finally born, its proud parents will know they have done everything they can to assure that it is healthy, happy and poised for future success.

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