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Value Matters™

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www.mercercapital.com
mcm@mercercapital.com

S Corporation Banks Beware

While most banks and their directors are generally aware of the tax benefits of an S election, there are some potential disadvantages. One disadvantage is the potential for S elections to encounter additional volatility to the equity account and lower capital ratios relative to C corporations when losses are incurred (all else equal).

When banks are profitable, the impact of the tax election on equity for S and C corporation banks is relatively muted as both pay out a portion of earnings to cover taxes either in the form of a direct payment of the federal tax liability as a C corporation or in the form of a cash distribution to shareholders to cover their portion of the tax liability as an S corporation. However, S corporations are typically limited relative to C corporations in their ability to recognize certain tax benefits when losses occur. The equity accounts of most C corporations benefit from the ability to recognize tax loss carrybacks and deferred tax assets following the occurrence of losses, which serve to soften the direct impact of the loss on capital. S corporations are generally precluded from any tax benefit after the recognition of losses and the resulting loss is directly deducted from equity. A few nasty quirks of book and tax income can make the situation even worse for shareholders and the S corporation bank.

To help illustrate the point further, consider the following example which details how losses realized as an S corporation can flow directly through to equity without the tax benefit recognized by a C corporation. As detailed below, the capital account of the S corporation was impacted more adversely following the recognition of losses than the C corporation (all else equal).

Bank Perspective			
		C Corp Troubled Bank	S Corp Troubled Bank
Pre-Tax Loss		(4,000)	(4,000)
Est. Tax Benefit	35.0%	1,400	na
Net Income (Loss)		(2,600)	(4,000)
Impact on Equity			
Beginning Equity Capital		8,000	8,000
Net Income (Loss)		(2,600)	(4,000)
Ending Equity		5,400	4,000
Total Assets		*100,000*	*100,000*
Equity/Asset Ratio		**5.4%**	**4.0%**

FIGURE ONE

In a recent survey of bank transaction activity nationwide conducted by Mercer Capital, we noticed some evidence of this disadvantage surfacing among S corporation banks. Of transactions (whole bank sales) involving target banks with assets between $100 million and $1 billion announced since June 30, 2008, the majority of S corporation banks sold were distressed, defined as either having non-performing assets as a percentage of assets greater than 3.0% (three out of four transactions involving S corporation targets) or reporting a loss in the most recent year-to-date period (two out of four transactions involving S corporation targets). This trend is illustrated more fully in the chart below and is notable especially when compared to transaction activity of C corporations over this period.

We found some additional evidence that S corporation banks may be experiencing the detrimental impact of additional capital volatility in a review of bank failures. Of 8 total S corporation bank failures since 1998, five have occurred since January 1, 2008, with three occurring since December 1, 2008.

"... it is too early to tell whether this evidence of increased transaction activity and failures among distressed S corporations is purely a coincidence or early indications of an emerging trend of capital volatility for S corporation banks"

Target Banks Assets Between $100 MM and $1 BN
Announced since June 30, 2008

	S Corps*		C Corps	
	No. of Transactions	% of Total	No. of Transactions	% of Total
Banks w/Non-Performing Assets / Assets > 3.0%	3	75.0%	4	26.7%
Banks Reporting Losses in Year-to-Date Period	2	50.0%	5	33.3%
Total Number of Transactions	4		15	

** Excludes one transaction announced but later terminated involving a S Corporation bank with non-performing assets > 3.0% and reporting a loss for the year-to-date period.*

FIGURE TWO

While it is too early to tell whether this evidence of increased transaction activity and failures among distressed S corporations is purely a coincidence or early indications of an emerging trend of capital volatility for S corporation banks, this analysis prompted a number of questions:

- Should a conversion to a C corporation be considered by an S corporation prior to recognizing losses?
- Should a conversion to a C corporation be considered even if no immediate losses are expected as a matter of conservatism?
- Should the exploration of acquisition possibilities by S corporations be accelerated prior to recognizing losses so that a C corporation buyer could recognize any tax benefits potentially unavailable to the S corporation or its shareholders?
- Should S corporations be managed more conservatively than C corporations given the added potential for volatility in the capital account?
- Should an increase in merger and recapitalization activity, bank failures, or conversion back to C corporations among troubled S corporation banks be expected for the remainder of 2009 and beyond?
- Do the shareholder limitations of S corporations limit their ability to raise capital, thereby forcing a distressed S corporation bank to pursue merger partners when substantial losses arise?

If your bank is dealing with any of these issues, feel free to give us a call to discuss the situation confidentially.

Jay Wilson, Jr.

James D. Wilson, Jr. (Jay)
wilsonj@mercercapital.com

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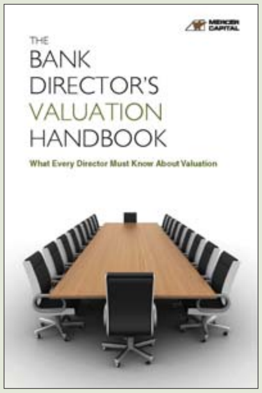

THE BANK DIRECTOR'S VALUATION HANDBOOK

What Every Director Must Know About Valuation

Valuation issues intersect with a bank's affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.

SECTION ONE: INTRODUCTION TO VALUATION
Chapter 1: The Valuation Process
Chapter 2: Core Valuation Concepts
Chapter 3: Financial Management & Performance Measurement

SECTION TWO: COMPENSATION & EMPLOYEE BENEFIT PLANS
Chapter 4: Employee Benefit Plans
Chapter 5: Stock Options, Restricted Stock, & Stock Appreciation Rights

SECTION THREE: STOCK TRANSACTIONS
Chapter 6: Estate & Gift Tax Issues
Chapter 7: Raising Capital
Chapter 8: Buy-Sell Agreements

SECTION FOUR: STRATEGIC ALTERNATIVES
Chapter 9: Mergers & Acquisitions
Chapter 10: Fairness Opinions
Chapter 11: Capital Gains & Dividends
Chapter 12: Sub-Chapter S Conversions

SECTION FIVE: FINANCIAL REPORTING
Chapter 13: Fair Value Accounting
Chapter 14: Fair Value Accounting In Business Combinations
Chapter 15: Share-Based Compensation

SECTION SIX: STATUTORY & LEGAL CONCEPTS
Chapter 16: A Primer on Litigation
Chapter 17: Statutory Fair Value
Chapter 18: Divorce of a Key Shareholder

SECTION SEVEN: CONCLUSION
Addendum: The Capital Purchase Program (CPP)
Addendum: IRS Provides New Tax Incentive for Banks

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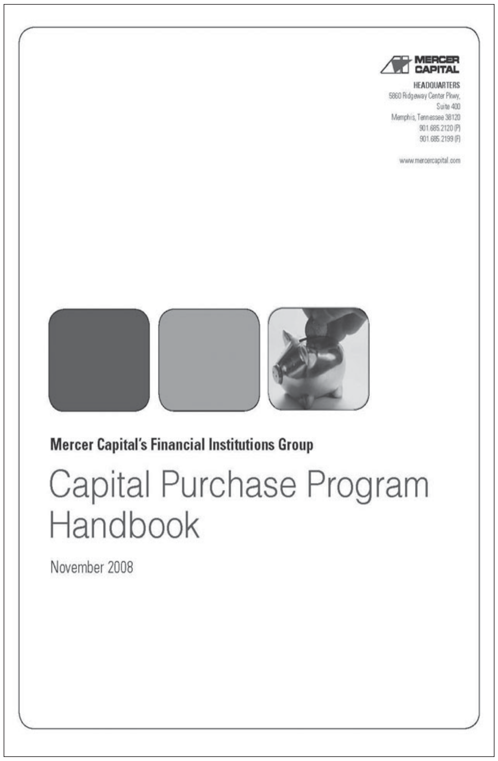
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Mercer Capital's Financial Institutions Group

Capital Purchase Program Handbook

November 2008

Download Mercer Capital's complimentary 33-page Capital Purchase Program Handbook at www.mercercapital.com and we will send you updates as the situation warrants

THE CAPITAL PURCHASE PROGRAM HANDBOOK

Available now at www.mercercapital.com

The Troubled Asset Relief Program ("TARP") became law on October 3, 2008, and was intended to address solvency concerns among banks. However, as market conditions continued to deteriorate, the implementation of the TARP changed. Realizing that repurchasing assets was unlikely to restore confidence in banks' solvency, the Treasury's priority shifted from repurchasing illiquid assets to direct investments in financial institutions. Over the weekend of October 10, 2008, the Treasury held meetings with the heads of the largest U.S. financial institutions, which led to the issuance of $125 billion of preferred stock by these institutions to the federal government. The government then announced that all U.S. financial institutions could apply for the program on similar terms. Thus, the Capital Purchase Program ("CPP") was born.

The CPP has the potential to change the banking landscape for years to come. This handbook covers a number of topics related to the CPP, including the activity to date in the program, the advantages and disadvantages of participating, accounting issues raised, and the actual cost of the preferred stock after factoring in the warrants. While this handbook covers issues applicable to all banks, we specifically directed our analysis to privately held banks for several reasons. First, while many analyses of the CPP have been prepared, we have found little guidance intended for privately held banks. Second, participation in the CPP by privately held banks creates issues that are not faced by publicly traded banks, and we address these issues in this handbook.

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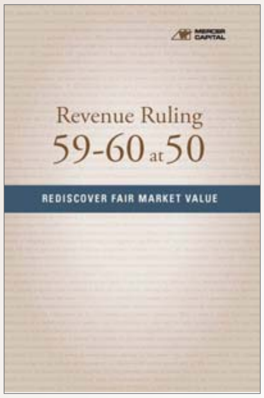

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Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

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TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
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Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.	**Complimentary**	*Currently Available*

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