CAPITAL PLANNING

strategic alternatives to effectively raise and deploy capital in the current banking environment

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Independent Bankers Association of New York State, Inc.

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Presentation Overview

1 Capital Markets Overview

2 Analysis of Equity and Debt Capital Alternatives

3 Mechanics of the Capital Raising Process

4 Prudent Deployment of Excess Capital

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CAPITAL MARKETS OVERVIEW

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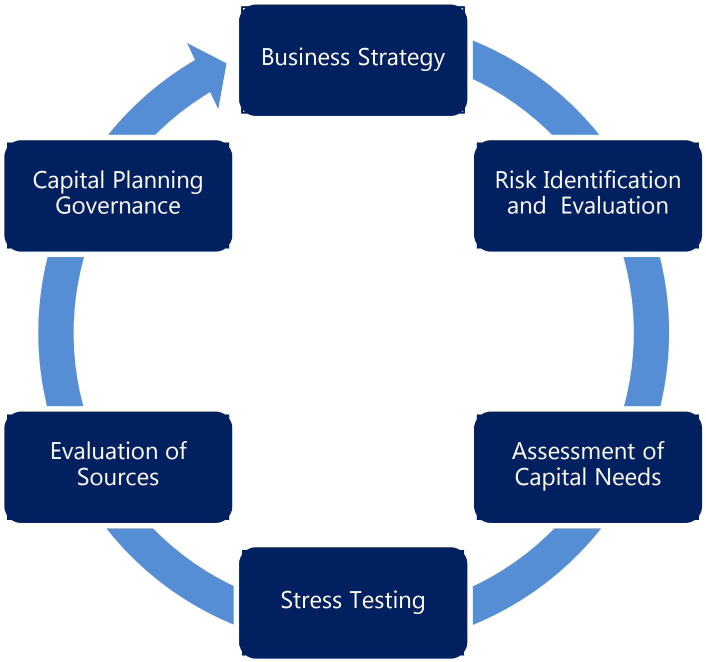
Capital Markets Overview

- Offering types and structures have varied widely and continue to evolved since the financial crisis.
- Bias has shifted to common equity: from the perspective of the regulators and investors.
- Trump Bump - In 2017, the public markets for banks was strong; 13 bank IPOs were completed. Trend will continue in 2018 as investors continue to see upside in bank stocks.
- Since 2015, we have experienced the proliferation of banks and bank holding companies issuing subordinated debt.
- Increased appetite for senior notes to take advantage of lower pricing relative to subordinated debt.

Capital Planning



- Regulatory expectation that all banks engage in capital planning – not just problem banks
- Provides management with reference points for primary and contingency capital sources
- Consider bank holding company needs and capital strategies afforded by holding company structure
- Planning will allow banks to optimize their "capital stack" through the issuance of combinations of equity and debt instruments
- Advance planning is critical; there is no such thing as "just-in-time" capital

Regulatory Developments Affecting Capital Planning

Regulatory Developments

- Revisions to small bank holding company policy statement – December 2014 (and perhaps again in 2018)
- Enhanced regulatory capital requirements under Basel III – Effective January 2015
- CECL implementation

Debt Capital Drivers

- Repricing of SBLF securities in first quarter 2016
- Low interest rate environment
- Enhanced shareholder returns without additional dilution

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Revisions to Small Bank Holding Company Policy Statement

"Small bank holding companies" have unique ability to utilize leverage to support regulatory capital levels at the bank.

SMALL BHCs ARE NOT SUBJECT TO CONSOLIDATED RISK- BASED CAPITAL RULES

- Bank holdings companies designated as "small bank holding companies" are not subject to the FRB's risk-based capital and leverage rules
- Required to report regulatory capital ratios only at the subsidiary bank level

INCREASE IN ASSET THRESHOLD FOR SMALL BHCs

- From $500 million to $1 billion in December 2014
- Legislation enacted in 2018 increased it to $3 billion

CHANGE PERMITS MORE BHCs TO USE DEBT FINANCING

- Small bank holding companies may use debt to finance up to 75% of the purchase price of an acquisition, allowing a bank holding company (in theory) to have a debt-to-equity ratio of up to 3:1
- Must retire parent company debt within 25 years
- Must achieve debt-to-equity ratio of .30:1 or less within 12 years of incurrence of debt

BHCs SHOULD MAINTAIN A DEBT-TO-EQUITY RATIO OF 1:1 OR LESS TO

- Avoid restrictions on dividends
- Avoid restrictions on stock redemptions
- Qualify for expedited processing of regulatory applications

Enhanced Capital Requirements under Basel III

Capital Ratios Phase-in Schedule					
January 1	2015	2016	2017	2018	2019
Minimum Common Equity Tier 1 %	4.5	4.5	4.5	4.5	4.5
Capital Conservation Buffer %	N/A	0.625	1.25	1.875	2.5
Common Equity Tier 1 with Capital Conservation Buffer %	4.5	5.125	5.75	6.375	7.0
Minimum Tier 1 Capital %	6.0	6.0	6.0	6.0	6.0
Minimum Tier 1 Capital with Capital Conservation Buffer %	N/A	6.625	7.25	7.785	8.5
Minimum Total Capital %	8.0	8.0	8.0	8.0	8.0
Minimum Total Capital with Capital Conservation Buffer %	8.0	8.625	9.25	9.875	10.5

Enhanced Capital Requirements under Basel III

Prompt Corrective Action (effective January 1, 2015)				
Prompt Corrective Action Categories and Ratios	**Tier 1 Leverage %**	**Common Equity Tier 1 RBC %**	**Tier 1 RBC %**	**Total RBC %**
Well Capitalized	≥ 5.0	≥ 6.5	≥ 8.0	≥ 10.0
Adequately Capitalized	≥ 4.0	≥ 4.5	≥ 6.0	≥ 8.0
Undercapitalized	< 4.0	< 4.5	< 6.0	< 8.0
Significantly Undercapitalized	< 3.0	< 3.0	< 4.0	< 6.0
Critically Undercapitalized	**Tangible Equity/Total Assets ≤ 2%**			

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Enhanced Capital Requirements under Basel III

Well-Capitalized Ratios vs. Buffer Zone Ratios			
	Common Equity Tier 1 RBC %	Tier 1 RBC %	Total RBC %
Well-Capitalized Ratios	≥ 6.5%	≥ 8.0%	≥ 10.0%
Buffer Zone Ratios	≥ 7.0%	≥ 8.5%	≥ 10.5%
BASEL III Minimum Ratios	≥ 4.5%	≥ 6.0%	≥ 8.0%
Size of Buffer	2.0%	2.0%	2.0%

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Enhanced Capital Requirements under Basel III

Maximum Payout Amount as % of Eligible Retained Income	Size of Buffer
No Buffer Limit	Greater than 2.5%
60% (40% cut)	> 1.875% to 2.500%
40% (60% cut)	> 1.250% to 1.875%
20% (80% cut)	> 0.625% to 1.250%
0% (100% cut)	≤ 0.625%

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ANALYSIS OF EQUITY AND DEBT CAPITAL ALTERNATIVES

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Types and Sources of Capital

Types

- Common Stock
- Preferred Stock
- Senior Debt
- Subordinated Debt

Sources

- Rights Offering
- Private Offering
- Underwritten
- Public Markets
- Private Equity Investors
- Institutional Investors
- Correspondent Banks
- Stockholders
- Customers
- Directors
- ESOPs

Capital Structure Influences

- How much additional capital is needed?
- Regulatory requirements: What type of “qualified capital” do you need and at what level?
- Corporate and capital structure
- Economic conditions – 2 to 3 rate hikes expected in 2018
- Financial condition
- Regulatory approval requirements
- Market demand: Who is investing?

Summary of Types of Capital

	Pros	Cons
Common	• All proceeds count as Tier 1 capital • Permanent capital • Preferred by regulators	• Dilutive to ownership • Pricing and execution risks • Negative effect on performance ratios • Concerns over ability to deploy excess capital
Preferred	• Non-cumulative, perpetual counts as Tier 1 capital at BHC level • Flexible structure (convertible, rates) • Non-dilutive to common ownership	• Not available for Sub S banks • Higher current cash cost relative to common stock • Dividends are after-tax
Senior Debt	• Non-dilutive to ownership • Down-streamed as Tier 1 capital • Interest payments tax deductible • No change to ownership structure • Typical maturity of 10 years	• Not permanent capital, must have ability to repay or refinance • Not treated as capital at BHC level • Usually includes extensive covenant • Usually secured by bank stock
Sub Debt	• Same as senior debt except • Can be issued by bank or BHC • Tier 2 capital at BHC level; down-streamed as Tier 1 capital • Minimum maturity of 5 years • Usually no loan covenants • Debt is unsecured	• Not permanent capital, must have ability to repay or refinance • Tier 2 capital qualification reduced by 20% during last 5 years of maturity • Interest rates are typically higher than senior debt

Common Stock

Benefits

- All proceeds count as Tier 1 capital
- Represents permanent capital
- Must serve as “dominant” component of the regulatory capital stack

Considerations

- Concerns about dilution to existing shareholders
- Pricing and execution risk
- Potential concerns over ability to effectively deploy “excess” capital
- Negative effect on performance ratios

Preferred Stock

Benefits

- Increases tangible equity without increasing common shares
- Non-cumulative perpetual preferred counts as Tier 1 capital
- Can structure to be convertible into common stock, either mandatorily or at the option of the holder
- Fixed or floating rate coupon

Considerations

- Higher current cash cost relative to issuance of common stock
- Dividends are paid in after-tax dollars
- Less dilutive to shareholders than common stock
- Not available to Subchapter S corporations; usually privately placed with stockholders, another community financial institution or a private investor

Senior Debt

Benefits

- Issued by holding company with proceeds down-streamed to subsidiary bank
- Down-streamed proceeds count as Tier 1 capital at bank level, no capital treatment at holding company level
- Maturity typically up to 10 years
- Interest payments are tax-deductible
- No change to ownership structure

Considerations

- Can you raise enough?
- Not permanent capital, must have ability to repay or refinance
- Must be able to dividend funds from bank to service debt
- Does not support consolidated capital levels (if applicable)
- Earnings dilutive unless leveraged to break even or better
- Usually, but not always, obtained as a loan from another financial institution
- Amortization – how is principal repaid?

Subordinated Debt

Benefits

- Interest-only with principal payable in a bullet at maturity (cheaper debt service)
- Interest payments are tax-deductible
- Unsecured; minimal, if any, covenants or rights to acceleration
- No change to ownership structure
- If issued by holding company, is generally considered Tier 2 capital at holding company level (if applicable); proceeds can be contributed to bank as Tier 1 capital
- If issued by bank, is considered Tier 2 capital at bank level

Considerations

- Can you raise enough?
- Not permanent capital, must have ability to repay or refinance
- If Tier 2 capital, capital qualification is reduced 20% annually during last 5 years to maturity
- Impact on earnings of interest cost; must be able to service debt at issuer level
- Usually privately placed with stockholders, retail investors or private investors (including banks and insurance companies)

Tier 2 Capital Treatment of Subordinated Debt

PRACTICAL OBSERVATION: Most subordinated debt issuances by financial institutions (even those with less than $1 billion in total consolidated assets) are structured consistent with Tier 2 capital treatment.

LITTLE-KNOWN FACT: Basel III eliminated limitations on the amount of Tier 2 capital that can be recognized in total capital (due to the increased common equity and Tier 1 capital requirements), as well as the limitations on the amount of subordinated debt that can be included in Tier 2 capital.

MATERIAL REQUIREMENTS INCLUDE:

- Subordinate in right of payment to claims of senior debt holders and general creditors
- Minimum original maturity of 5 years
- Redeemable by the issuer no less than 5 years after issuance
- Unsecured
- No acceleration of principal prior to maturity except in the event of bankruptcy, appointment of a receiver or failure of subsidiary bank
- No credit sensitive features tied to financial condition of the issuer
- Tier 2 capital treatment is reduced by 20 percent of the original principal amount, net of any redemptions, during each of the last five years of the instrument

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Analyzing Senior Debt Versus Subordinated Debt

Interest Rate

- Typically lower for senior debt, although retail subordinated debt offerings are competitive
- Rate is sensitive to size and public company-status of the issuer

Amortization

- Subordinated debt is interest-only, with principal due at maturity; senior debt can be interest-only, but is often amortizing
- Amortization can increase the amount of bank dividends required to service BHC debt, which reduces retained earnings and bank common equity tier 1 capital and, in turn, lending capacity

Covenants

- Senior debt typically involves extensive covenants regarding regulatory capital, financial condition and no additional debt
- Very few, if any, for subordinated debt

Acceleration

The only "event of default" for subordinated debt triggering acceleration is bankruptcy/bank failure

Senior debt can be accelerated for breach of loan covenants, failure to pay interest and deterioration in financial condition, among others

Redemption

Subordinated debt cannot be redeemed within 5 years of issuance, except in certain limited circumstances

Who Buys Subordinated Debt?

Retail Investors

- Large depositors and shareholders are frequently receptive to the higher rates associated with subordinated debt, as compared to CDs
- Typically the cheapest sub debt issuances in terms of rate structure, but least efficient from an execution standpoint

Private Equity Investors

- Typical Market: Insurance companies, other banks or bank holding companies, private equity groups
- Kroll ratings: Kroll's BBB- ratings (or "investment grade but for size") allow insurance companies to purchase bank or bank holding company issued subordinated debt

Subordinated Debt Pools

- "TruPS 2.0"
- Most participants are smaller, private institutions that are seeking efficient execution and relatively small deal size

NOTE ON EXECUTION: Senior debt often provides the most efficient execution due to a more streamlined negotiation with the lender. The efficiency of a subordinated debt transaction generally depends upon the nature of the purchaser(s).

Using Debt to Enhance Shareholder Value

	No BHC Debt	With BHC Debt
Bank Level		
Total Assets	$1000	$1000
Common Stock	$100	$100
ROAA	0.80%	0.80%
Net Income	$8.00	$8.00
BHC Level		
Subordinated Debt (6.99%)	$0	$40
Common Stock	$100	$60
Income from Bank	$8.00	$8.00
Debt Expense	$0.00	($1.80)
Net Income	$8.00	$6.20
ROAE	***8.00%***	***10.3%***

Except for ability to downstream additional capital to banking subsidiary as common equity, the revised policy provides for no material change at the bank level.

Debt becomes a larger component of the bank holding company's capital structure.

Despite lower net income due to debt service, earnings are spread over a significantly smaller equity base, thus increasing return on equity.

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Alternative Sources of Capital Creation

- Branch Sales or Divestitures – shrink the balance sheet
- Boost retained earnings and/or reduce dividends
- Capital Accretive Stock Transactions
- Acquiring an overcapitalized bank
- Dividend reinvestment plans
- ESOPs/KSOPs
  - Special rollover election
  - Matches and discretionary contributions
  - Leveraged ESOPs

MECHANICS OF THE CAPITAL RAISING PROCESS

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Registered vs. Unregistered Offering

	Pros	Cons
Registered Offering	▪ Pricing ▪ Broader distribution ▪ Greater liquidity	▪ More reporting ▪ More expensive ▪ Longer process
Unregistered/ Exempt Offering	▪ Less reporting ▪ Less expensive ▪ Flexibility	▪ Lack of liquidity ▪ Limitations on marketing

Private Offering Exemptions

Reg. D No General Solicitation	Reg. D General Solicitation	Intrastate Offering Exemption
▪ Accredited and up to 35 non-accredited ▪ No advertising or general solicitation ▪ Pre-existing relationship ▪ Bad actor rules ▪ 1 year holding period, generally ▪ Disclosure requirements ▪ Generally preempts state blue sky laws	▪ General solicitation permitted ▪ Accredited only ▪ Verification process ▪ Bad actor rules ▪ 1 year holding period, generally ▪ Disclosure requirements ▪ Generally preempts state blue sky laws	▪ All subscribers must be residents of the same state of which issuer is incorporated or has its principal place of business ▪ No transfer to nonresident for 6 months ▪ General solicitation can be permitted (depending on state exemption), but not encouraged

Practice Note: Recent amendments to Reg. D will permit limited offerings of up to $5.0 million to an unlimited number of non-accredited investors. Such offerings will be subject to the bad actor rules and certain state securities laws requirements.

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IPO Process – Phases

Pre-Filing Phase

- Due diligence
- Structuring
- Valuation
- Choose co-managers
- Documentation
- Positioning
- Prepare S-1 registration statement
- Begin stock exchange listing process

SEC Review Phase

- Prepare and schedule roadshow presentations
- Respond to SEC comments
- Finalize underwriting agreements
- Finalize lockup agreements
- Board presentation on public company obligations

Marketing Phase

- Circulate "red herrings"
- Analyst presentation to underwriters' sales forces
- Target key investors
- Invitation of underwriting syndicate
- Sell-side analyst presentation by Company
- Roadshow presentations
- Develop institutional and retail "books"

Pricing, Trade and Follow-up support

- Probe pricing sensitivity
- Determine appropriate mix of retail and institutional allocations
- Determine IPO price
- Trading begins
- Closing
- On-going research
- Periodic reporting requirements begin

Capital Raising Process Timeline

Pre-Offering	Marketing

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PRUDENT DEPLOYMENT OF EXCESS CAPITAL

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Distribute, Reinvest or Acquire

- Dividends
- Tender Offers
- Stock Repurchase Plans
- Discretionary Repurchases
- Mergers and Acquisitions

Returning Capital to Investors via Dividends

- Most common method to deploy excess capital
- Creates expectations for future distributions
- Provides income but not investment liquidity
- Can inhibit future growth opportunities
- Makes investors “happy”

Tender Offers

- Proactive solicitation of stock repurchases during a set time frame
- Regulatory approvals/consents
- Must be open for at least 20 business days
- Board sets pricing and structure; no shareholder approval
- Flexibility in design – can target a specific subset of shareholders, determined by ownership level, date of purchase, etc.
- Disclosure of all material information to offerees
- Test the Waters Letter

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Stock Repurchase Programs

- Reactive response to shareholder requests to liquidate or market conditions
- Formal repurchase plan with repurchase windows or discretionary repurchases from time to time as shares become available for sale
- Pricing considerations – typically formulaic or based on an appraisal, but ultimately determined by the board
- Board approval of structure – no shareholder approval
- Regulation M – no repurchases during any "distribution" of stock by the company
- Company is the ultimate insider – suspend program or disclose any material nonpublic information to sellers

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Mergers and Acquisitions

- Utilize excess capital to jumpstart growth through acquisitions
- Enter new markets or take out a competitor
- Complementary acquisition based on the dynamics of your institution
  - A rural institution with low cost deposits but anemic organic growth
  - Metro institution with demand for high-quality loans but competitive deposit market
- Address management and board succession issues via merger
- Lift out acquisitions – hire high-performing banking teams

Recent M&A Pricing Metrics

United States				
	2016	2017	Q2 2018	
Aggregate Transaction Value ($M)	$26,812	$26,444	$16,484	
Median Deal Value/ Earnings (x)	20.2	22.1	24.9	
Deal Value/ Tangible Book (%)	133	161	1.71	
Number of Transactions	239	259	140	

Source: Sheshunoff & Co.
Note: Deal value metrics do not include any transactions without publicly-available pricing information.

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SPEAKER INFORMATION

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Geoffrey S. Kay is a Partner of Fenimore, Kay, Harrison & Ford, LLP, one of the largest banking specialty law firms in the United States. The sole focus of Mr. Kay's legal practice is the corporate and regulatory representation of financial institutions and financial service businesses. He regularly represents public and private financial institutions in connection with securities and capital markets transactions, mergers and acquisitions, regulatory issues, and corporate governance matters. Mr. Kay has numerous publications and frequently speaks about matters affecting the financial services industry. Prior to joining Fenimore, Kay, Harrison & Ford, LLP, Mr. Kay was an attorney in the financial institutions practice group of a large international law firm.

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Mr. Flowers is a lawyer with one of the premier community banking specialty law firms in the United States, Fenimore, Kay, Harrison & Ford. He has more than 14 years of legal banking experience and another three years advising clients on employee benefits and employment matters.

Mr. Flowers represents banks, thrifts and other financial institutions, as well as their investors, directors and executive officers in a full range of corporate, transactional, securities and regulatory matters confronting the financial services industry. His experience in the fields of bank mergers and acquisitions, bank regulatory matters, securities law and corporate governance provides a solid foundation for the representation of financial institutions in a broad variety of transactions.

Mr. Flowers has numerous publications and frequently speaks about matters affecting the financial services industry. Prior to joining Fenimore, Kay, Harrison & Ford, LLP, he was a Partner in the financial institutions practice group of a large international law firm.

ABOUT FKHF

FKHF specializes in providing legal services to financial institutions on a full range of corporate, securities and regulatory matters. All of our attorneys are alumni of financial institutions practice groups within large international law firms, bringing a wealth of sophisticated experience in representing financial institutions. The founding vision of the firm was to create a new model that departed from the traditional "mega-firm" approaches and, instead, focused on delivering efficient, team-oriented services of the highest quality. Our law firm model simply aligns the interests of clients and attorneys by eliminating the inefficiencies of the traditional law firm model and focuses on delivering legal services in a responsive and cost-effective manner.

Since FKHF's formation in July 2010, we have served as legal counsel in connection with more than 115 whole-bank and branch acquisition transactions involving community banking organizations. In addition, the firm has served as legal counsel on over 100 private and public capital offerings totaling more than $2.0 billion, including five IPOs by community banking organizations. The firm has been consistently recognized as one of the top law firms in the United States in SNL Financial's league tables for bank and thrift legal advisors, based on the number of M&A transactions.