
MEMORANDUM

FROM: Financial Institutions Group
Powell, Goldstein, Frazer & Murphy LLP

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RE: Financing Growth

I. INTRODUCTION

There are several alternatives for financing the growth and a decision of which alternative to pursue is not necessarily just a question of cost. Although a treatise could probably be written on the alternatives, we thought it might be helpful to summarize some of the key elements involved in each, along with a short discussion of the advantages and disadvantages of each. This discussion is by necessity only a summary, and there are numerous technical issues that must be considered before a final choice is made.

These different alternatives have different implications under the primary capital measurement standards of the bank regulators. These requirements are summarized under Section VII.

II. CORRESPONDENT BANK DEBT

The simplest and probably cheapest way to raise new capital for the Bank is for the Company to borrow from a correspondent bank. A majority of the borrowed funds would be downstreamed to the Bank as a contribution to its capital, with the balance being maintained at the Company to pay the expenses of the borrowing, including the interest carry for the first couple of years. This avoids putting an immediate strain on the Bank to service debt.

While Company debt is not considered capital, the capital contribution to the Bank is treated as Tier 1 Capital. The Federal Reserve will generally permit debt at the Company level in amounts of up to 50% of total capital.

One of the advantages of correspondent bank debt is that it need not all be drawn down at one time. It can usually be drawn down over a period of years, as it is needed by the Bank for capital.

The debt generally has a maturity of three to seven years, although some correspondent banks like to see annual renewals. The interest rate on a line of credit such as this would probably be around prime.

Federal Reserve approval may be required since the Federal Reserve imposes debt limitation conditions from time to time in transaction approvals. Approval by the Georgia Department of Banking and Finance may also be required if the debt service exceeds certain levels.

The primary advantage of correspondent bank debt is that it is the least expensive alternative. Equity investors expect a return of 12% to 15% on their funds, and it is unlikely that the interest rate on the indebtedness would approach that level. Plus, apart from a review of the initial loan agreement, the legal costs are also minimal.

The primary disadvantage of correspondent bank debt is that it is an interim solution. At the maturity of the indebtedness, there will be greater pressure to raise additional equity. However, given the low multiples on bank stock today, one would hope that in three to five years there would have been sufficient market improvement for bank stock so that any equity raised at that time would be at a greater price/earnings or price/book multiple than can be obtained at the present time and thus ultimately be less dilutive to existing shareholders. In addition, if a Company is going to incur the expense of a common stock offering, it is often better to raise more money, for example \$5 million to \$10 million, and then use a portion of the proceeds to repay correspondent bank debt and the balance to support future growth.

III. TRUST PREFERRED STOCK

Trust preferred stock is a hybrid security. A separate trust is organized which is a wholly owned subsidiary of the Company. The trust issues preferred stock to either private investors or the public. The proceeds from the issuance of the preferred stock are then loaned to the Company in the form of subordinated debt.

For regulatory purposes, trust preferred stock counts as Tier 1 Capital at the Company level so long as (1) the preferred stock provides for a minimum five-year consecutive deferral period on distributions to preferred shareholders, and (2) the intercompany loan is subordinated to all subordinated debt of the Company and has the longest feasible maturity (30 years is standard). The amount of trust preferred stock that can be included in Tier 1 Capital is limited, however, to 25% of total Tier 1 Capital before the deduction for goodwill and other intangibles. Any amount in excess of the allowable portion to be included in Tier 1 Capital can be included in Tier 2 capital. The total amount reinvested in the Bank counts as Tier 1 Capital at the Bank level.

Because of the nature of the transaction, the interest payments on the subordinated debt by the Company to the trust are tax deductible. This hybrid security has an advantage over traditional preferred stock because preferred stock dividends are not deductible.

Because of the costs in establishing the outside trust and the legal complexity of the transaction, it is considerably more expensive than correspondent bank debt. On the other hand, interest rates are generally more favorable. While the trust preferred product was originally contemplated in larger dollar amounts (\$10 million to \$20 million minimum), various investment banks have been putting together pooled offerings from groups of community banks to bring the overall cost down and the availability up. In addition, investment banks and commercial banks are arranging private placements of trust preferred stock. As a result, we are aware of minimum offering amounts as low as \$2 million.

Like the correspondent bank debt described above, trust preferred is an interim instrument, but one that would have a significantly longer term.

IV. CONVERTIBLE SUBORDINATED DEBENTURES

Several community banks have used convertible subordinated debentures (or debt) as an interim capital measure. The debt is subordinated to the general claims of the Company's creditors, but in the unlikely event of a liquidation, it is superior to the claims of the Company's shareholders. The proceeds of the debt issuance are generally downstreamed to the Bank as capital with a reserve established at the Company to provide debt service and liquidity over the first several years of the instrument.

The debt usually carries a fixed interest rate below the prime rate, although there are no prohibitions on using a variable interest rate. The lower interest rate gives the debenture a short-term cash flow advantage over correspondent bank debt. The ultimate return to the investor, however, includes the right (or in many cases, the obligation) to convert the subordinated debt to common stock at maturity. The conversion price is usually a premium of 15% to 20% over the present market price. The term is typically ten years.

This instrument is particularly useful where the amount of capital to be raised is less than is realistic for a public common stock offering (because of the costs involved) and where the Company wants to hold down interest costs. Because the nominal rate of interest is 100 basis points or more below the interest rate on correspondent bank debt, there is an immediate interest expense/cash flow benefit to this type of financing. In contrast to the sale of preferred or common stock, debentures generally have investor appeal, since the periodic interest payments on the debentures will help the investors fund the debt service they may incur to acquire the debentures in the first place.

Generally, convertible debentures are sold in a private placement, free of SEC registration and the related costs.¹ Investors are usually provided with most of the information that would generally go into a full SEC offering circular, but since the SEC does not review the offering circular, it costs less to prepare. In addition, if the Company sells debentures in a private placement, there are limits on the offerees. You may, however, offer the debentures to:

- all of the Company's directors and executive officers; and
- an unlimited number of accredited investors (generally, investors with \$1 million in net worth or \$200,000 (\$300,000 with spouse) in annual income); and
- up to 35 non-accredited investors.

¹ Whenever a company sells securities, it either needs to register the sale with the SEC or find an exemption from registration. A private placement exemption is provided by Regulation D under the Securities Act.

Banks using this financing generally require a \$10,000 to \$100,000 minimum investment to keep down the administrative cost of having a large number of holders with multiple bookkeeping and interest payment requirements.

In many ways, a convertible subordinated debenture is like a note with an option attached. For investors who believe in the long-term future of the Bank, the convertibility feature is the primary attraction.

Because the debenture must, as a practical matter, be sold to a relatively small number of people, it is typical to see the debenture offered to the board, to significant existing shareholders and to a handful of potential new shareholders, but not to shareholders generally. Because it may appear to favor insiders, it is important to obtain a fairness opinion as to the terms of the offering from a respected third party to ensure that the non-participating shareholders are treated fairly.

The debentures often provide that they must be converted into common stock at maturity. At maturity, the holder would receive that number of shares of the Company's common stock determined by dividing the face amount of the debenture by the conversion price. Depending on the ultimate performance of the Bank, the debenture can be dilutive to shareholders generally if the Company's shares are trading at a significant premium to the conversion price at the time of maturity.

The advantage of mandatory convertible debentures is that they count as capital for the Company as well as for the Bank, unlike correspondent bank debt. At the Company, mandatory convertible debentures are counted as Tier 2 capital with no limitation as to the amount which can be included in the Tier 2 capital calculation. Term subordinated debentures, which are not mandatorily convertible, may be included in Tier 2 capital up to an amount equal to 50% of total Tier 1 Capital, as long as the debentures have a term of at least five years and are unsecured.

This alternative also facilitates reinvestment by the Bank's key supporters -- those individuals who have contributed the most to the Bank of their time, effort and money so far -- and can bring in significant new shareholders in a fair manner.

Because of the offering circular preparation, the front-end cost of a convertible subordinated debenture offering is greater than that of a correspondent bank loan. It costs significantly less, however, than a trust preferred stock offering.

V. PREFERRED STOCK

In this day of fascination with the potential gains in common stock, we seldom utilize the preferred stock vehicle. The dividends paid to preferred shareholders are not deductible by the Company. Accordingly, we believe that the convertible debenture alternative is probably more attractive to the institution. Both "qualifying" cumulative and noncumulative perpetual preferred stock is included in Tier 1 Capital. To qualify, the stock must have no maturity date, may not be redeemed at the option of the holder, and must have no other features which would require future redemption. There is no limit on the amount of noncumulative perpetual preferred stock that can be included in Tier 1 Capital. The amount of

cumulative perpetual preferred stock that can be included in Tier 1 Capital is limited to 25% of total Tier 1 Capital before the deduction of goodwill and other intangibles. Any amount in excess of the allowable portion to be included in Tier 1 Capital can be included in Tier 2 capital. In addition, long-term preferred stock (i.e., with a maturity date of 20 years or more) is counted as Tier 2 capital without limitation as to the amount.

VI. COMMON STOCK

The direct issuance of common stock in today's market is probably the most expensive alternative. If the Company does a public offering of common stock to be sold by the board and senior executives to investors, the transaction would be subject to full SEC registration. In addition, the issuance of additional common stock is "more expensive" than bank debt, since a bank lender expects a return of only about prime, while shareholders expect a return of 12% to 15%. Finally, if bank stocks are trading at relatively low multiples, the issuance of common stock is also going to be relatively more expensive than it might be in an environment where stocks are trading at higher price/earnings and price/book ratios.

The primary advantage of a common stock offering is that the capital, once raised, is capital going forward. However, the additional capital, when raised on the front-end like this, does have a dilutive effect on return on equity until the capital is fully utilized. Moreover, it is all raised at once, unlike correspondent bank debt where the capital can be drawn down as needed.

The Company can also sell common stock in a private placement, and the parameters of such an offering would be the same as for a private placement of subordinated debentures:

- offering circular required;
- no SEC review; and
- purchasers can consist of all of the Company's directors and executive officers, plus an unlimited number of accredited investors and up to 35 non-accredited investors.

If sold in a private placement, the stock will be "restricted," which means that the owner has to agree to hold it for at least a year. The stock certificates will carry a legend to this effect, but the legend can be removed after two years. (These restrictions would also apply to a private placement of subordinated debentures, but debenture holders generally do not expect to be able to sell debentures the way shareholders expect to be able to sell common stock.)

VII. OVERVIEW OF HOLDING COMPANY REGULATORY CAPITAL REQUIREMENTS

The Federal Reserve has two capital adequacy guidelines: the Risk-Based Capital Measure and the Tier 1 Leverage Measure.

A. Risk-Based Capital Measure

The Risk-Based Capital guidelines were implemented to make the capital requirements more sensitive to differences in risk profiles among banking organizations. The Risk-Based Capital Measure is the one most commonly referenced. Under the Risk-Based Capital Measure, a company's total capital consists of two components, Tier 1 Capital and Tier 2 Capital. In our discussion above, we have noted which instruments qualify as Tier 1 Capital and Tier 2 Capital in calculating a Company's Risk-Based Capital Measure. The chart below describes the Capital instruments included in each component and the minimum requirements, limitations, and deductions applicable to each component.

Under these requirements, a company must have 10% Risk-Based Capital to be well capitalized.

B. Tier 1 Leverage Measure

The Tier 1 Leverage Measure provides for a minimum ratio of Tier 1 Capital to total assets. The principal objective of this measure is to limit the degree to which a Company can leverage its equity capital base. The Tier 1 Leverage Measure is applied on a consolidated basis only to holding companies with consolidated assets of \$150 million or more. For bank holding companies with consolidated assets below this level, the guidelines are applied on a bank-only basis unless the parent company is engaged in non-banking activities involving significant leverage or has a significant amount of outstanding debt held by the general public. The Tier 1 Leverage Measure guidelines are used in the examination process and in the analysis of applications acted on by the Federal Reserve. The definition of Tier 1 Capital used in this capital measure mirrors that used in the Risk-Based Capital Measure (see chart of Risk-Based Capital components below). For bank holding companies that are rated "1" and have implemented the Risk-Based Capital Measure for market risk set forth in Appendix E to Regulation Y, the Tier 1 Leverage ratio requirement is 3%; for others, the requirement is 4%, although a higher percentage may be imposed on a case-by-case basis.

The Georgia Department of Banking and Finance has adopted the definitions of Tier 1 and Tier 2 Capital used by the Federal Reserve in its Risk-Based Capital Measure. Like the Federal Reserve, the DBF requires a minimum ratio of Tier 1 Capital to total assets of 4% (except this requirement is lowered to 3% for holding companies that are rated "1" and have implemented the Risk-Based Capital Measure for market risk promulgated by the Federal Reserve). However, holding companies having less than \$150 million in total consolidated assets, having no significant debt held by the general public, and engaging in no non-banking activities involving significant leverage and no significant off-balance sheet activities will not be required to meet this minimum capital ratio on a consolidated basis. Generally, for these smaller and less complex institutions, this minimum capital ratio will be applied only to the banking subsidiary.

**Summary of Capital Instruments Includable as Components
In Risk-Based Capital and the Tier 1 Leverage Ratio for Bank Holding Companies**

Components	Minimum Requirements
Tier 1 Capital	Must equal or exceed 4% of weighted risk assets.
Common stockholders equity	No limit.
Qualifying noncumulative perpetual preferred stock.....	No limit.
Qualifying cumulative perpetual preferred stock and trust preferred stock ¹	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock (including trust preferred stock) and minority interests.
Minority interest in equity accounts of consolidated subsidiaries	
Less goodwill and other intangible assets required to be deducted	
Tier 2 Capital	Total of Tier 2 is limited to 100% of Tier 1. ²
Perpetual preferred stock and trust preferred stock.....	No limit within Tier 2.
Hybrid capital instruments, perpetual debt and mandatory convertible securities.....	No limit within Tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).....	Subordinated debt and intermediate-term preferred stocks are limited to 50% of Tier 1, ² amortized for capital purposes as they approach maturity.
Allowance for loan and lease losses	Limited to 1.25 % of total weighted risk assets
Deductions (from sum of Tier 1 and Tier 2 Capital)	
Investments in unconsolidated subsidiaries	
Reciprocal holdings of banking organizations' capital securities	
Other deductions as determined by supervisory authority	
Total Capital (Tier 1 + Tier 2 – Deductions)	Must equal or exceed 8% of weighted risk assets.

¹ To qualify as Tier 1 Capital, trust preferred stock must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. Additionally, the intercompany debt between the holding company and the trust must be subordinated to all subordinated debt of the holding company and must have the longest feasible maturity (30 years is standard).

² Amounts in excess of limitations are permitted but do not qualify as capital.

VIII. SUMMARY

As the above illustrates, there are a large number of issues for the Bank to consider. Over the years, our clients have utilized all of these alternatives. Because the greatest fees are associated with the sale of common stock to the public or the sale of trust preferred stock to the public, we generally believe that bank holding companies will want to consider other capital measures - correspondent bank debt, convertible subordinated debentures or a private offering of trust preferred stock - before deciding on a public offering of common stock or a public offering of trust preferred stock.

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