SUCCESSFUL SUPERCOMMUNITY BANKS 1/7/04

Effective SuperCommunity banks distinguish themselves by focusing on one key strength and building it to maximize their longer-term franchise value and short-term income stream. This article (the first of two) contains illustrations of this point and how successful SuperCommunity banks have capitalized on a strength and use it to enhance their overall performance.

STRATEGIC ALTERNATIVES

There are many strategic paths to success for community banks. One of the beauties of the banking business is that there is more than one way to make a mark and be a consistently profitable institution. Companies which perform successfully over time have taken some of the following strategic paths to success:

1. **Aggregator**
   Some community banks view acquisitions as a line of business. They continue to buy banks in-market or in contiguous markets and use their expertise in effective acquisition targeting, negotiations and integration to build their franchise value while performing well through cost containment and product line enhancements of the acquired banks.

   Examples: Sky Financial, Bowling Green, OH; First Community, Pasadena, CA

2. **All things to SOME people**
   Some banks focus on a specific market segment and maximize their share and share-of-wallet of that segment. There are banks that serve only the small business market segment, for example. They only have ranches designed to cater to that segment, do not have a retail strategy and are focused exclusively on fulfilling the entire needs spectrum of the small business owner/operator.

   Examples: Sterling Bank, Houston, TX; Citizens Business Bank, Orange County, CA; City National Bank, Beverly Hills, CA

3. **Unique branding**
   Brand identity is not only the domain of large banks that can afford to spend millions to create brand perception and awareness among their customers. Community banks have been able to develop highly recognizable and valuable brands as well, and some approached the task with highly original thinking, branding everything from the branch look and feel to the coffee customers are served.

   Examples: Umpqua Bank, OR; Commerce Bank, Mt. Laurel, NJ

4. **Culture-driven**
   Community banks with strong, almost tangible culture have done exceptionally well even in counter-intuitive situations. For example, even those banks with additional layers of management, more than one charter and highly decentralized organizations that had extremely tangible culture have done very well over long periods of time.

   Examples: Cullen/Frost Bank, San Antonio, TX; Synovus, Columbus, GA; Macatawa Bank, Grand Rapids, MI

5. **Innovator**
   Some community banks with a strong entrepreneurial bent continue to be opportunistic in their approach to the marketplace with stellar results. They identify niches in either product or geographic slices that are underserved and capitalize upon those niches to yield super profits for many years. They enjoy a management style that fosters original and contrarian thinking, they are anything but faddish, and yet outperform the industry year after year.

   Examples: MidFirst Bank, Oklahoma City, OK; Ohio Savings Bank, Cleveland, OH; Capitol Bank, Lansing, MI

6. **Flawless execution**
   Many highly successful community banks appear to be doing nothing special. All they do is basic community banking. Yet they do it so very well that their results are consistently spectacular. One does not have to discover a new niche or financial engineering approach in order to achieve success. Flawless execution is certainly a legitimate and proven path to long-term success in community banking.

   Examples: Valley Bank, Wayne, NJ; Park National Bank, Newark, OH

7. **Category killers**
   Some community banks add a line-of-business focus on top of their community banking franchise (the fourth leg of the SuperCommunity Banking strategy) to shore up basic banking earnings and create additional franchise value. There are enough LOB niche opportunities that community banks can capture that this strategy works well for those who make a strategic commitment to that business.

   Examples: Synovus, Columbus, GA; M&I, Milwaukee, WI; First National Bank of Omaha, NE; First Interstate of Montana, Billings, MT

8. **Low cost producer**
Community Banks aren't expected to be low cost performers. The commonly accepted myth is that this is the exclusive domain of the large banks, where scale yields cost advantages. There are some community banks that blast this falsehood with outstandingly consistent cost performance which does not compromise revenue growth. Those who effectively execute this strategy enjoy long-term prosperity.

Examples: Park National, Newark, OH, First Banks, CO

THE VALUE OF FOCUS: STERLING BANK

Sterling Bank in Houston is one of those unusual banks where the vision came first, then the execution. Sterling's first CEO, George Martinez, envisioned a unique company serving only owner operated businesses. He grew the company from a de novo into a thriving $3.5 billion institution by continuously executing the vision without wavering. The results: An investor who put $100,000 in Sterling at its inception in 1974 would now have more than $4.5 million. "This is easily one of the most successful banks in the country", said Joe Stieven, previously director of financial institutions research at Stiefel, Nicolaus in St. Louis, MO. Sterling boasts 37% of its deposits in interest free demand deposits. Fully 80% of its loans are commercial with a scant average size of $160,000, and 70% of its deposits are funded by the borrowers.

<u>Clear vision and culture: Target market –only small business</u>

Sterling has a strong set of values and culture, plus a narrow yet deep enough target market. As a result of this uniquely strong initial alignment, Sterling has grown into a highly profitable, highly focused bank with over 35% of its deposits in non-interest bearing demand deposits. It only serves small businesses and almost all have both deposits and loans with the Bank. Average loan size is now inching above $170,000. Its product line is aimed only at that target market, and the retail product offering is merely sufficient to meet the needs of the small business owners and employees. The branch network is rationalized and efficient, again reflecting this razor-sharp market focus.

<u>Unique de novo branching strategy</u>
Sterling developed an innovative strategy to branch openings. Well before a new branch opens in a community, Sterling will hire the "mover and shaker" commercial banker within that community. This, by itself, is common practice. The next step is unique: Sterling seeks out the major players in the community and forms an advisory bank board even before the branch opens. Each branch therefore has a CEO and an advisory board. The founding board members get up to 2000 shares of convertible preferred stock. If the branch breaks even (about $25 million of deposits) within 18-24 months, the shares can be traded in for 1.25 common shares. If the branch breaks even within 36 months, they get a 1.1 share

for each they own, and if the branch breaks even after 36 months they get a 1.1 distribution. If the goal isn't reached within three years, the conversion rate is 1-to-1. This tool has several benefits:

- **It aligns the board's interest with the shareholder base's**
- **It provides financial incentives for the board to accelerate the branch's growth and profitability**

Sterling branches therefore break even sooner than the industry's typical 3+ years. When the doors open the branch not only has a built-in business base but also a set of influential advocates that facilitate the branch's growth and early profitability yield. More than 50% of Sterling's branches achieved early breakevens, and the business mix is consistent across the board: strictly small business, 36-27% non interest bearing checking accounts.

Acquisition strategy
Sterling has grown organically throughout the years, but it has also acquired 8 banks in the metro areas it serves: Houston, Dallas and San Antonio. However, the way it goes about acquisitions is different. "When Sterling buys a bank, they don't try to cut 40% of its overhead. They invest in it. They understand that to make money, you've got to spend some money", says Joe Stieven. Sterling buys banks that are culturally compatible with its philosophy and core business strategy, and turns down transactions that do not support its small business focus. Once the bank is acquired, they integrate it into the mainframe etc. very quickly and efficiently, and, equally importantly, they ensure that the cultural base is consistent. I spoke with one of the CEOs of the acquired banks, and he said, with surprise: "They did everything they promised they'd do". That includes no blood bath of employees, and respectful treatment. Sterling executives know that they don't have a monopoly on wisdom, and they are open to suggestions.

Employer of choice
In addition to being a pure business bank, Sterling set out to become an employer of choice in the markets it operates. Many banks include this goal in their strategic plans, but few acted and executed like Sterling. The Bank examined the different jobs within the employee corps and targeted tellers, those who have the most customer contact and the least upward mobility or income potential in their current jobs. The company developed a training and career pathing program for its tellers and abolished the name "teller" from its vocabulary. Instead, Sterling's Front Office managers take great care of the customers because they understand their role in the Bank. They continue education and training on the job and get raises as they pass through different grades and levels of knowledge. Their job satisfaction improved greatly and turnover declined to extremely low levels by comparison to other banks (less than 20% annually in the Huston market).

An integral part of being thoughtful about employees was Sterling's commitment to become one of America's 100 best companies to work for, a Fortune magazine

designation. This designation is particularly difficult for smaller companies like Sterling, since it is earned, in part, by randomly surveying 500 employees; in Sterling's case, this is 50% of the workforce. In Continental Airlines' case, this is less than 10% of the workforce. Sterling earned this coveted designation on its second bid for it in 2003, and entered at an impressive 26th place into the list of Top 100. This achievement was not reached by overpaying employees or by giving them unusual perks or financial rewards. It was earned because employees feel valued at Sterling. They know what their contribution is and they are proud of it. They feel that Sterling is a special place and they have a hand in making it so. Interestingly, Sterling has improved its efficiency in recent years to the point that its employee based has declined below the 1,000 minimum number for "Best Places To work", and it has dropped off the list.

Sterling is indeed a benevolent company, but it doesn't mean that accountability isn't enforced. The Bank has a crystal-clear scorecard that is updated annually to reflect current strategic goals and financial expectations. That scorecard is updated quarterly and is the foundation of Sterling's incentive compensation. It is supported by a strong short term incentive plan to reinforce accountability and the bank's reward for performance philosophy.

<u>Focus on execution</u>
Sterling management also thinks strategically about the future. Its new CEO, Downey Bridgwater, dared to dream by setting a lofty but very well carved vision for the future. That vision includes contribution to the community via job creation and other innovative measures not typically seen in banks' scorecards. Although this is a strategic, long-term picture, it gets updated quarterly to show all audiences whether progress is being made toward making that vision a reality. Further, the board receives a monthly update on the progress against the strategic plan, to ensure that the entire team doesn't take its eye off the ball. Downey communicates his vision constantly to employees and asks them through leadership meetings to update the actions needed to bring the strategic plan about. This communication is what differentiates this vision document from others; it's not just a piece of paper on the shelf but a live document that is kept current by the employees of the Bank, not just by its management.

Downey also had the courage to refocus the Company when, due to the refinancing boom, the mortgage company Sterling owned became too big for the bank, contributing 50% of its earnings and confusing the marketplace as to what is Sterling – a bank with a mortgage company or a mortgage company with a bank attached. In a courageous move, Bridgwater sold the mortgage company (for a great price) and has spent the past two years redeploying the capital in core business banking assets, back to Sterling roots. As he says, "For us to stay in the game, we have to continue growing our earning assets at the rate our shareholders demand. But I don't want to abandon the strategy that has brought us to the dance".

The strategy is key to Sterling's success and very being. "In a mature industry like banking, the question is, "how do we distinguish ourselves?", Bridgwater explains. "Our competitive advantage is personal service" with the focus on small business, and every Sterling employee knows and understands that focus. At Sterling, like other successful community banks, service is not just a word. It is a daily practice.

The strong cultural tenets served Sterling and its shareholders very well. They helped the company continue to focus itself around its core competencies and made very difficult decisions easier to make because the culture and strategic focus were so well articulated. Sterling is rebuilding itself to become a perfect company, and, given current progress, it has excellent prospects to achieving that vision within its planning horizon.

TRADITION AND CONTINUITY PAY OFF: PARK NATIONAL BANK

Park National is a hidden bank jewel in Newark, Ohio. Without investor relations, analyst presentations or marketing materials to the external community, not enough bankers realize what a superb role model this bank offers.

Uncommon continuity

People are amazed that the Red Sox has had only two left fielders over forty years. Park National has been led by only four people since 1928, whose tenure ranged from 73 years to 33 years and still going strong. Ed Reese joined Park National in 1921, became President in 1928, and passed away at the age of 94, in 1995, after 73 years of service and two weeks after attending a Bank board meeting in his honorary capacity. He was followed by John Alford (51 years), who was succeeded by Bill McConnell (47 years), and now Dan DeLawder at 36 years.

Strong culture

Such continuity can bring about one of two things: either stagnation and an inward looking, stodgy management, or extremely strong culture and foundation that frames all decisions and every level. At Park National, the latter is clearly the case. I have met several of the Bank's managers, and they share much in common: they all have an extraordinary sense of humility, great common sense, very focused and business-oriented, clear about their goals, vision and mission, and have a rye sense of humor. They are great listeners too, which makes them great learners.

The workforce tends to be homogeneous, which enhances communications, teamwork and focus. This is not accidental. Management tries to ensure that new hires fit well into the organization's high achievement, matter-of-fact philosophy, which tends to attract a certain cadre of people with similar work ethic and style.

Merger candidates are also screened with cultural fit in mind. Consequently, the Company has not lost its soul despite numerous mergers. Rather, it preserves and enhances the spirit of the acquired companies by continuing to run a highly

decentralized organization with 8 charters and 12 banks, each with its own infrastructure.

Read Park National's annual report to better understand the Company's culture. It is written in simple, conversational English, is down-to-earth and is completely full disclosure. It highlights accomplishments and credits them to the line staff that made them happen. It manages future expectations and shows where the vulnerabilities are, including those that are masked by the numbers. And it shows yet again that Park national is all about people.

Low cost producer

One might think that this is a very costly system to manage, but Park has enjoyed an efficiency ratio in the 40s for the past ten plus years. This is not only due to continuous revenue growth, even in face of formidable competitors such as Fifth Third (until the recent past) and Sky Financial, but also due to a disciplined cost-conscious culture that permeates the entire organization. Park national doesn't have to go through cost cutting projects; its team ensures that costs are at the absolute minimum required to continue revenue growth and safety and soundness without any prodding from Management. It's integral to the corporate culture. This is supported structurally by economy in management. Each of the senior managers wears at least two hats. This not only helps economize, but prepares those managers for broader responsibilities as well as teaches them how to manage both line and staff functions. It's an excellent management development tool while being efficient.

Park's extraordinary efficiency ratio is particularly surprising as the Company operates 8 different bank charters, all with different names and brand identities, none with more than 19 offices and one with only 2 branches. Such expense layers have been taken out of much less efficient banks long ago, yet Park continues to protect the brand identity of the banks it bought and developed, yielding greater revenue growth than most banks, which more then covers the incremental expense.

Park National also shies away from fads, and only expands product lines when it makes sense, not because others are doing it. This has not impeded revenue, loan, deposit or fee income growth. In fact, I believe it ensures that the bankers sell only what customers need to their market, which only enhances customer retention.

Consistency of focus

Park National is no ordinary company, if its leaders and performance are any indication. The prevailing philosophy is simplicity and common sense in everything, while being ultra-conservative in financial and capital management. Politics are not tolerated, and merit and teamwork rule. As a result, Park National never surprises; it is the "steady Eddie" of banking, while its performance is consistently at the stratosphere.

Park National is so focused it chooses not to produce analysts' presentations, nor do they do investor presentations. It's a luxury not many banks can afford, and Park National is content within that luxury and the heavy retail ownership it brings.

<u>Diversification of income sources</u>
1. <u>Credit Cards</u>. Park National is down to earth and it sticks to the basics. It avoids fads. But it doesn't mean the company is stagnant. Park continues to change with its customers by offering them the products they wants. Park was the second bank in Ohio to offer BankAmericard (right after Bank One) in 1967. It was a product the customers needed, and the bank was there with them. The rate remained at 18% when Prime was at 15% as well as 21%. The bank continued to do well, but so did the customers.

As times changed, so did Park's card product. It's high growth card product is now equity-based, floating rate and offers the consumer flexibility in access both through the card and through checks. It has no bells and whistles, no frequent flyer miles etc., but it is priced fairly and customers like it and use it.

2. <u>Mortgage origination and servicing</u>. The card has been growing fast as Park grew its mortgage business, up from $650 million in originations in 2002 to $1.1 billion in 2003. This huge growth in production reflects market conditions and the refinance boom, but Park continued capitalizing upon these market opportunities in its own quiet, highly efficient way. The equity card is often a cross sell product with the mortgage, which helped the company cement customer relationships.

Park retains all variable rate loans, and sells all the fixed loans, retaining servicing. Some say there is no scale in servicing $1.2 billion of loans for others, but Park makes $2.5 million a year servicing this portfolio. Park indeed doesn't have the scale to service mortgages, and that has served it very well. It maintains the low cost advantage at its current size without the disadvantages of bigness.

3. <u>Trust services</u>. Park also has wealth management services, and they are consistent with the rest of the bank's posture: conservative and very decentralized. The management of trust services is decentralized to each affiliate bank, with local administrators and, in some cases, even local portfolio managers. Operations, investment services, internal audit and general corporate policy-making are performed at the lead bank level, in perfect tandem with the SuperCommunity Bank model. Note: Park is concerned with the inefficiencies of individual trust department audits, which have been conducted due to the separation of charters among affiliate banks. One affiliate is a state-chartered bank and is examined by both the State and the Fed, a costly and inefficient process. Park reviews periodically this structure to ensure that the benefits still outweigh the costs.

Each department at the affiliate bank level has a trust department leader who managers all staff and other functions at the local level ands reports to the CEO of that affiliate. All personnel decisions are made at the affiliate bank.

This loose federation of trust departments has frequent and regular interaction to coordinate pricing, compliance, marketing, strategy and management. Thus, they enjoy all the benefits of decentralization as well as most of the benefits of centralization, particularly of control and idea sharing. This coordination leads to similar, if not identical, fee schedules. The banks also shoot for uniform procedures, policies and forms corporate-wide.

From a marketing standpoint, the affiliates are typically in smaller communities, mostly county seat towns under 50,000 in population. In almost all cases, there is no longer a competitor offering locally administered trust services in these communities. I can't think of better marketing than that!

Trust asset growth has slowed down in well established affiliates, but is thriving in those banks where Trust started 10-15 years ago. One of the newcomers, in business for 13 years, now generates more fees than two banks that have been in business 50 years. This might be attributed to the low hanging fruit in some markets, as well as the differential growth rates across the state.

Park opened two metro trust offices in Columbus and Cincinnati. They have enjoyed relative success competing against much larger banks in both markets. Many of the large banks have raised their minimums for the trust business, and what is too small for them is big business for community banks like Park.

One might think that this structure is extremely inefficient and cumbersome. In fact, Park enjoys a contribution margin of 50% (about twice the national average) in its trust department, and the growth has been impressive and sound. The SuperCommunity bank model of decentralized delivery coupled with centralize customer-transparent activities works very well at Park National in all businesses, including the specialized lines of business described above.

"We view trust services as a fundamental and important component of an effective community bank", says DeLawder. While it takes a few years to break even, Park uses trust services as an important differentiator from the competition. These services played a major role in the company's past success, and it remains committed to making additional investments when similar opportunities arise.

Park's main characteristics are:

- **Unique Management and cultural continuity**
- **Counter-intuitive low cost**
- **Consistency of focus**
- **Down-to-earth character**
- **Long-term approach to the business**

In summary, this is an example of a company with extraordinary continuity of culture and management. It's a high performing, ethical, team oriented culture, supported by hiring the right people who fit into such an environment and thrive in it. The results speak for themselves!

VALLEY NATIONAL BANK – FIRMLY GROUNDED OUT-OF-THE-BOX THINKER

Valley National Bank has an enviable track record over the past twenty years: Assets grew from $733 million to $9.1 billion, EPS from $0.22 per share to $1.65 and dividends per share from $0.08 to $0.89. During this period ROA dipped as low as 1.29% in one year, but almost always remained above 1.50% and even exceeded 2.00% a couple of years. Similarly, ROE dipped below 15% only once, and has exceeded 20% during 11 of those years, including 2002. This is a truly remarkable track record. How did VNB's management achieve such success? Much has to do with its management team and its leader, Gerry Lipkin.

Disciplined execution

Gerry Lipkin has been Valley's CEO for over 20 years. Gerry is a down-to-earth, blocking-and-tackling banker. He works only half days, he says (7am to 7pm), and has shepherded the Bank's consistent growth without earnings hiccups throughout the period.

Gerry has always been deeply involved and a hands-on manager. He is intimately familiar with the goings on and provides guidance as needed. His thinking is highly disciplined, and extremely focused on shareholder value creation. He has created a cohesive and experienced management team, some of whom are second generation with Valley. They are all intimately familiar with the decision-making discipline and approval criteria that Gerry requires: bottom line comes first. That discipline has ensured that almost all decisions are made to build shareholder value, and no risks are taken that can jeopardize that proposition.

In addition, the Bank has solid cost discipline, which has yielded an impressive efficiency ratio throughout the years. Yet, unlike many other highly efficient banks, Valley isn't too cost conscious to invest in growth ventures and to give its employees the appropriate leeway to spend wisely rather than not spend at all. This philosophy starts at the top, where Gerry Lipkin looks for value in spending as opposed to cost elimination. It is the return on the investment or the spending he seeks, not simple cost cutting. This approach helped Valley grow organically, in addition to acquisitions, for the past twenty plus years, and to build a cohesive culture of value creation for all constituencies – shareholders, customers and employees.

<u>Solid growth, both organic and through acquisitions</u>
Valley has grown organically for years. Its acquisition philosophy has focused on market extensions and fill-ins, consistent with the conservative nature of the organization. Valley's growth was accomplished through a strong commercial banking culture that has competed with the larger banks in its marketplace successfully. Citibank and Chase cannot provide the service level and intimate customer involvement Valley's bankers can. Valley's conservative yet responsive credit posture has served it well throughout the years by establishing a strong position in the market, and truly delivering on the service promise, which is often easily made but rarely realized.

Valley's focus on the business community is well balanced by its retail strategy. Its roots are in serving small and medium size businesses, which helped the Bank's organic growth and supported its efficiency due to larger average branch size (over $100 million), deposit and relationship size.

Strategic growth has been a cornerstone of the Bank's strategy for years., Valley has been growing through all channels: relationship building; de novo branching (7 under construction in 2002 alone); and a disciplined approach to acquisitions. The Bank has been buying other depository institutions with similar philosophies, particularly on the credit side, in both New Jersey and New York. It continues to enjoy geographic density, which makes both management and efficiency maintenance easier. The Company also continues to buy fee income generating companies that complement its main businesses and strengthen its fee income base. As an example, in a single year, it bought a general insurance agency, a title agency and a municipal securities firm. All three fit well into the Bank's current business fabric, as Valley is closely tied into its communities through charity and philosophy, as well as financial activities. A municipal securities firm adds another dimension to the local government relationships Valley already has, as does the insurance agency to its business banking base. The Bank's acquisitions have been well-reasoned and financially profitable, and their broad range of activities is consistent with the bank's out-of-the-box thinking.

<u>Thinking out of the box</u>
Many community banks do extremely well without innovation. In fact, many who innovate for faddish reasons alone do poorly. Valley, on the other hand, is a bank whose management team thinks out of the box. It constantly searches for better ways of doing things, from service delivery to tax reduction strategies. Management ensures that core profitability is strong enough to support R&D type investments in growth businesses, realizing full well that some may not pan out. Its financial strength allows Valley to take some of the losses associated with unsuccessful businesses, while continuing to grow revenues by continuous innovation and business expansion. Financial performance is more solid than it seems because the consistent performance includes an investment component that other banks do not share. Valley is open to trying new things that make sense, which is a commendable and important characteristic. It helps the Company maintain its competitive

advantage against the big guys without compromising its identity as a community bank. In that regard, Valley is the quintessential SuperCommunity Bank: it delivery locally, produces centrally and augments customer-transparent cost savings with an extremely strong product line that can effectively compete with the New York money center banks in the market segments that Valley focuses on (small and middle market, for example).

The willingness to innovate without jeopardizing financial performance is a unique characteristic of Valley's management team. It presents a very special combination of excellent management of the basics, rooted in Lipkin's early years as a bank examiner and the financially conservative nature of the management team, coupled with open-mindedness and a constant strive for improvement, as well as a well reasoned and thought out growth strategy which does not compromise the Bank's core strengths.