

the Curtis Alert

The Big Squeeze: Net Interest Income Margin

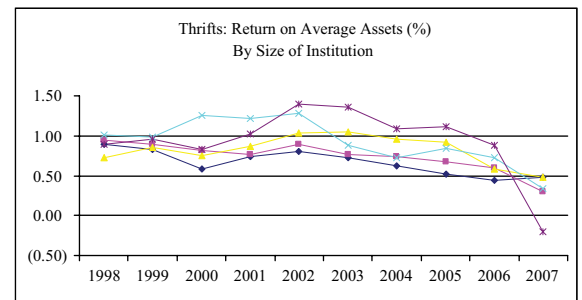
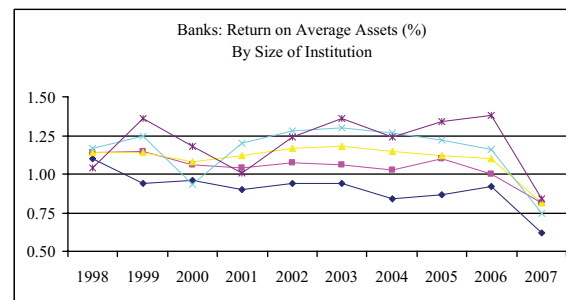
By Michael Demers and Matthew Pellini

After years of record earnings, the banking industry experienced turmoil in 2007 and the first quarter of 2008. In part due to asset quality issues, banks and thrifts experienced a considerable decline in net income. Although large organizations were the most affected, smaller and medium-size institutions also experienced declines in earnings.

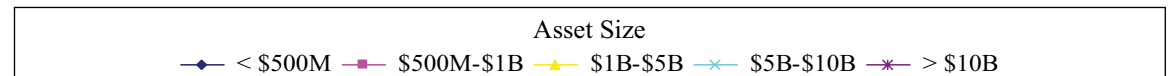
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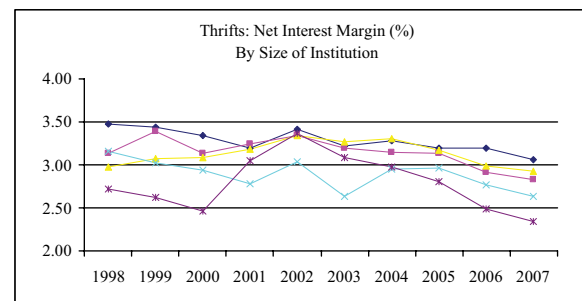
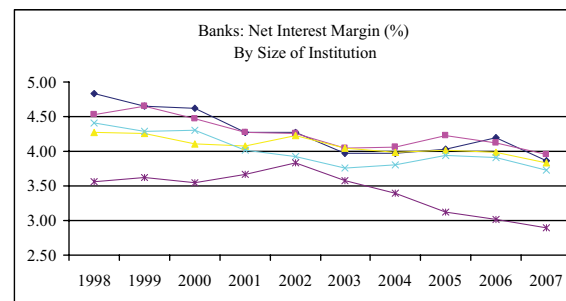


Source: SNL Financial LC



As of the end of April, bank stocks on average were down approximately 30% year over year and thrift stocks on average were down approximately 40% year over year. Although write downs tied to sub-prime mortgages and credit quality issues received a great deal of attention, declines in net interest margin also contributed to depressed earnings.

Although select banks and thrifts have recently experienced an increase in net interest margin for the first quarter of 2008 (due in part to the Fed's recent interest rate reductions), industry wide net interest income margins have been trending downwards for several years.



Source: SNL Financial LC



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Although there are several factors that impact net interest margin, competition among financial institutions may prove to be the longest lasting. Historically competitive lending rates are now being accompanied by institutions vying for deposits. With the perceived convenience of internet banking and the publishing of deposit rates on websites, customers have become savvier and are requiring higher rates on their deposit accounts. Accompanied with the ease of transferring funds, these trends are forcing financial institutions either to increase deposit rates or risk losing deposits.

Credit quality has received the most press due to its enormous impact on the industry as a whole; however, now that it has been exposed, it is likely to improve via strengthened credit and underwriting standards. On the other hand, the problem of declining net interest margins may not be as easy to fix, as rate compression on loans and higher yielding deposits are less a function of internal operations than one of an ever more efficient marketplace.

To counteract the decline in net interest margin, banks and thrifts can take several steps. Management can focus on reducing costs, but may run the risk of lower levels of customer service. Lending institutions can also focus on generating fee income derived from traditional banking activities (e.g. account service fees, etc.). However, such fees may be viewed by customers as punitive, resulting in a weakening of the customer relationship.

Another alternative for financial institutions is through the acquisition and development of ancillary financial services businesses. Ancillary lines of business

provide four key benefits: diversify an institution's revenue stream away from net interest income; provide a recurring fee income stream; strengthen existing customer relationships through the offering of value-added services; and, serve as defensive mechanisms against non-bank competitors. Although there are a number of ancillary businesses a bank or thrift may want to consider, in this article, we highlight asset management operations.

Demographics: The Trend is Your Friend

By 2030, the population of Americans 65 and older is expected to nearly double from the current number of 37 million. As such, the need for retirement and trust services for these customers is expected to increase dramatically. Existing customer relationships and trusted reputations uniquely position financial institutions to capitalize on the opportunity of retirement planning and asset management.

The development or acquisition of an asset management business may also serve as a defensive strategy against brokerage houses. Not only are asset management operations appealing to older customers, but younger clientele are becoming more financially aware and are being lured by the diverse services and competitive offerings of brokerage firms. For these customers, the interaction with tellers has been replaced with the convenience of internet banking, increased capabilities of ATMs and 1-800 customer service lines with extended hours. Aggressively priced rates on FDIC insured deposits, asset management services, checking capabilities and reimbursed ATM fees are icing on the cake.

In addition to the competitive advantages associated with offering asset management services, an attractive feature of these businesses is that they can provide a valuable recurring revenue stream. In a rising investment environment, revenues can increase due solely to investment performance as assets under management increase. As a result of the recurring revenue and perceived growth prospects, publicly traded asset management firms typically trade in excess of 20 times trailing twelve month earnings, representing a premium to bank and thrift multiples.

The benefits of ancillary businesses are demonstrated by market multiples when comparing banks with various levels of non-interest income. As shown in the following table, a relationship exists between the level of non-interest income as a percentage of operating revenue and a bank's price-to-earnings, price-to-book and price-to-tangible book multiples as well as the all-so-important return on average assets.

Although asset-quality has received enormous coverage due to its impact on the largest of financial institutions, community banks that have remained prudent in underwriting have to contend with different issues. Acquiring or developing ancillary businesses may provide banks and thrifts with alternative and recurring revenue streams, which not only provide a means for diversification during difficult interest rate environments, but also serve as competitive advantages, resulting in strengthened relationships with existing customers, and the addition of new clientele.

Fee Income: The Banker's Best Friend

Valuation Multiples for Publicly Traded Banks

Sorted by Non-interest Income as a Percentage of Operating Revenue

	Non-interest Inc/ Operating Rev (%)	Price/ LTM EPS (x)	Price/ Book (%)	Price/ Tangible Book (%)	ROAA (%)
Top Third	32.0	14.2	149.0	207.0	0.98
Middle Third	22.4	14.0	123.5	152.4	0.91
Bottom Third	12.6	12.2	99.0	128.2	0.75

Source: SNL Financial LC, banks with between \$1 billion and \$20 billion in assets

Preparing Your Software Company for Sale

By Paul Yeakel

When a small- to mid-size software business-owner decides to sell, the objective is to maximize value. In large part, the ability to do so is contingent upon proactively preparing and positioning the company for sale. All too often, business owners do not spend the time upfront to understand the attributes that potential buyers value, and to position their businesses accordingly. The result is a sale that generates less than maximum potential value.

What affects value in software company transactions? Anecdotally, historical software industry transaction data provides some interesting insights. Segmented by deal size, the data indicate that the highest average and median valuations (measured in terms of sale price as a multiple of revenues) for software companies were for companies generating under \$10 million in annual revenues, followed by companies with revenues between \$10 and \$25 million. Additionally, both of these segments (which represent the smaller software companies) exhibited the greatest variance with respect to the range between low and high valuation multiples. This data suggests that smaller, emerging software companies can more readily drive exit value creation by properly positioning their companies. Conversely, it suggests that small software company owners who neglect to position their companies proactively may be particularly at risk of foregoing value upon a sale. As compared to larger software companies, owners of smaller software companies have a much greater opportunity to influence the value of their companies in a sale transaction.

So, what can you do to prepare your software company for sale?

Generally speaking, you should enhance your company's value proposition to would-be acquirers, including: 1) understanding key attributes valued by acquiring companies, and 2) improving, modifying and highlighting the most attractive characteristics of your business, while mitigating actual and potential weaknesses and risks.

Understanding Prospective Buyers

Understanding the universe of likely buyers (and their acquisition rationales) for your software company is critical. Historically, the vast majority of acquirers of small- to mid-size software companies have been strategic in nature. Interestingly, in recent years, large strategic buyers have made it easier for small software company owners to identify potential buyers. For instance, SAP (presumably to generate deal flow) recently broadcast its interest in acquiring companies with strong intellectual property positions targeting the small to medium enterprise ("SME") market. Additionally, at a recent industry convention, Microsoft CEO Steve Ballmer stated that Microsoft wants to acquire emerging companies focused in virtualization, software as a service ("SaaS") and Web 2.0. He even provided his email address and encouraged software company owners to contact him directly. Gaining an understanding of buyer acquisition preferences should better enable you to position your business for an exit.

Unique Value Drivers for Software Companies

To increase the likelihood of capturing additional value from the sale of your business, you also should gain perspective on broader perceived value-enhancing software company attributes, as follow.

Business Model

Software business models continue to evolve driven by various competitive market dynamics. SaaS has emerged in recent years as an attractive business model to customers, in that it enables more frequent and seamless upgrades, a lower total cost of ownership, and a higher level of service. Specific benefits to software company owners include a relatively scalable business model, lower R&D costs, and faster development and upgrade capabilities. Emerging, high-growth software companies able to migrate their software delivery models to SaaS can position themselves favorably and

attract additional value. This is supported by a recent McKinsey study, in which publicly traded SaaS companies outperformed the overall software company index (excluding Microsoft) by more than 13 percent during a recent five-year period.

Recurring Revenue Predictability and Growth

Buyers will assign additional value to software companies with demonstrable recurring revenues and strong growth prospects, as these factors enhance predictability – thus reducing post-closing buyers' risks. The more contractually bound revenue the company can book, the more likely it is to maximize exit value. According to Brent Arslaner, vice president of marketing and business development at Jamcracker, SaaS enables hosts to drive revenue and maximize customer retention, reducing the probability of customer attrition between 80 and 90 percent. Additionally, Gartner Research projected that SaaS would grow at a compound annual rate of 22.1% from 2006 through 2011, well above growth expectations for the publicly traded application software sector. Not surprisingly, a subset of companies utilizing the SaaS model were valued at an average of 4.65x revenues, vs. the application software sector, which yielded a value of 2.8x revenues.

So, owners can create value by adopting new business models, or proactively extending customer licensing and/or maintenance contract through pricing discounts prior to selling their business.

Scalability

A software company that can demonstrate scalability to meet future market demand adds value. Scalability is driven largely by a company's business model and the flexibility of the underlying technological architecture. Again, SaaS is a good example here, as it enables: 1) multiple customers to utilize a single platform, 2) easier integration with existing customer IT platforms (particularly if it is built utilizing service

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oriented architecture) and, 3) accelerated development and upgrade cycles. Thus, companies utilizing the SaaS model are highly valued.

Mitigating Risks

Every business has weaknesses and exposure to risk. Weaknesses can include customer concentration, supplier concentration, product or service commoditization, a lack of intellectual property and management depth, and improper accounting procedures. Risks can include increased competitive pressures, product obsolescence and impending litigation. Following are specific areas of importance:

Software and Legal Documentation

Providing buyers with comprehensive, well-organized software code documentation is critical. It is important to ensure that all proprietary in-house code is owned and documented as such by the company. To the extent your company’s developers utilized third-party or open source code, be sure that it is fully documented and licensed. Any legal issues or potential hurdles, such as obtaining customer or supplier consents or settling outstanding or looming litigation should be mitigated. Finally, the company should be in full compliance with all applicable local, state and federal laws, and should consider and address customer contract assignment/termination provisions proactively.

Financial Statements

Owners should ensure they have accountant-prepared financial statements. Within the financial statements, the most important area software company owners should focus on is revenue recognition. Owners should make sure that their revenue recognition procedures are accurate and reflect current accounting standards.

Gathering the aforementioned information and preparing your software company for sale takes a lot of time and hard work. Sadly, most business owners do not take the time, and consequently, sell out at lower valuations. This is supported by a recent study by the Alliance of Merger and Acquisitions Advisors, which discovered that 90% of mid-size businesses are currently unprepared to sell, while seven out of ten mid-size business owners intend to transfer ownership during the next decade.

The task of preparing your software company for sale is daunting, and the list of things to accomplish is much more extensive than the items described in this article. Such preparation can, however, be much more manageable with the assistance of key professional advisors, including experienced investment bankers, transaction attorneys and certified public accountants. Armed with the right information and advisors, you can greatly enhance the likelihood that your software business will sell at a premium valuation.

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The undersigned served as exclusive financial advisor and issued a fairness opinion to Verlan Holdings, Inc. in connection with this transaction.


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The undersigned provided a fairness opinion to the Board of Directors of NOVA Financial Holdings, Inc. in connection with this transaction.

CURTIS SECURITIES
A Better Point of View