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Date: January 18, 2011
To: CCCERA
From: Bob Helliesen and Timothy Price
Subject: Carpenter

Introduction and Recommendation

Carpenter Community BancFund has proposed increasing the size of the fund by re-opening the fund to additional investment. The proposal is to admit new investments to the fund to change its commitment level from $280 million currently to $500 million, a $220 million or 78.6% increase. It is proposed that the new funds would come in at a higher price than the current investments reflecting a 12% annual increase, around an 18% total markup given the length of time the fund has been up and running. There also would be a fee reduction on new investments.

CCCERA has two decisions to make:

1. Should it vote to authorize the expansion of the fund?
2. Should it increase its investment from the current commitment of $30 million – with the new investment at the higher price - or opt to remain at its existing $30 million?

Our opinion on the first point is that CCCERA should authorize the expansion of the fund. The new money will be coming in at a substantially higher price than the initial investments. Carpenter feels that the environment is such that allowing the new money in will increase the return to the original investment substantially, and we suspect this will be the case. If more than 50% of the investors approve, the expansion will go through.

On the second question, we would favor consideration of either no new investment or an increase of $5 - $15 million (to $35 - $45 million total). CCCERA overall total assets are approximately equal to those when the fund began at year-end 2007. While the Carpenter investment has had a promising start and seems to have very good prospects, the new money will be coming in at a higher price. Carpenter projects IRR on the existing investments will improve from 20% plus with no expansion to around 33% net with the benefit of the new funds.

Discussion

It is somewhat unusual for a closed end fund to seek to re-open. Carpenter did not contemplate this action when it was setting up this fund. A reason is that Carpenter set up this fund as a bank holding company, a somewhat involved and time-consuming process. Carpenter estimates it would take 12-18 months to set up a new holding company, which it would need for a second fund.

The initial thesis of the fund as outlined in late 2006 has changed somewhat. Initially, it was thought that the primary source of new investments would be brand new banks that Carpenter would set up. With the economic distress since 2006, the emphasis has shifted to investing in existing banks that need rescue funds. Carpenter through its investments has the opportunity to buy good bank assets at a fraction of their stated value (and then to package and re-sell them). Carpenter sees the new funds as an opportunity to enhance IRR by building bigger banks, which typically sell for higher multiples, and because the new investments are expected to have a quicker payout. Part of the thesis is an increase in the selling price of banks towards historical averages.

Carpenter has called some $218 million of the original $280 million commitment, and has reserved $27 million additional for committed investments and $24 million for Costs and Fees, leaving only $10 million for new investments. Commitments currently are 78% drawn.

Carpenter valued its investments as of September 30, 2010 at $167,518,710 (compared to a cost value of $154,058,349). As Carpenter itself conducted the valuation, the firm hired a third party appraiser to audit its methodology in reaching the values. The third party firm – RSM McGladrey, Inc. – concluded that the Carpenter approach was appropriate. Carpenter justifies the higher price to the new investment – calculates at $181,221,032 – as appropriate. Carpenter justifies the step-up as coming from conservative estimates that do not reflect the value of its holding company infrastructure.

It shows a certain lack of foresight for Carpenter to be in this position. None-the-less, we see this as a promising investment. As stated above, we favor approval of the modification of the fund and would consider further investment.