

How Banks and Credit Unions Should Make the Decision to Sell or Buy

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PRACTICES

Banking and Finance

Financial Institutions Corporate
 and Regulatory

Fair Lending

Consumer Financial
 Compliance and Litigation

Peter's practice focuses on corporate and regulatory representation of a wide range of financial institution franchises.

Peter is Practice Group Leader of the Financial Institutions Section of Hunton Andrews Kurth LLP, a national firm. During the past several years, Peter has devoted substantial time to strategic planning, bank compensation and defense of enforcement matters, including concerning fair lending and BSA. He has counseled institutions on more than 300 M&A transactions, hundreds of securities offerings, including over a dozen IPOs and capital planning, over 50 de novo banks, and hundreds of administrative and other enforcement actions. He was a guest lecturer for Harvard's Kennedy School of Public Policy in Beijing, China in 2017. His team also composed ICBA's manual on how banks can access FinTech.

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Relevant Experience

Representation includes:

- hired by national law firm as an expert witness on banking regulation – 2017;
- facilitated over a dozen strategic planning retreats in 2017;
- convinced the U.S. Treasury to issue the first community development financial institution designation for a for-profit indirect lender (a lender that buys loans). The U.S. Treasury had previously not approved such entities to be CDFIs for policy reasons;
- obtained the first ever shelf charter (a charter that was not activated until a bank failed) to buy assets and assume liabilities from the FDIC as receiver of failed banks;
- proposed to senior regulatory personnel changes to the Shared National Credit ("SNC") review process and how that process may be enhanced;
- 2017 M&A Advisor Award for Financial Deal of the Year for the sale of Cascade Bancorp to First Interstate BancSystems, Inc.;
- lead counsel in merger of equals creating a \$13 billion bank – 2016;
- lead counsel on the North American Corporate Deal of the Year (Middle Market) – The M&A Atlas Awards – for Cascade Bancorp, Inc.'s successful topping bid to acquire Home Federal Bancorp, Inc., a NASDAQ-listed bank;
- Finance Monthly Deal Maker of the Year Award 2014 – Cascade Bancorp, Inc.'s successful community bank topping bid in connection with Cascade's agreement to acquire Home Federal Bancorp;
- more M&A transactions than any firm over the last 16 years (according to *SNL Financial*, December 2016);

EDUCATION

JD, Duke University School of
 Law, 1985

BA, State University of New
 York, 1982

BAR ADMISSIONS

Texas

- number 1 in 2013 with 19 M&A transactions and in 2014 with 20 M&A transactions, number 2 in 2016 with 15 transactions (according to SNL Financial);
- hundreds of capital offerings, including over 18 IPOs;
- hundreds of fair lending, CMPs, and other enforcement actions with all bank regulators, HUD, CFPB and FinCEN;
- testimony before Panel of the House Judiciary Committee regarding Operation “Choke Point” in July 2014;
- myriad compliance issues before all of the federal bank regulatory authorities, including the CFPB; and negotiations of administrative actions; and
- worked with Puerto Rico taxing authorities to create a tax structure to allow Puerto Rican bank holding companies to issue trust preferred.

For the last 21 years, he has served as co-editor of ICBA’s Newsletter, "SUBCHAPTER S: THE NEXT GENERATION." He is the author of numerous articles in law and banking publications. His article, “Acquisitions of Failed Banks Present Risk and Opportunity,” was voted the second best article appearing in The Risk Managers Association Journal of 2011. He has spoken at over 250 banking conferences and seminars and is listed in Chambers USA “Leaders in Their Field” for banking and as AV Preeminent in Martindale-Hubbell®.



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Richard has more than 30 years' experience representing banks, savings institutions, credit unions and holding companies on a nationwide basis. He has served as counsel on more than 40 bank mergers.

In addition to his general work in bank and credit union regulatory matters and mergers and acquisitions of both stock and mutual institutions, Richard focuses on bank and credit union charter changes, new products and services, FinTech, regulatory compliance, de novo bank and credit union formations, cross-industry mergers, government assisted acquisitions of failing financial institutions, enforcement matters, corporate governance, stock and mutual holding company formations and mutual-to-stock conversions.

Richard is admitted to practice in the US Supreme Court. He has also served as counsel at the Federal Reserve Board and another federal banking agency and a bank holding company. He also served as an adjunct professor of Banking Law at Rutgers University School of Law.

Relevant Experience

Representation includes:

- Represented the first stock bank to be acquired by a credit union;
- Represented the first mutual savings bank conversion to a national bank charter in a mutual holding company structure;
- Represented the first mutual savings institution to simultaneously convert to stock form and a national bank;
- Represented a New England based credit union, in its charter conversion to a state savings bank and subsequent \$50 million initial public common stock offering;

EDUCATION

JD, Rutgers University
School of Law, 1979

BA, Temple University,
cum laude, 1974

BAR ADMISSIONS

District of Columbia

New Jersey

Pennsylvania

- Served as counsel to an online bank deposit auction marketplace;
- Serves as counsel to a web-based loan exchange marketplace;
- Serves as counsel to developers of a dark web search engine;
- Serves as counsel to a mobile payment technology company;
- Serves as counsel to a BSA/AML compliance company using blockchain technology;
- Represented a Fortune 10 Company in its formation of a federal savings bank;
- Represented a Fortune 10 Company in its formation of a Utah industrial loan company;
- Represented a major insurance and mutual fund company in the conversion of its trust bank to a full-service federal savings bank;
- Represented a state trust company to a federal thrift with trust only powers;
- Represented several former credit unions in their conversion to a bank and their initial public offering;
- Represented the acquiring credit union in one of the largest NCUA assisted acquisitions;
- Represented the credit union in the largest Community Development Capital Initiative awarded by the United States Department of the Treasury; and
- Served as counsel to the organizers of a nationwide faith-based credit union.

Trump Agenda: How did he do?

Agenda:

- Regulatory reform
- Infrastructure and spending increases (thus interest rate increases)
- Tax reform

Turnover at the Agencies:

- FDIC: Jelena McWilliams (Fifth Third GC and former senior counsel to Sen. Shelby)
- OCC: Acting Keith Noreika now Joseph Otting (One West Bank)
- Federal Reserve: Jay Powell, Fed Chair, and Randy Quarles (P/E investor; former UST), Supervision
- CFPB: Acting Mick Mulvaney
- NCUA: one vacancy remains

Change in Regulation:

- Two for one Executive Order, including two for one cost savings
- Freeze on new regulations pending Trump appointees
- Regulatory Review Executive Order
- Regulatory Principles Executive Order
- Senate Banking Committee bipartisan deal
- Financial Choice Act – House
- Economic Growth, Regulatory Relief and Consumer Protection Act - Senate

Net Interest Margin



Corporate

2017 Tax Rates		2018 Tax Rates
Tax Rate	35%	21%. Starting 1/1/26 rates revert
Alternative Minimum Tax	AMT	No AMT, but “base erosion minimum tax” (BEAT) of 10% of income determined w/o regard to tax deductions and tax benefits to address foreign re-incorporations.
Interest	No limit	Limited to 30% of EBITDA for five years; then 30% of EBIT for five years

Corporate

2017 Tax Rates		2018 Tax Rates
Pass Through	Taxed at individual rates – no deduction	20% deduction of that taxpayer’s “domestic qualified business income” subject to phase-out for smaller closely held firms, and exceptions for investment income and income from businesses for which principal asset is skill or reputation, e.g., law, accounting, health, etc.

Individual

2017 Tax Rates		2018 Tax Rates
Tax Rates	Seven marginal rates – top 39.6%	Still seven marginal rates, but income ranges have changed – top 37%. Starting 1/1/26 rates revert
SALT	Deductible subject to AMT	\$10,000 cap; still subject to AMT
Alternative Minimum Tax	AMT	AMT (no change)

Individual

2017 Tax Rates		2018 Tax Rates
Personal Business NOLs	No limits	Limit of \$250k individual and \$500k joint for losses attributable to a trade or business (three year carryforward)
Itemized Deductions	Pease limitation for miscellaneous deductions above 2%.	No Pease limitation, but SALT and more interest limits

- Phase-out of deduction of FDIC premiums for banks above \$10 billion
- Required holding period for carried interest to achieve capital gain treatment now three years
- NOLs after 12/31/17 deductible only to 80% of taxable income. Indefinite carryforward but no carryback
- REIT dividends qualify for the pass-through deduction
- Immediate expensing for property (other than real estate) after 9/27/17, but before 1/1/23 (thereafter immediate expensing decreases 20% a year)
- Employer-provided meals now only 50% deductible
- Nonresident alien now can be beneficiary of ESBT in an S corporation
- For one year after converting from an S corporation, a C corporation may treat distribution out of AAA instead of C Corp E&P. Thereafter, distributions are deemed to be paid pro rata out of AAA and C Corp E&P

Combined Effect

Indexes					
Friday, December 22, 2017					
P/E RATIO				DIV YIELD	
	12/22/2017 [†]	Year ago [†]	Estimate [^]	12/22/2017 [†]	Year ago [†]
Russell 2000	123.89	Not provided	25.96	1.33	1.44
Nasdaq 100	26.89	24.45	21.45	1.05	1.23
S&P 500	25.25	24.95	19.99	1.90	2.07

[†]Trailing 12 months

[^]Forward 12 months from Birinyi Associates; updated weekly on Friday

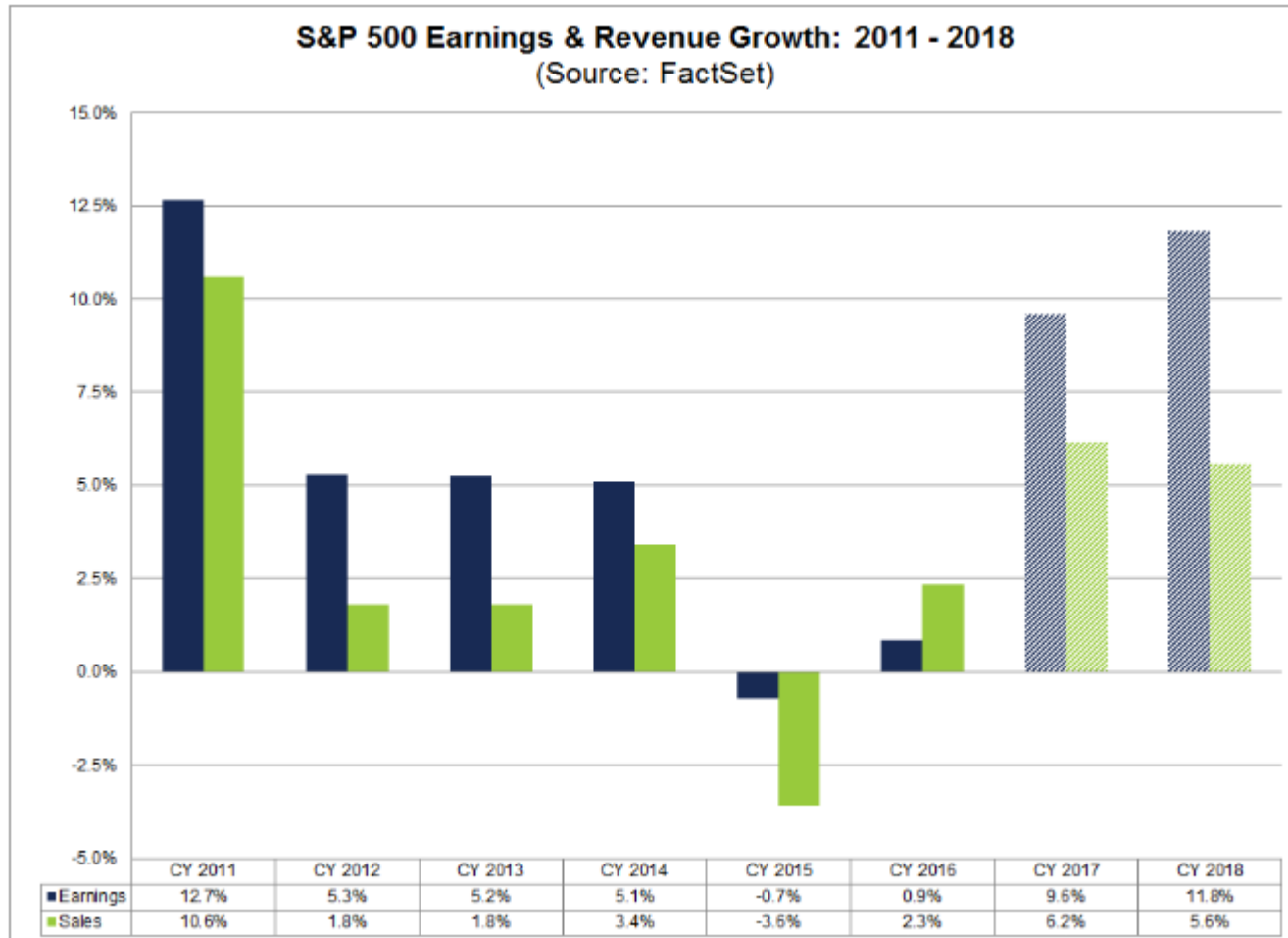
P/E data based on as-reported earnings; estimate data based on operating earnings

Source: Birinyi Associates

The large drop in the S&P 500 P/E Ratio from 25.25 to 19.99 forward 12-month estimate includes the impact of lower corporate tax rates.

S&P 500 Earnings Growth Estimate 2018

(Source Factset)



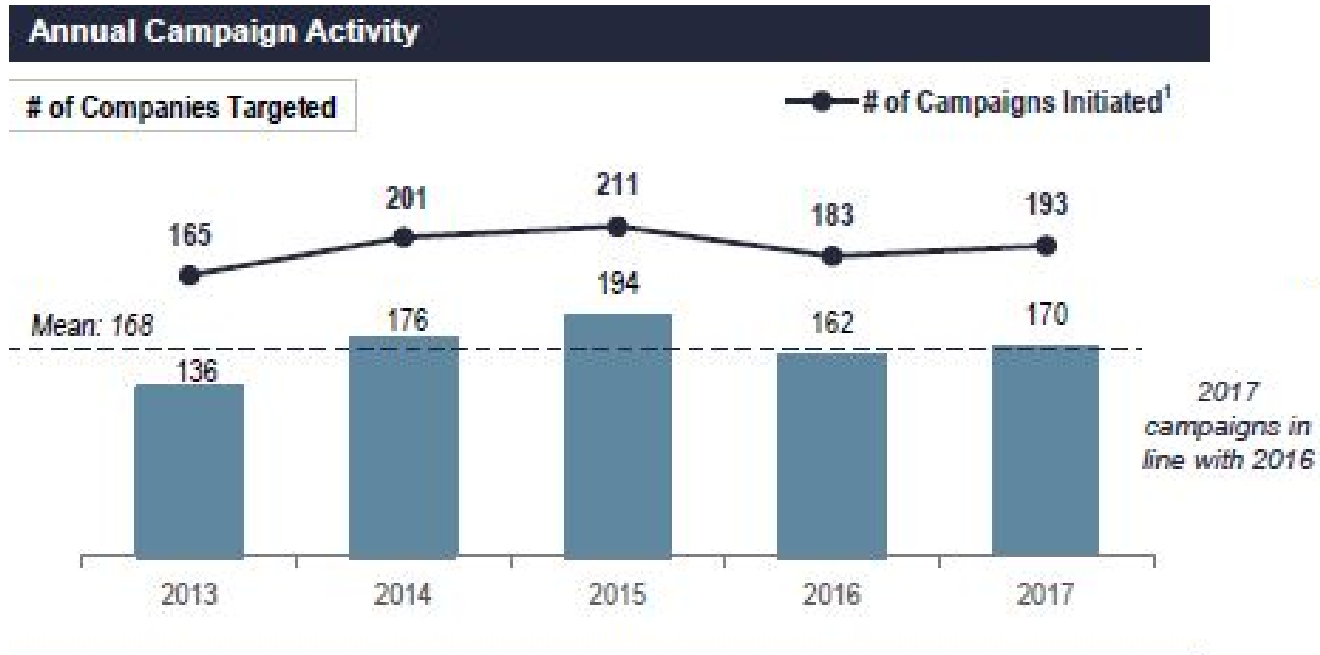
Valuation Multiples (LTM)

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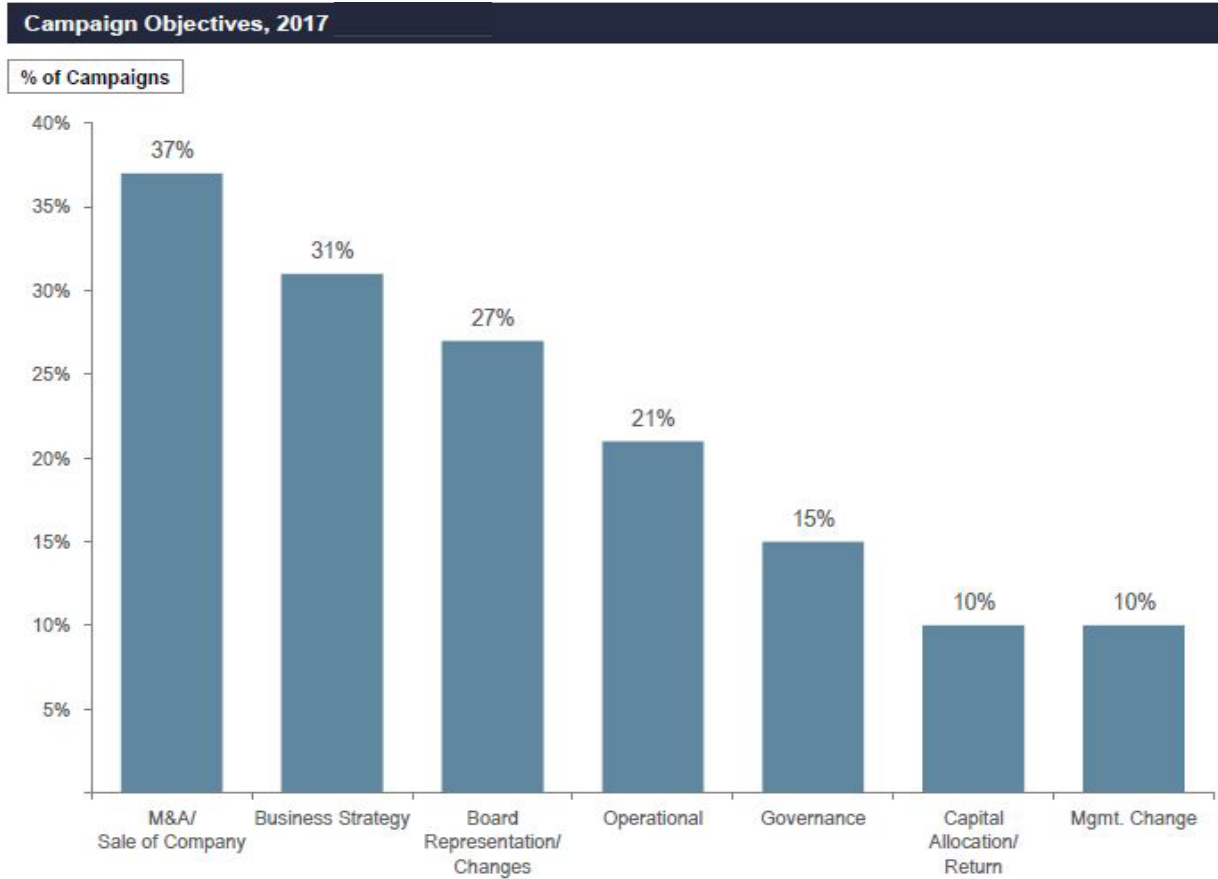


- Personal responsibility for internal controls under SARBOX
- ISS rejection of change in control defenses and staggered boards. Increasing index fund ownership
- SEC requirements such as “say on pay” and “universal proxy” cards
- Elimination of “golden parachute” excise tax gross-ups and single triggers
- More performance-based compensation. Post-Wells Fargo focus on incentive compensation
- Levels of “withhold” votes have steadily increased

Campaign Activity and Capital Deployment



Key Campaign Objectives



- 2017 activist campaigns third most ever
- 20% nanocap (<\$50 million) and another 20% microcap (\$50 million-\$250 million)
- Institutional/passive investors increasingly voicing their priorities (Vanguard, State Street and Black Rock)
- Financials/banking continue to be perceived as “low hanging fruit” – 20% aimed at sector

- \$150 million asset bank – proxy fight/T.O.
- \$175 million asset bank – proxy fight/regulatory filings
- \$250 million asset bank – proxy fight/T.O./TRO
- \$500 million bank holding company – proxy fight
- \$800 million family bank sold in split vote (after patriarch died)
- \$350 million family bank sold in split vote (after patriarch died)
- Lawsuit by private equity against management team
- \$200 million asset bank warded off unsolicited offer by investor group
- Dozens of shareholder inspections, letter-writing campaigns and other soft-pressure issues

Shareholder Letters

Dear Board of Directors of _____ Bank

Now is the optimal opportunity to explore the sale of the company. Shouldn't you look into partnering with a bigger, more stable and conservative bank?

Each share is estimated to have a value of at least ___ or at least ___ higher than the currently trading value. During the past two years, there has not been a large change in the value of _____ shares, and the stock has been trading closer to that of its book value. Selling the franchise is the only way to maximize value for the shareholders.

Good quality loans will be more difficult to find and bank stocks will suffer, including _____, if these trends continue. _____ stock value was severely depressed between 2006 and 2010, and we want to avoid a similar stock value depression from happening again.

The reaction to our first letter sent in _____ of this year shows that over _____ of the shareholders support our opinion. We are sensitive to the needs and changes because of the long-term investors in the _____ banking sector.

The two largest _____ banks, _____ and _____, have the capital to make an offer at a price that is fair to _____ shareholders. The Board should explore partnering with these banks and other larger entities while their higher valuations still enable them to pay full value. _____ Bank and _____ cash dividends are both above, and _____ will be able to offer better stability if it merged with a larger and diversified corporation.

According to the most recent proxy statement, the Board and executives hold approximately _____ of the shares, with the remaining shares held by others. Without even looking into it, perhaps if the Board is trying to complete a sale at a very high price, it appears they will need to purchase the remaining shares at this high price and fair price.

For shareholders with questions, we wish you will contact the Board of Directors. Thank you.

Shareholder Letters (cont'd)

_____, 2016

This letter is a follow-up to our original letter dated _____, 2016, in which we advocated exploring the Company's strategic options in light of the relatively opportune market conditions for a sale of the Company.

Thank you for your _____ letter in response. In the letter you state that "carrying out the Bank's standalone strategic plan, which includes seeking growth organically and potentially through acquisitions, will result in continued strong returns on equity and will maximize shareholder value over the long-term."

Our issue is not with management's respectable, current profitability, but with the value of the shares over the medium-to-long term. Buying smaller banks with our deflated currency is not in the best interest of shareholders, and growing to \$1 billion in assets – an often stated goal – is also not an astute strategy. We feel the Board has not fully explored what the franchise is worth by discussing strategic options with potential buyers.

If these buyers were to express that the Company is not worth more than its current trading value on the open market, then a Board decision to stay the course would seem logical. However, if buyers were to offer a higher valuation to _____ shareholders, then we feel it is the Board's fiduciary duty to represent this value to outside shareholders, or to pay outside shareholders a commensurate price and run the Company privately.

We continue to believe that the Company's worth to an acquirer is _____ to _____ tangible book value per share – up to _____ per share, or _____ higher than where the shares trade now. The two most acquisitive banks in the _____ space, _____ and _____, continue to trade at premiums to the rest of the sector.

Our goal is not to nominate an outside slate of directors, as we are hopeful the current Board will act in shareholders' best interests. However, we retain the right to explore all alternatives. Since our original letter, we have been contacted by a number of like-minded outside shareholders, who believe that the Board should unlock shareholder value through genuine engagement with potential buyers of the Company.

Shareholder Letters (cont'd)

We encourage shareholders interested in supporting the positions expressed in this letter to contact Board members at the Company as well as us. Expressions of support are highly appreciated and effective.

Thank you,

_____ Opportunity Fund LP

Telephone: _____

_____ Limited, LP

_____ Limited, LP

Telephone: _____

_____ Opportunities Fund II, LP

Fiduciary duty is to the hypothetical long-term investor who has no need for current liquidity.

Warren Buffett: “I believe in running the company for shareholders that are going to stay, rather than the ones that are going to leave.”

- Engagement with long-term shareholders
 - Expanded from business/finance to include governance
 - Participation by independent directors
 - Waiting until activist activity to communicate may be too late
- Enhanced clarity/transparency in disclosures (“Sunlight is the best disinfectant”) (remember Reg. FD)
 - E&Y 57.4% of S&P 500 companies disclosed shareholder engagement activities in 2016
 - Of those, 24% disclosed board involvement in such efforts
 - Investor Stewardship Group (largest institutional investors) voluntary corporate governance code calling for collaboration among companies and investors to create long-term growth

- Consider going private/dark. There were fewer than 4,000 listed companies (down 46% in two decades) and approximately 15,000 traded OTC
- Do not dismiss activist ideas out of hand
- Before an activist shows up, consider the strategic plan – know where you are vulnerable

Think like an activist:

- Sale of company
 - Make the case against
- Stock buybacks
 - Good use of capital or opportunity cost
- Reduction in headcount
 - Regulatory risk and other risk as most employee growth is in IT/ERM/CMS/QC
- Cutting investment
 - May jeopardize long-term returns or even viability
- Insiders overcompensated and entrenched
 - Compensation vs. peer and performance

- Retain structural defenses (or consider adding to them)
- Consider amending the bylaws to:
 - Eliminate removal of directors by shareholders without cause
 - Eliminate shareholder action by consent
 - Extend advance notice to make proposals and structure
 - Extend advance notice to nominate directors
 - Require director nominee disclosure
 - Institute director qualifications (third-party compensation)
 - Adopt exclusive forum for shareholder class action
 - Provide structure around proxy access, shareholder meetings, etc.
 - Contrast Federal Credit Union bylaw rigidity
 - Some state laws provide flexibility (e.g., CA)

Consider amending articles/certificates:

- Shareholder percentage to call meeting
- Staggered board
- Super majority voting
- Fair price provision
- Drag/tag agreements and ROFO agreements
- ESOP

- When should banks consider selling?
- vs.
- When do banks consider selling?
- Do not start the process just to see what the bank may be worth
- Risks to employees / customers / shareholders of the consideration of a sale
- Role of the strategic plan

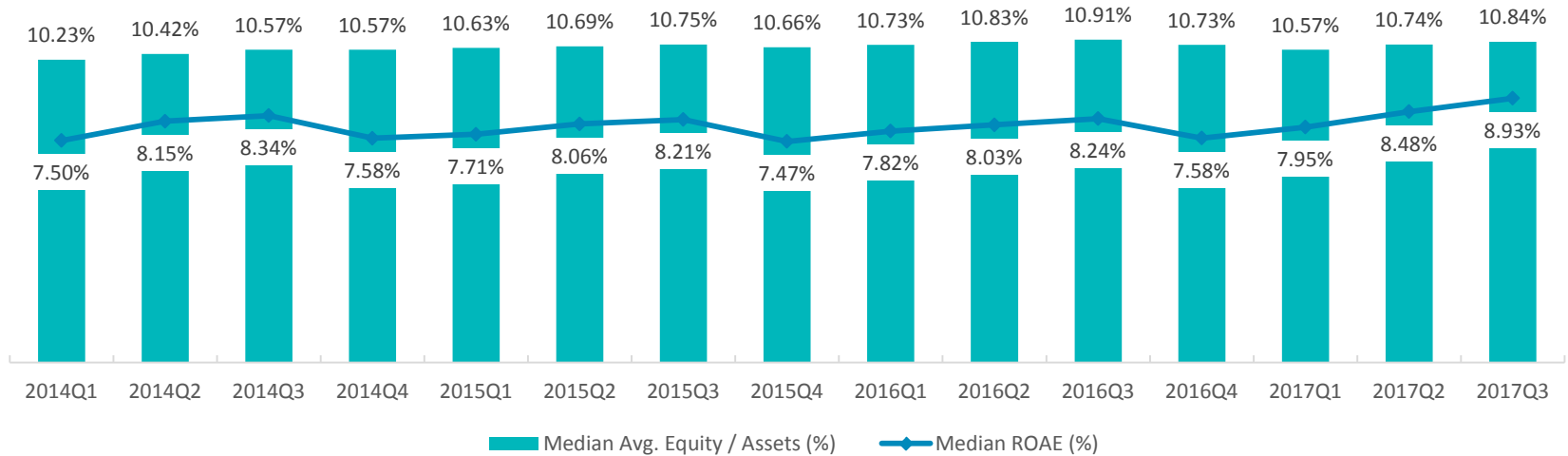
- Directors have no absolute legal duty to:
 - Explore a proposal to buy the bank,
 - Meet with, discuss or negotiate a bid, or
 - Submit a bid to shareholders, even if the bid is a premium to market.
- Federal Credit Union directors owe a fiduciary duty to their members.

- Decision to “just say no” is a fiduciary decision. It must be:
 - Well informed
 - Based on strategic plan
 - Supported by projections
- Key to strategic plan:
 - Plan should consider short- and long-term interests
 - Analyze the data (historical and prospective)
 - True road map for asset growth based on reasonable assumptions
 - Risk appetite
 - Subchapter S
 - High stock price/value is best takeover defense
 - Assistance from investment banker?

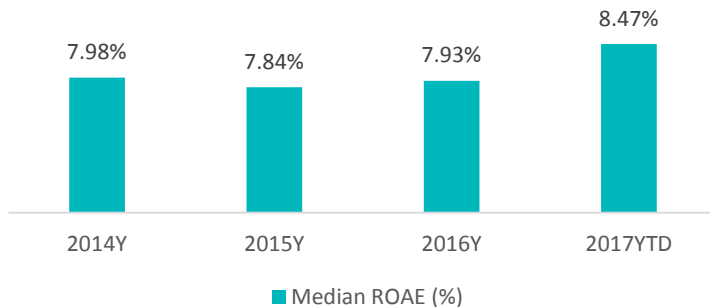
- Key for independence is growth in earnings
 - Evaluate quality of earnings growth
 - Get behind the “noise”
 - Consider one-trick ponies – fee income, cost savings, etc.

Community Bank Return on Average Equity

Quarterly ROAE (%)



Yearly ROAE (%)



• Median values are derived from a nationwide population of regulated depositories with total assets under \$10.0B in the respective time period shown

– As of Q3'17, there are 5,387 regulated depositories with assets under \$10.0B

Source: SNL Financial

Top Tier Consolidated Bank Holding Companies, Savings & Loan Holding Companies, Commercial Banks, Savings Banks, and Savings & Loan Associations with Total Assets < \$10.0B in the respective time period shown

New Expectations for Bank Performance

- Maybe 8% core ROAE in this interest rate/economic environment is enough?
- Between 1991 and 2006, ROEs exceeded the inflation rate by 10% on average (even with the uptick in 2017, it was less than 7% for 2013-2017)

What to do?

- Nothing – we already chin the bar on 8% ROAE
- Nothing – when we clean up our problems, we will chin the bar
- Nothing – we are Subchapter S and we are clipping our coupons
- Take action to invest in the future because we are not generating an 8% ROAE

**Once the Decision has Been Made to Sell:
What is the Process?**

What do/should sellers do to prepare for sale?

- Consider time horizon
 - 1, 2 and 3 year steps, e.g., stock buybacks; ESOPs
- Employee agreements, severance, etc.
 - What is in place gets paid
- Run 280(g) calculations
- Facilitate exercise of stock options and warrants
- Address Articles and Bylaws
 - Indemnification
 - Exculpation
- If Subchapter S, confirm no inadvertent ownership issues

- “Fatten the hen”
- “Clean the cupboard”:
 - Clean up credit files and identify and work problem loans
 - Sell OREO
 - Manage portfolio to avoid risk
- Avoid capital investments and branching
- Address overstaffing
- Address compliance issues: Cole Taylor, Investors and Hudson City situations
- Address director confidentiality
- Care in selecting investment bankers
- NCUA has proposed full insider benefit disclosure and member-to-member communication

- Establish a special committee?
- Hire an investment banker?
- Hire counsel
- Negotiate with limited group of prospective bidders or auction?
- Nondisclosure agreement
- Merger consideration composition and valuation
- Expression of interest or letter of intent
- Due diligence
- Consider a credit union

Benefits for the seller:

- Sets pricing expectation at outset
- Enhances compliance with diligence
- Fiduciary duty: valuation before marketing
- Increases pricing
- Expertise in selling process
- Negotiates all economic terms – not just price
- Preserves confidentiality
- Provides fairness opinion

How to Pick an Investment Banker

- Negotiate investment banker agreements
- Insist on valuation before marketing effort
- Structure pricing to align investment banker compensation with seller's interests

For potential sellers:

- Existing management/KSOP/community
- MOE – understand role of investment banker
- One-on-one negotiations
- Limited “auction”
- Full auction
- Pre-qualify buyers to confirm they have obtained “green light” from regulators and specifically:
 - Sufficient pro forma capital to “write the check”
 - Asset quality ratios are consistent with approval
 - No outstanding compliance issues

- Why M&A?
 - Liquidity pressures have returned – 1/3 of banks >90% LTD ratio
 - Concentration ratio limits are leading search for diversification
 - Cost of funds has dropped to the bottom
 - Cost cutting, including simplifying operations/rationalizing branch networks, has reached its limit
 - Easing standards to grow echoes 2005/2006 activity
 - Compliance, IT and employee costs continue to climb
 - Headwinds from interest rate environment, anemic loan growth and competition continue
 - Focus has shifted to growth
 - Legacy asset issues are no longer the fundamental concern for buyers
 - M&A offers a way to use cost savings to grow eps on a risk-adjusted basis

What purchasers should do to prepare for acquisition?

- Evaluate alternatives
 - Stock repurchases
 - Branching (de novo or P&A)
 - Organic growth
 - “Lift outs”
 - Mortgage, leasing, factoring, consumer and SBA

- Strategic plan/M&A roadmap – rural rollup, fill in and adjacent markets, stock buyer, etc.
- Look for strategic fit – TMobile: Dwyane Wade/Barkley Fave Five
- Capital plan
- Is your house “clean”?
 - Asset quality
 - Pro forma capital and concentration ratios
 - Compliance/BSA
- Consider the bank’s “compensation stack”
- Conducive culture
- Does the bank’s name travel?
- Regulatory buy-in even if current administrative action
- Address compliance issues
- Executive planning sessions/team buy-in
- Team in place, especially diligence and integration
- Free up talent for evaluations
- Stock authorized?
- Consider a financial advisor to assist in evaluations
- NDAs may lay dormant like shingles

Identifying a Buyer's Dance Partner(s)

For potential buyers:

- Overleveraged holding companies
- Problem bank list
- Compliance issues
- MOE/stock candidates
- Branches
- Consider a credit union?

- Not by investment banker: face-to-face
- Avoid buyer arrogance
- Social issues
 - Role of seller's management
 - Role of seller's directors
- Show them your homework*
- Stock – why stock?

* John Allison, former Chairman and CEO of BB&T, would share BB&T's "analysis of the economics of the merger from both our and their perspective and how we arrived at the price we were willing to offer."

- Return as compared to stand-alone yields
- Book value dilution recapture (assume accretive to earnings)
- Time period to recoup book value on dilution
- Adequate pro forma capital and AS ratios
- Purchase accounting marks
- Target compliance issues

- Unwillingness to take any asset risk
- Underwater bond portfolios
- Maturities of loans and deposit – extrapolating into the future
- 34% of banks are Subchapter S – tax benefits/inadvertent termination
- “Adjusted shareholders’ equity”
- Blanket bond
- Bonus/retention pool/agreements
- Cost savings vs. needed investments
- Vender contracts – understanding expense cutting

- Acquisition of Illini Corp. by United Community Bancorp, Inc. - \$70/share: \$30,879,000 merger consideration
- Terminating merger with Hometown Community Bancorp, Inc. - \$64/share: \$28,230,000 merger consideration
- \$850,000 termination fee

- Well-thought-out internal and external PR and outreach
- Written integration plan
- Functioning integration committees
- Change management plan for target/culture
- Systems conversion should not “wag the dog”

- Decide on strategic direction – goal for ROE
- Prepare to buy/prepare to sell
- Identify dance partners
- Understand the motivations of dance partners
- Recognize the issues relating to deal structure

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