

July 1, 2013



***A Rational Approach to Maximizing Stakeholder
Value At the Strange Intersection of Community
Banking and Corporate Bankruptcy***

HoldCo Advisors, L.P.

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1. The Story

Org Chart - back in 2008

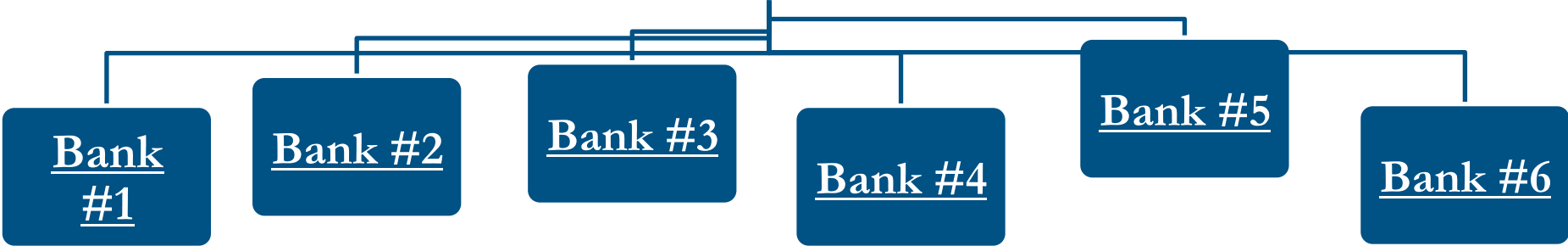
- Back in 2009, Mercantile Bancorp, Inc. (“MBI”) owned 6 banks totaling almost \$2 billion in assets and >\$100mm in equity

MBI

Assets: (1) 100% of the equity in 6 banks totaling ~\$200 million of book value

Liabilities: (1) Approximately \$25mm of senior loans and (2) approximately \$60mm of trust preferred securities

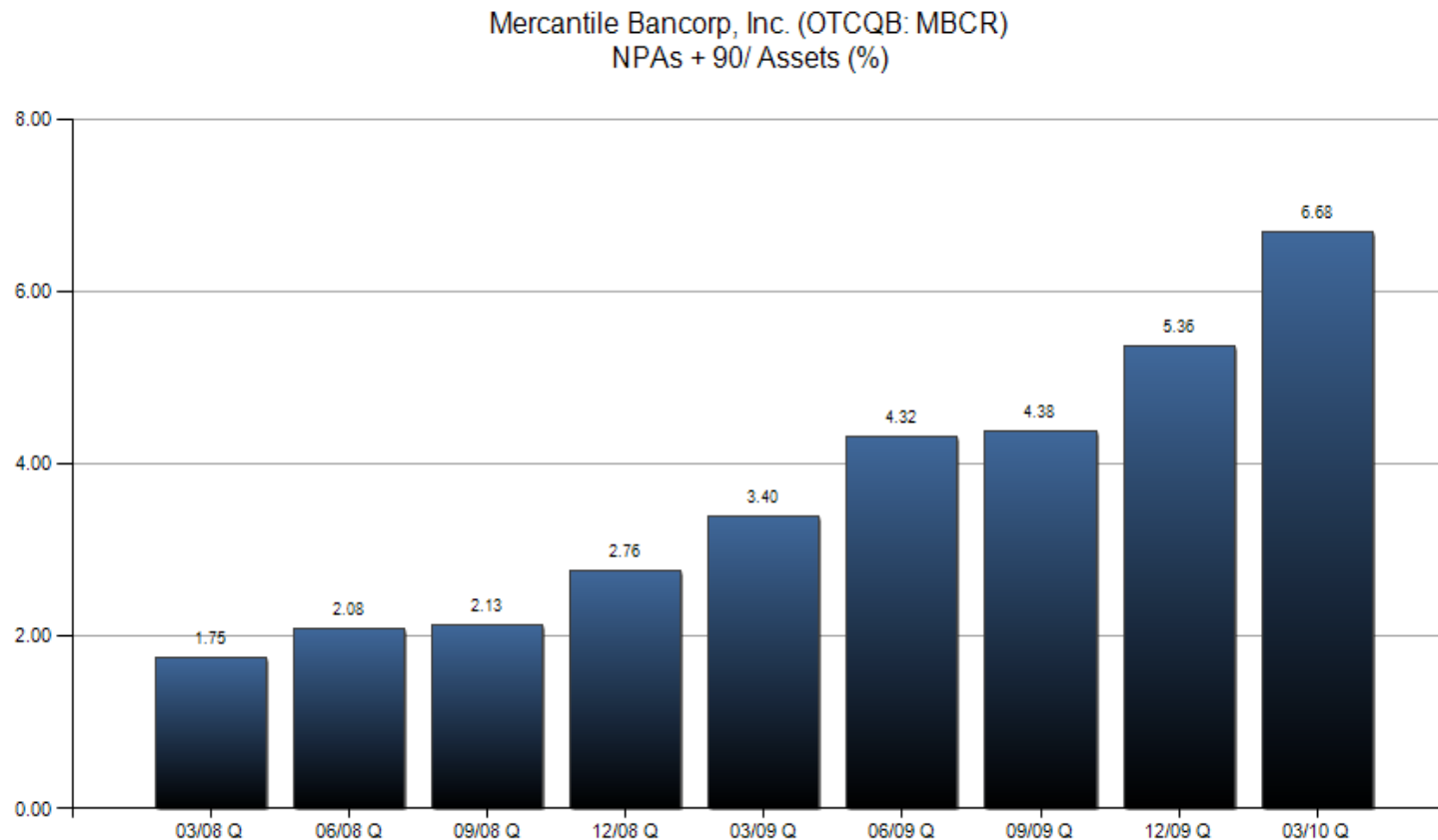
Equity: ~>\$100mm of book value



Note: from regulatory filings

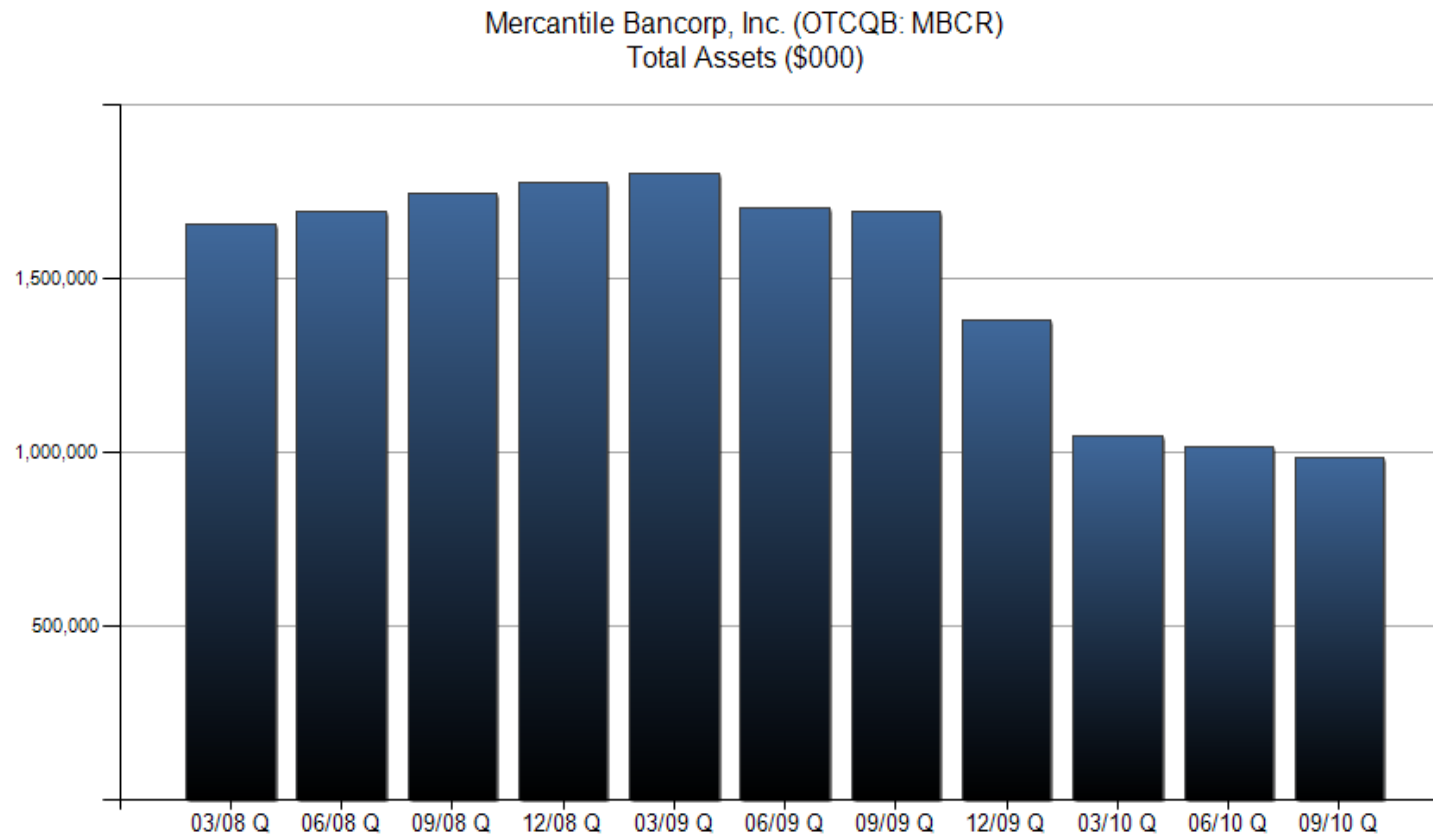
But then the financial crisis happened...

- As financial assets deteriorated, some of MBI's of these banks got into trouble and non-performing loans skyrocketed...



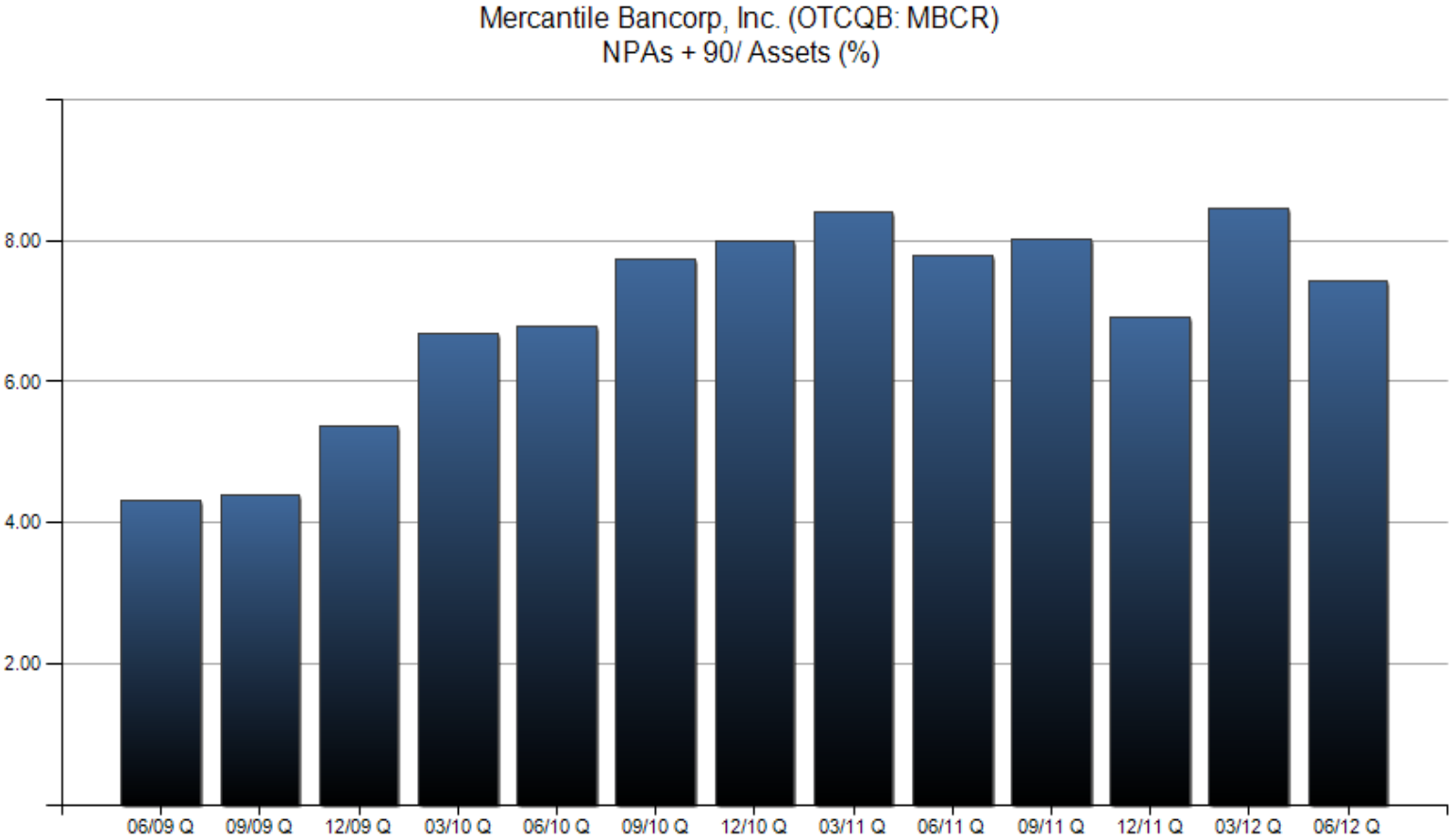
And the company moved to deleverage...

- Unable to raise capital, and with a dwindling equity base supporting its large asset base, MBI had no choice but to sell off 3 of its banks in early 2010 and begin the “shrinking game”



But it was not enough...

- Still, NPAs continued to rise as MBI's three remaining banks continued to suffer...

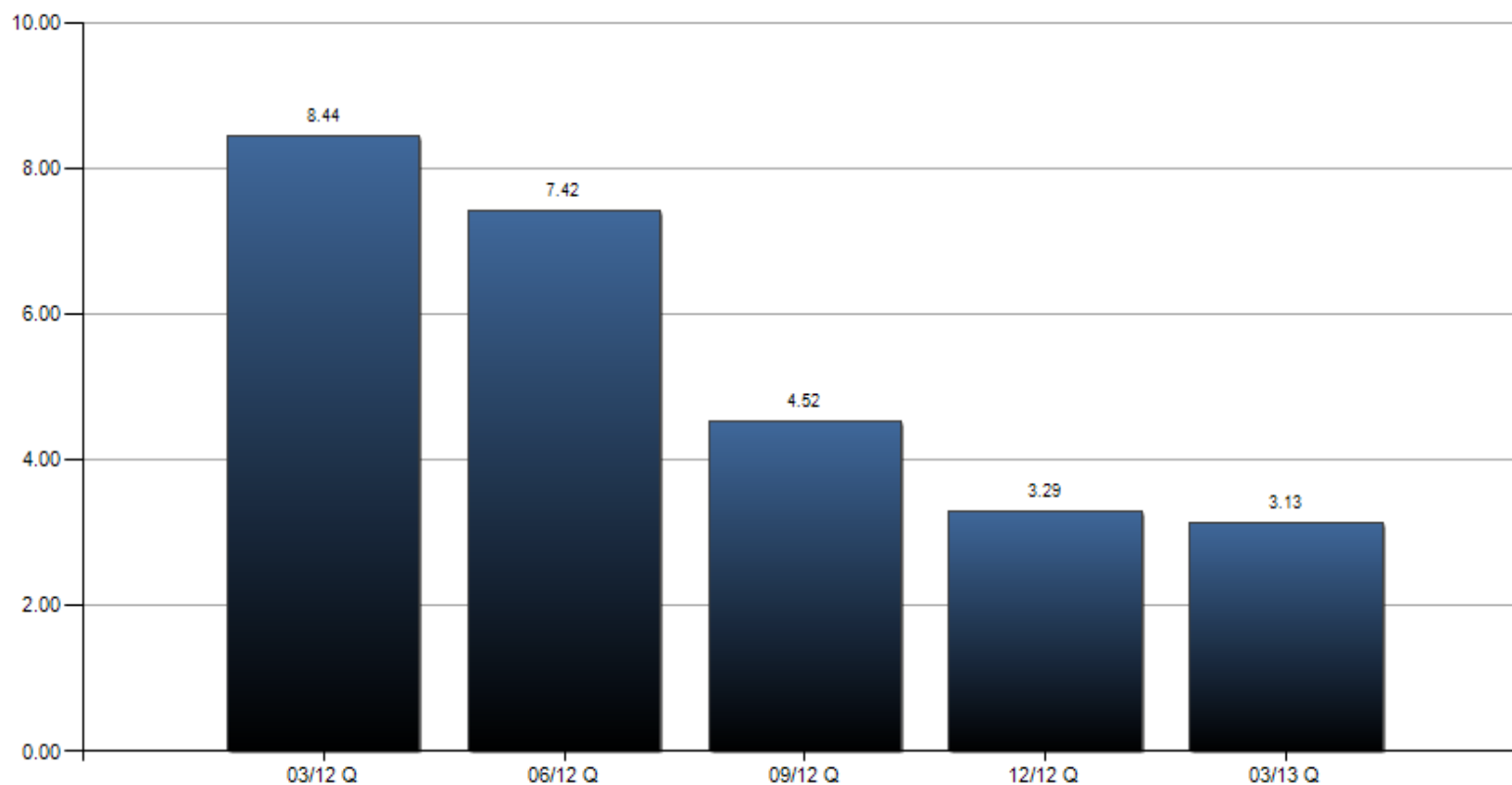


Until Suddenly Something Dramatic Occurred...

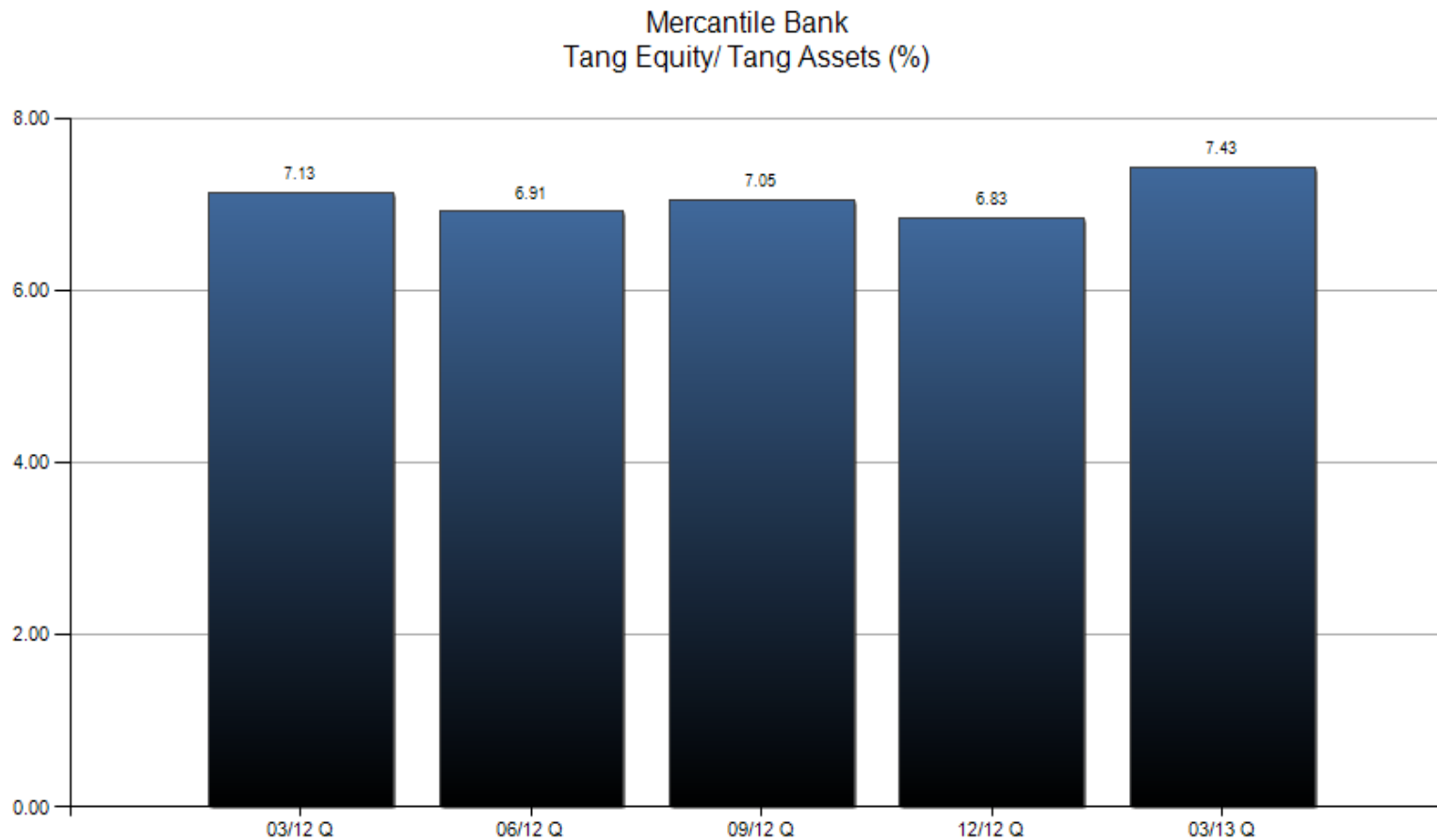
- Two of the three remaining bank subsidiaries were seized in July 2012, with the FDIC seemingly taking a significant estimated hit on behalf of the deposit fund
- In so doing, the FDIC estimated future combined losses of approximately \$16.6 million to the Deposit Insurance Fund:
- **FAILURE #1:** “The FDIC and Metcalf Bank entered into a loss-share transaction on \$54.3 million of Heartland Bank's assets. Metcalf Bank will share in the losses on the asset pools covered under the loss-share agreement...**The FDIC estimates that the cost to the Deposit Insurance Fund (DIF) will be \$3.1 million.**” (FDIC Press Release, July 2012)
- **FAILURE #2:** “To protect the depositors, the FDIC entered into a purchase and assumption agreement with First National Bank of the Gulf Coast, Naples, Florida, to assume all of the deposits of The Royal Palm Bank of Florida....**The FDIC estimates that the cost to the Deposit Insurance Fund (DIF) will be \$13.5 million.**” (FDIC Press Release, July 2012)

And with the bad banks gone, all of a sudden asset metrics looked good again...

Mercantile Bancorp, Inc. (OTCQB: MBCR)
NPAs + 90/ Assets (%)



and the subsidiary capital ratios looked good again!



and just when it seemed that a simple holding company restructuring would do the trick...

MBI PARENT COMPANY

Right size ~\$70 million of outstanding trust preferred securities through bankruptcy or out-of-court tender and all of your problems are solved!!!



Mercantile Bank

Healthy and sound!

the FDIC said “not so fast”

- 12 USCS 1815 is a law that states, in part:
 - “Any insured depository institution shall be liable for any loss incurred by the Corporation, or any loss which the Corporation reasonably anticipates incurring...in connection with (i) the default of a commonly controlled insured depository institution...”
 - **Meaning Mercantile Bank is liable for whatever losses the FDIC “anticipates” it will incur?**
 - “the Corporation...shall on a case-by-case basis, establish the procedures and schedule under which any insured depository institution shall reimburse the Corporation for such institution’s liability under paragraph (1)...or require any insured deposit institution to make immediate payment of the amount of such institution’s liability under paragraph (1)”
 - **Meaning the FDIC has the right to assess such liability immediately?**
 - “If the amount of compensation estimated by and paid to the Corporation by 1 or more such commonly controlled depository institutions is greater than the actual loss incurred by the Corporation, the Corporation shall reimburse each such commonly controlled depository institution its pro rata share of any overpayment.”
 - **Meaning that if the FDIC over-assesses the liability, Mercantile Bank is at least allowed to recoup the difference eventually?**

and we are left with a two box org chart that is not so simple after all...

MBI

Assets: (1) 822,000 cash on hand; equity in Mercantile Bank (book value of ~\$29mm); (2) \$159,738 of “miscellaneous assets”; (3) undisclosed “non-majority” ownership stake in Midwest Independent Bancshares; and (4) a significant deferred tax asset (“DTA”)

Liabilities: \$60mm of trust preferred securities with deferred accrued interest of ~\$14mm coming due in June 2014

Equity: market capitalization of approximately \$600,000 as of 6/28/2013 (negative book equity)



Mercantile Bank

Assets: ~\$386mm of tangible assets (including loans, cash, securities, PP&E, and OREO)

Liabilities: (1) ~\$358mm of liabilities including deposits, repos, and other borrowings;

(2) EDIC cross-guarantee liability for the 2 bank failures? (amount unknown)

Equity: book value of approximately \$29 million wholly owned by the parent

Note: parent company cash on hand, “miscellaneous assets”, and undisclosed stake in Midwest Independent Bancshares was stated in the first day bankruptcy CEO declaration; bank balance sheet information from 3/31 regulatory filings.

2. The Process

Case Summary

- **Petition Date:** 6/27/13
- **Type:** Chapter 11
- **Venue:** Delaware
- **Judge:** Carey
- **Subsidiary Mercantile Bank:** Non-Debtor (did not file bankruptcy)
- **Debtor's Attorneys:** DLA Piper
- **Debtor's Financial Advisor:** Hovde Financial
- **Assets and Liabilities:** See page 14
- **First Day Motions:** (1) Bidding procedures for a proposed sale under section 363 of the bankruptcy code ("363 sale") to United Community Bancorp, Inc. and (2) standard cash collateral motion

The 363 Sale: Non-Price Issues

- Timeline: Proposed procedures contemplate auction process conclusion within 50 days from the petition date (August 16th, 2013)
 - Seems too fast for an auction of a bank
- However, purchaser appears to have 5 months (until December 1, 2013) to achieve necessary regulatory approvals
 - Seems too long to wait for certainty that the purchaser is going to close the deal
- Break-up fee is approximately \$1mm (\$668k plus up to \$250k purchaser expenses)
 - Very high compared to the expected payment received by MBI (see next page)
- Purchaser obligated to purchase tail insurance from D&O's costing up to \$400k, and D&Os named as third party beneficiaries to such provision in the contract
 - An extremely strange condition particularly because the creditors are not even named as third party beneficiaries to the contract
- Broker getting paid \$700k
 - Extremely high compared to the expected payment received by MBI (see next page)
- DLA Piper is debtor's attorney and is tasked with mitigating the FDIC's potential cross-guarantee claim
 - DLA Piper is the FDIC's preferred counsel when they battle against bank holding companies (WaMu, First Federal, Colonial, etc), creating what appears to be a potential conflict of interest here

The 363 Sale: What is the Real Purchase Price?

- Based on HoldCo Advisors estimates, the parent company is receiving somewhere between **\$0 and \$5mm** for the sale of the bank – **in light of this, doesn't the break-up fee and broker fees seem way too high?**

Purchase Price Formula

	Low	Medium	High	Note
Starting amount	\$ 22,277,000	\$ 22,277,000	\$ 22,277,000	From purchase agreement
minus: amount owed to financial advisor (Hovde Financial)	(700,000)	(700,000)	(700,000)	Exhibit B to the purchase agreement
minus: difference in closing book vs "target book"	(1,000,000)	(500,000)	-	"Target book" is \$28mm and book is now about \$29mm
minus: payment to FDIC for cross-guarantee	(23,000,000)	(19,800,000)	(16,600,000)	See next page on cross-guarantee liability
minus: amounts over \$400k for D&O insurance	(100,000)	-	-	Hard to predict what D&O tail insurance will cost
Amount payable to MBI	\$ -	\$ 1,277,000	\$ 4,977,000	
plus: cash at holding company	822,000	822,000	822,000	
plus: miscellaneous holding co assets	159,738	159,738	159,738	
plus unknown stake in Midwest Independent	-	480,000	960,000	Assume 0-2% of \$48mm book value at 1x book value
minus: DLA Piper and other debtor fees	(1,000,000)	(750,000)	(500,000)	DLA is an expensive law firm even for a short 363 sale
Amount recovered by holding company stakeholders	\$ (18,262)	\$ 1,988,738	\$ 6,418,738	

Recovery to TRUPs (% of face) if no priority claims	0%	3%	11%
Recovery to common if no priority claims ahead of TRUPs	0%	0%	0%

Note: HoldCo Advisors estimates; not to be relied on

Understanding the FDIC Cross-Guaranty Liability

- Understanding the FDIC cross guarantee liability discussed on page 13 (pursuant to 12USCS 1815) is crucial because it literally is taken dollar for dollar out of the recovery received by MBI creditors
 - Parent recovery is reduced by “all amounts that are due and owing by the Bank to the FDIC pursuant to 12 USC 1815(e) with respect to the cross-guaranty liability attributable to Heartland Bank or the Royal Palm Bank of Florida”
- As mentioned earlier, such liability is for losses on commonly controlled banks that the FDIC “reasonably anticipates incurring”
- What is this figure? It is undisclosed, but clues exist:
 - We have begun reviewing the P&A agreements for the failures of the Royal Palm and Heartland banks and are unsure whether the FDIC has yet lost money, but other information makes clear that it “reasonably anticipates” incurring significant losses
 - As discussed on page 13, the FDIC estimated in its closure press releases a combined loss of **\$16.6 million**
 - Even worse, however, in Section 3.11 of the Disclosure Schedule to the purchase agreement, the Company states that “Verbally, the FDIC has recently indicated the claim may be in an amount of **\$23 million**” – **this would wipe out any debtor recoveries!**

- **What is most disturbing about the above is that if ultimately the FDIC loses less than the amount that it assesses, it appears that the holding company will NOT receive a refund for such excess**
- **Even worse, the language of 12USCS 1815 (quoted on page 13) indicates that the bank (and therefore the purchaser of the bank) would likely receive a refund of such deficiency when it is ultimately known, resulting in a windfall to the purchaser**
- **Thus, it is both in the FDIC and the purchaser’s interest to overstate the cross-guarantee liability**

3. Our Proposed Solution

What is the Problem With the Current Proposal?

- An estimated \$0-5mm purchase price (see page 18)
 - Those are very low figures resulting in a 1% to 11% recovery to the TRUPs
 - Compare that to \$1mm break-up fee and \$700,000 broker fee

- The strong possibility that the Debtor is receiving \$16-20mm less than it should and the purchaser is receiving future \$16-20mm windfall if the two FDIC bank failures don't ultimately lose anything or lose less than expected
 - See page 19

- Holding company directors appear to be signing off on a deal that stands to primarily benefit the FDIC and the purchaser (neither of whom are bank holding company creditors) and injuring holding company stakeholders to whom they owe fiduciary duties
 - In return, they are getting releases from the FDIC and the holding company, and a brand new \$400,000 tail insurance policy: **seems highly improper**

Easy to criticize, but what's the solution?

- We think there is a relatively simple solution and it does **NOT** involve a purchaser
- The fact of the matter is that Mercantile Bank is healthy and does not need capital
 - Given this, there is **ABSOLUTELY NO RHYME OR REASON** to urgently sell a regulated financial institution in a self-imposed, extremely quick 50-day bankruptcy auction process fraught with high broker fees, high break-up fees, high lawyer fees (DLA Piper's fee practices have been the subject of recent news articles), and perverse incentives surrounding the FDIC cross-guarantee claim; all to a purchaser **THAT MAY NEVER RECEIVE REGULATORY APPROVAL!**

- So what is the solution?
- A bankruptcy reorganization plan which divvies up the company between the FDIC and holding company creditors and does not raise a cent of capital!
- Besides avoiding a firesale of a bank (the worst possible asset to firesale) with prohibitive break-up fees, avoiding outsized costs, and keeping it simple, are there any other benefits? The answer is yes: **THE PRESERVATION OF A MASSIVE DEFERRED TAX ASSET**

\$28 million of free money? – well thank you, IRS...

- §382(l)(5) in the tax code that permits a company to retain and use, subject to adjustment but **without annual limitations**, its deferred tax asset so long as pursuant to a bankruptcy plan the current stakeholders maintain at least 50% or more of the reorganized equity upon emergence from bankruptcy and provided that holders of the credit have held such securities for either 18 months or since issuance.

		<u>Note</u>
DTA as of 9/2011	40,000,000	From 10Q
Divided by assumed 35% rate	114,285,714	
plus: pre-tax losses 9/11 - present	25,000,000	From regulatory filings
NOLs as of today	139,285,714	
minus: tolling charge	(10,000,000)	3 years of interest on debt
minus: CODI (assumed \$15mm plan value)	(49,000,000)	\$74mm accrued minus tolling charge minus \$15mm plan value
NOLs available under a 382L5 plan	80,285,714	
multiplied by: 35% assumed rate	35%	
<u>DTA available post 382L5 plan effective date</u>	<u>\$28,100,000</u>	

Note: HoldCo Advisors estimates; not to be relied on

Not really \$28 million...but still pretty valuable

- Based on the prior slide, it appears that the company may (net of adjustments relating to 382L5) be able to structure a plan that saves \$28 million of future taxes
- **But what is that really worth?**
- Let's use some very non-heroic assumptions:
 - The bank generates after-tax 8% ROE on about \$30mm of book value
 - The bank pays a 35% tax rate
 - The bank doesn't pay dividends and reinvests its profits
- The result?
 - The bank saves about \$28 million of taxes over 11 years

■ Discounting that back by 10%, 12%, and 15% respectively yields a present value of \$14 million, \$13 million, and \$11 million

So what's the catch?

- The catch is that existing stakeholders (including TRUPs that we assume are qualified creditors) need to own at least 51% of the company's post-reorganized equity
 - That sounds pretty simple, actually
- Well there's one more catch...we're going to need the FDIC to agree to take equity in lieu of their cross guarantee liability
 - We need to convince the FDIC to take equity?

DEBTOR AND FDIC, LET'S DO A DEAL

- Abandon this fatally flawed 363 deal
- Put forth a plan where existing debtor stakeholders (TRUPs/equity) get 51% of the new common stock and the FDIC receives 49% of the common stock in return for a release of its cross-guarantee claim
- Appoint a new management team acceptable to the real stakeholders!

And the math works!

- If you give 49.9% of the company to the FDIC, they get present value of between \$16 million and \$24 million that compounds at 8-10% a year!
 - If you want to give them more, you can give them preferred stock on top of it
- Parent company stakeholders get \$16mm to \$24mm (compare to \$0-\$6mm on pg 18)

	<u>Low</u>	<u>Mid</u>	<u>High</u>	<u>Note</u>
Present Value of bank	22,000,000	27,000,000	33,000,000	Low is current price; mid is 0.9x book; high is 1.1x book
Present Value of NOL	11,000,000	13,000,000	14,400,000	Assumes 8% ROE; low assumes 15% discount rate, mid 12%, high 10%
plus: cash at holding company	822,000	822,000	822,000	Same assumptions as page 18
plus: miscellaneous holding co assets	159,738	159,738	159,738	Same assumptions as page 18
plus unknown stake in Midwest Independent	-	480,000	960,000	Same assumptions as page 18
minus: DLA Piper and other debtor fees	(1,000,000)	(750,000)	(500,000)	Same assumptions as page 18
Total Present Value to Stakeholders	32,981,738	40,711,738	48,841,738	

Value to FDIC	16,457,887	20,355,869	24,420,869	Assumes FDIC receives 49.9% of reorganized debtor
Value to debtor creditors/equity	16,523,851	20,396,581	24,469,711	Assumes parent stakeholders receive 50.1% of reorganized debtor

Assuming FDIC cross-guarantee liability of even \$23mm (maximum estimate):

Value to FDIC	23,000,000	23,000,000	24,420,869	Assumes FDIC receives 49.9% of common and gap-filling preferred stock
Value to debtor creditors/equity	9,981,738	17,752,450	24,469,711	Assumes parent stakeholders receive 50.1% of reorganized debtor