

AVIS BUDGET GROUP, INC.

Form 10-Q

August 08, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2011

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File No. 1-10308

Avis Budget Group, Inc.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

06-0918165
(I.R.S. Employer
Identification Number)

6 Sylvan Way

Parsippany, NJ
(Address of principal executive offices)

07054
(Zip Code)

(973) 496-4700
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares outstanding of the issuer's common stock was 105,022,453 shares as of July 29, 2011.

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FORWARD-LOOKING STATEMENTS

The forward-looking statements contained herein are subject to known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. These forward-looking statements are based on various facts and were derived utilizing numerous important assumptions and other important factors that could cause actual results to differ materially from those in the forward-looking statements. Forward-looking statements include the information concerning our future financial performance, business strategy, projected plans and objectives. Statements preceded by, followed by or that otherwise include the words believes, expects, anticipates, intends, projects, estimates, plans, may increase, may fluctuate and similar expressions or future or conditional verbs such as will, should, would, may are generally forward-looking in nature and not historical facts. You should understand that the following important factors and assumptions could affect our future results and could cause actual results to differ materially from those expressed in such forward-looking statements:

the high level of competition in the vehicle rental industry and the impact such competition may have on pricing and rental volume;

an increase in our fleet costs as a result of an increase in the cost of new vehicles, disruption in the supply of new vehicles, and/or a decrease in the price at which we dispose of used vehicles either in the used vehicle market or under repurchase or guaranteed depreciation programs;

the results of operations or financial condition of the manufacturers of our cars, which could impact their ability to perform their payment obligations under the agreements we have with them, including repurchase and/or guaranteed depreciation arrangements, and/or their willingness or ability to make cars available to us or the rental car industry as a whole on commercially reasonable terms or at all;

any reduction in travel demand, including any reduction in airline passenger traffic;

any weakness in economic conditions generally, including in the housing market, particularly during our peak season or in key market segments;

our ability to continue to achieve and maintain cost savings and successfully implement our business strategies;

our ability to obtain financing for our operations, including the funding of our vehicle fleet via the asset-backed securities and lending market consistent with current costs, and the financial condition of financial-guaranty firms that have insured a portion of our outstanding vehicle-backed debt;

an occurrence or threat of terrorism, pandemic disease, natural disasters or military conflict in the locations in which we operate;

our dependence on third-party distribution channels, third-party suppliers of other services and co-marketing arrangements with third parties;

our ability to utilize derivative instruments, and the impact of derivative instruments we currently utilize, which can be affected by fluctuations in interest rates, gasoline prices and exchange rates, changes in government regulations and other factors;

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our ability to accurately estimate our future results;

a major disruption in our communication networks or information systems;

our exposure to uninsured claims in excess of historical levels;

our failure or inability to comply with regulations or contractual obligations or any changes in regulations or contractual obligations, including with respect to personally identifiable information;

any impact on us from the actions of our licensees, dealers and independent contractors;

substantial increases in the cost, or decreases in the supply, of fuel, vehicle parts, energy, labor or other resources on which we depend to operate our business;

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risks related to our indebtedness, including our substantial amount of debt and our ability to incur substantially more debt;

our ability to meet the financial and other covenants contained in the agreements governing our indebtedness;

the terms of agreements among us and our former real estate, hospitality and travel distribution businesses following the separation of those businesses from us during third quarter 2006, particularly with respect to the allocation of assets and liabilities, including contingent liabilities and guarantees, the ability of each of the separated companies to perform its obligations, including its indemnification obligations, under these agreements, and the former real estate business' right to control the process for resolving disputes related to contingent liabilities and assets;

risks associated with litigation involving the Company;

risks related to tax obligations;

the effect of future changes in accounting standards;

risks related to our recently announced agreement to acquire Avis Europe plc (Avis Europe), including our ability and the timing to complete such acquisition, the expected incurrence of incremental indebtedness, our ability to complete, and the terms and timing of, any financing, our ability and the timing to obtain required regulatory approvals, and our ability to realize the synergies contemplated by the transaction and to promptly and effectively integrate the businesses of Avis Europe and Avis Budget Group;

risks related to the potential acquisition of Dollar Thrifty Automotive Group, Inc. (Dollar Thrifty), including the timing to consummate such acquisition, the ability and timing to obtain required regulatory approvals and financing (and any conditions thereto), the expected incurrence of incremental indebtedness to help fund the acquisition, our ability to promptly and effectively integrate the businesses of Dollar Thrifty and Avis Budget Group, and the impact of pending or future litigation relating to any potential acquisition; and

other business, economic, competitive, governmental, regulatory, political or technological factors affecting our operations, pricing or services.

Other factors and assumptions not identified above, including those described under Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2010 Annual Report on Form 10-K were also involved in the derivation of these forward-looking statements, and the failure of such other assumptions to be realized, as well as other factors, may also cause actual results to differ materially from those projected. Most of these factors are difficult to predict accurately and are generally beyond our control.

You should consider the areas of risk described above, as well as those described under Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2010 Annual Report on Form 10-K and those that may be disclosed from time to time in filings with the Securities and Exchange Commission, in connection with any forward-looking statements that may be made by us and our businesses generally. Except to the extent of our obligations under the federal securities laws, we undertake no obligation to release any revisions to any forward-looking statements, to report events or to report the occurrence of unanticipated events. For any forward-looking statements contained in any document, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Avis Budget Group, Inc.****CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

(In millions, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2011	2010	2011	2010
Revenues				
Vehicle rental	\$ 1,034	\$ 961	\$ 1,952	\$ 1,827
Other	378	333	694	619
Net revenues	1,412	1,294	2,646	2,446
Expenses				
Operating	725	639	1,383	1,251
Vehicle depreciation and lease charges, net	259	339	535	636
Selling, general and administrative	169	143	322	274
Vehicle interest, net	68	76	132	150
Non-vehicle related depreciation and amortization	21	23	44	46
Interest expense related to corporate debt, net				
Interest expense	47	41	94	81
Early extinguishment of debt				40
Transaction-related costs	34	2	36	2
Restructuring charges		2		3
Total expenses	1,323	1,265	2,546	2,483
Income (loss) before income taxes	89	29	100	(37)
Provision for (benefit from) income taxes	37	3	41	(25)
Net income (loss)	\$ 52	\$ 26	\$ 59	\$ (12)
Earnings (loss) per share				
Basic	\$ 0.49	\$ 0.25	\$ 0.56	\$ (0.12)
Diluted	\$ 0.42	\$ 0.22	\$ 0.49	\$ (0.12)

See Notes to Consolidated Condensed Financial Statements (Unaudited).

Table of Contents**Avis Budget Group, Inc.****CONSOLIDATED CONDENSED BALANCE SHEETS****(In millions, except share data)****(Unaudited)**

	June 30, 2011	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 645	\$ 911
Restricted cash	406	10
Receivables	417	315
Deferred income taxes	132	130
Other current assets	306	272
Total current assets	1,906	1,638
Property and equipment, net	405	425
Deferred income taxes	639	587
Goodwill	76	76
Other intangibles, net	484	481
Other non-current assets	275	255
Total assets exclusive of assets under vehicle programs	3,785	3,462
Assets under vehicle programs:		
Program cash	76	4
Vehicles, net	8,185	6,422
Receivables from vehicle manufacturers and other	79	149
Investment in Avis Budget Rental Car Funding (AESOP) LLC related party	316	290
	8,656	6,865
Total assets	\$ 12,441	\$ 10,327

**Liabilities and
stockholders
equity**

Current liabilities:		
Accounts payable and other current liabilities	\$	1,006 \$ 925
Current portion of long-term debt		6 8
Total current liabilities		1,012 933
Long-term debt		2,492 2,494
Other non-current liabilities		530 535
Total liabilities exclusive of liabilities under vehicle programs		4,034 3,962
Liabilities under vehicle programs:		
Debt		831 528
Debt due to Avis Budget Rental Car Funding (AESOP) LLC related party		5,456 3,987
Deferred income taxes		1,430 1,333
Other		158 107
		7,875 5,955
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, \$.01 par value authorized 10 million shares; none issued and outstanding		
Common stock, \$.01 par value authorized 250 million shares; issued 137,003,237 and 136,982,068 shares		1 1
Additional paid-in capital		8,500 8,828
Accumulated deficit		(2,578) (2,637)
Accumulated other comprehensive		148 92

income

Treasury stock, at cost 31,581,615 and 33,247,139 shares	(5,539)	(5,874)
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Total stockholders equity	532	410
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Total liabilities and stockholders equity \$

Director Attendance at Annual Meetings

Directors are expected to attend the annual meeting of stockholders. In 2011, eight directors attended the annual meeting of stockholders.

Stockholder Proposals

Under our by-laws, certain procedures are provided that a stockholder must follow to introduce an item of business at an annual meeting of stockholders or to nominate persons for election as directors. These procedures provide, generally, that stockholders desiring to bring a proper subject of business before the meeting, or to make nominations for directors, must do so by a written notice received not later than 90 days in advance of the meeting (or if we do not publicly announce our annual meeting date 100 days in advance of the meeting date, by the close of business on the 10th day following the day on which notice of the meeting is mailed to stockholders or publicly made) by our corporate secretary containing the name and address of the stockholder as they appear on our books and the class and number of shares owned by the stockholder. If the notice relates to an item of business it also must include a representation that the stockholder intends to appear in person or by proxy at the meeting. Notice of an item of business shall include a brief description of the proposed business and a description of all arrangements or understandings between the stockholder and any other person or persons (including their names) in connection with the proposal of business by the stockholder and any material interest of the stockholder in the business. If the notice relates to a nomination for director, it must set forth the name and address of any nominee(s), any other information regarding each nominee as would have been required to be included in a proxy statement filed pursuant to the proxy rules of the Securities and Exchange Commission had each nominee been nominated by the board, and the consent of each nominee to be named in the proxy statement and to serve on the board.

The chairman of the meeting may refuse to allow the transaction of any business not presented, or to acknowledge the nomination of any person not made, in compliance with the foregoing procedures. Copies of our by-laws are available from our corporate secretary.

Compensation Committee Interlocks and Insider Participation

During 2011, the compensation committee was comprised of Ms. Himle and Messrs. Berning, Fogarty, and Dr. Smith. None of the members is an executive officer, employee or former employee of our company, and

no interlocking relationship exists between the board or compensation committee and the board of directors or compensation committee of any other company.

Related Person Transaction Approval Policy

On February 28, 2012, our board of directors readopted a written policy for related person transactions, which sets forth our policies and procedures for the review, approval or ratification of transactions subject to the policy with related persons who are subject to the policy. Our policy applies to any transaction, arrangement or relationship or any series of similar transactions, arrangements or relationships that have a financial aspect and in which we are a participant and a related person has a direct or indirect interest. Our policy, however, exempts the following:

our payment of compensation to a related person for that person's service to us in the capacities that give rise to the person's status as a related person;

transactions available to all of our employees or all of our stockholders on the same terms;

any extension of credit by our banking subsidiary in which a related person has a direct or indirect interest and which complies with the requirements of Regulation O under Title 12 of the Code of Federal Regulations and has been approved by either the board of directors of our banking subsidiary or its loan committee; and

transactions, which when aggregated with the amount of all other transactions between the related person and our company, involve less than \$120,000 in a fiscal year.

We consider the following people to be related persons under the policy:

all of our executive officers and directors;

any nominee for director;

any immediate family member of any of our directors, nominees for director or executive officers; and

any holder of more than 5% of our common stock, or an immediate family member of the holder.

The audit committee of our board of directors must approve any related person transaction subject to this policy before commencement of the related party transaction. The committee will analyze the following factors, in addition to any other factors the committee deems appropriate, in determining whether to approve a related party transaction:

whether the terms are fair to our company;

whether the transaction is material to our company;

the role the related person has played in arranging the related person transaction;

the structure of the related person transaction; and

the interests of all related persons in the related person transaction.

The committee may, in its sole discretion, approve or deny any related person transaction. Approval of a related party transaction may be conditioned upon our company and the related person taking any actions that the committees deems appropriate.

If one of our executive officers becomes aware of a related person transaction that has not previously been approved under the policy:

if the transaction is pending or ongoing, it will be submitted to the audit committee promptly and the committee will consider the transaction in light of the standards of approval listed above. Based on this evaluation, the committee will consider all options, including approval, ratification, amendment, denial or termination of the related person transaction; and

if the transaction is completed, the committee will evaluate the transaction in accordance with the same standards to determine whether rescission of the transaction is appropriate and feasible.

There were no related person transactions in 2011 required to be reported in this proxy statement.

Certain Transactions

The bank follows a policy of granting loans to eligible directors, officers, employees and members of their immediate families for the financing of their personal residences and for consumer purposes. As of December 31, 2011, the aggregate amount of the bank's loans to directors, executive officers, affiliates of directors or executive officers, and employees was approximately \$4.0 million or 7.10% of our stockholders' equity. All of these loans were current as of December 31, 2011. For the period beginning January 1, 2011, all of the loans to directors and executive officers (a) were made in the ordinary course of business, (b) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons not related to us or the bank, and (c) did not involve more than the normal risk of collectability or other unfavorable features.

Independent Registered Public Accounting Firm Fees

The following table presents fees for professional audit services rendered by KPMG LLP for the audit of our annual financial statements for 2011 and 2010, and fees for other services rendered by KPMG LLP relating to these fiscal years.

Description of Fees	2011	2010
Audit Fees ^{(1) (2)}	\$ 181,000	\$ 207,000
Audit-Related Fees ⁽³⁾	43,000	45,000
Total Audit and Audit-Related Fees	\$ 224,000	\$ 252,000

(1) Audit fees consisted of the annual audit and quarterly reviews of our consolidated financial statements, statutory audit, audit of internal controls over financial reporting and assistance with and review of documents filed with the Securities and Exchange Commission.

(2) The audit of internal control over financial reporting was not performed in 2011, as it is no longer required due to the decrease in asset size of the bank below \$1 billion and market capitalization of the company being below \$75 million.

(3) Audit-related fees consisted of employee benefit plan audits and audit of compliance with HUD-assisted programs.

Approval of Independent Registered Public Accounting Firm Services and Fees

The audit committee pre-approved 100% of the services provided by KPMG LLP, our independent registered public accounting firm. KPMG provided no other services to the company, other than those noted above.

The audit committee's current practice on pre-approval of services performed by the independent registered public accounting firm is to approve annually all audit services and, on a case-by-case basis, recurring permissible non-audit services to be provided by the independent registered public accounting firm during the fiscal year. The audit committee reviews each non-audit service to be provided and assesses the impact of the service on the registered public accounting firm's independence. In addition, the audit committee may pre-approve other non-audit services during the year on a case-by-case basis. Pursuant to a policy adopted by the audit committee, the chair of the audit committee is authorized to pre-approve certain limited non-audit services described in Section 10A(i)(1)(B) of the Exchange Act. Mr. Nigon, as the chair of the

audit committee, did not pre-approve any non-audit services pursuant to this authority in 2011.

Report of the Audit Committee

The audit committee has (i) reviewed and discussed our audited financial statements for 2011 with our management; (ii) discussed with our independent registered public accounting firm the matters required to be discussed by Statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T, as currently in effect; (iii) received the written disclosures and the letter from our independent registered public accounting firm required by the applicable requirements of the

PCAOB regarding the independent accountant's communications with the audit committee concerning independence; and (iv) has discussed with our independent registered public accounting firm its independence. Based on the review and discussions with management and our independent registered public accounting firm referred to above, the audit committee recommended to the board that the audited financial statements be included in our annual report on Form 10-K for the fiscal year ended December 31, 2011, and filed with the Securities and Exchange Commission.

The Audit Committee

Bernard R. Nigon

Malcolm W. McDonald

Mahlon C. Schneider

SECURITY OWNERSHIP OF MANAGEMENT AND CERTAIN BENEFICIAL OWNERS

The following table sets forth, as of February 28, 2012, the beneficial ownership of: (i) each stockholder known by management to beneficially own more than five percent of the outstanding common stock, (ii) each of the current executive officers listed in our summary compensation table, (iii) each director, and (iv) all directors and executive officers as a group. Unless otherwise indicated, the listed beneficial owner has sole voting power and investment power with respect to the shares of common stock and maintains an address at 1016 Civic Center Drive N.W., Rochester, Minnesota 55901-6057.

Name and Address (if required) of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percentage of Outstanding Shares
United States Department of the Treasury ⁽¹⁾ 1500 Pennsylvania Ave., NW Washington, D.C. 20220	833,333	15.9%
HMN Financial, Inc. Employee Stock Ownership Plan ⁽²⁾	741,443	16.8
Dimensional Fund Advisors LP ⁽³⁾ Palisades West, Building One 6300 Bee Cave Road Austin, TX 78746	351,037	7.9
Tontine Associates, LLC ⁽⁴⁾ 55 Railroad Avenue, 3 rd Floor Greenwich, CT 06830	282,789	6.4
<i>Directors, director nominees and executive officers:</i>		
Allen J. Berning ⁽⁵⁾	10,000	*
Jon J. Eberle ⁽⁶⁾	77,875	1.8
Michael J. Fogarty ⁽⁷⁾	20,500	*
Karen L. Himle ⁽⁸⁾	16,200	*
Dwain C. Jorgensen ⁽⁹⁾	94,604	2.1
Susan K. Kolling ⁽¹⁰⁾	89,790	2.0
Bradley C. Krehbiel ⁽¹¹⁾	111,363	2.5
Malcolm W. McDonald ⁽¹²⁾	21,993	*
Lawrence D. McGraw ⁽¹³⁾	23,000	*
Bernard R. Nigon ⁽¹⁴⁾	5,000	*
Mahlon C. Schneider ⁽¹⁵⁾	3,200	*
Hugh C. Smith ⁽¹⁶⁾	13,600	*
Mark Utz		
All directors, director nominees and executive officers of the company as a group (13 persons) ⁽¹⁷⁾	487,125	10.7

* Less than 1% Owned

(1) Represents shares of common stock covered by a warrant that is currently exercisable. The United States Department of the Treasury has agreed not to exercise any voting rights with respect to shares of our common stock issued under the warrant.

(2) As reported on a Schedule 13G/A dated February 10, 2012, and filed on February 10, 2012. The amount reported represents shares of common stock held by the HMN Financial, Inc. Employee Stock Ownership Plan, known as the ESOP. As reported on a Form 5 dated February 10, 2012, and filed February 10, 2012, 339,991 of the 741,443 shares of common stock beneficially owned by the ESOP have been allocated to accounts of participants. First Bankers Trust Services, Inc., Quincy, Illinois, the trustee of the ESOP, may be deemed to beneficially own the shares of

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common stock held by the ESOP. First Bankers Trust expressly disclaims beneficial ownership of these shares. Participants in the ESOP are entitled to instruct the trustee as to the voting of shares of common stock allocated to their accounts under the ESOP. Unallocated shares or allocated shares for which no voting instructions are received are voted by the trustee in the same proportion as allocated shares for which instructions have been received from participants. The ESOP has sole voting power for 401,452 of the shares it holds, and shared voting power for 339,991 of the shares it holds.

- (3) As reported on a Schedule 13G/A dated February 10, 2012, and filed on February 14, 2012. Dimensional Fund Advisors LP is an investment adviser. The amount reported represents shares of common stock held in various advisory accounts. No account has an interest relating to more than 5% of the outstanding shares of common stock. Dimensional Fund Advisors LP exercises sole dispositive power for 351,037 of the shares it holds and sole voting

power with respect to 348,537 of the shares. In its role as investment advisor, Dimensional Fund Advisors, LP may be deemed to be the beneficial owner of the shares held by it. Dimensional Fund Advisors, LP expressly disclaims beneficial ownership of these shares.

- (4) As reported on a Schedule 13F dated December 31, 2011, which was obtained by a third-party securities ownership tracking service. On a Schedule 13D/A dated May 28, 2003, filed on May 30, 2003, associates of Tontine Associates, LLC reported ownership of 421,729 shares of common stock. Tontine Associates, LLC and its associates have filed no amendments to the Schedule 13D/A dated May 28, 2003.
- (5) Includes 10,000 shares of common stock held jointly with his spouse.
- (6) Includes 53,059 shares of common stock held directly, 11,323 shares of common stock allocated to Mr. Eberle's account under our employee stock ownership plan and 13,493 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (7) Includes 4,500 shares of common stock held in a fiduciary capacity, 1,000 shares of common stock held in a fiduciary capacity jointly with his spouse and 15,000 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (8) Includes 1,200 shares of common stock held directly and 15,000 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (9) Includes 48,150 shares of common stock held directly, 2,150 shares of common stock held by the IRA account of Mr. Jorgensen's spouse, 10,065 shares of common stock under the bank's 401(k) plan, 18,159 shares of common stock allocated to Mr. Jorgensen's account under our employee stock ownership plan and 16,080 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (10) Includes 53,867 shares of common stock held directly, 15,779 shares of common stock allocated to Ms. Kolling's account under our employee stock ownership plan, 7,175 shares of common stock held under the bank's 401(k) plan and 12,969 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (11) Includes 86,257 shares of common stock held directly, 8,724 shares of common stock allocated to Mr. Krehbiel's account under our employee stock ownership plan and 16,382 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.
- (12) Includes 6,993 shares of common stock held directly, of which 2,675 were pledged as collateral security for certain margin securities accounts he maintained at brokerage firms which have since been closed, and 15,000 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012. During our last fiscal year, Mr. McDonald maintained margin securities accounts at brokerage firms and the positions held in such margin accounts, which may from time to time included shares of our common stock, were pledged as collateral security for the repayment of debit balances, if any, in the accounts. At February 28, 2012, there were no outstanding debit balances in any of these accounts and, as of February 29, 2012, he closed all his margin securities accounts.
- (13) Includes 31,750 shares of common stock held directly and 272 shares of common stock allocated to Mr. McGraw's account under our employee stock ownership plan.
- (14) Includes 5,000 shares of common stock held directly.

- (15) Includes 3,200 shares of common stock held directly.

- (16) Includes 7,600 shares of common stock held directly and 6,000 shares of common stock covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012.

- (17) Includes shares of common stock held directly, as well as shares of common stock held jointly with family members (if these shares are deemed to be beneficially owned by the director or officer), shares of common stock held in retirement accounts, shares of common stock held by these individuals in their accounts under the bank's 401(k) plan, shares of common stock allocated to the ESOP accounts of the group members, shares of common stock held in a fiduciary capacity or by certain family members and shares covered by options that are currently exercisable or exercisable within 60 days of February 28, 2012, with respect to which shares the persons included may be deemed to have sole or shared voting and/or investment power.

2011 DIRECTOR COMPENSATION

All of our directors also serve as directors of our banking subsidiary. During 2011, non-employee members of our board of directors were paid the following cash fees for their services to us and our banking subsidiary:

	Description of Fees			
	Chairman of the Board	Non- employee Directors	Chairman of the Audit Committee	Other Committee Chairs
Monthly fee	\$3,333	\$1,250	-	-
Board meeting attendance fee	\$1,000	\$500	-	-
Audit Committee attendance fee	-	\$500	\$1,500	-
Other board committee attendance fees	-	\$300	-	\$900

Our 2011 schedule for fees payable to non-employee members of our board of directors did not change from our 2010 schedule following the compensation committee's determination that such fees should not be increased between the periods. In accordance with the fee schedule set forth above, our non-employee directors received the following total compensation for 2011 for their service on our board of directors:

Non-Employee Director	Fees Earned or Paid in Cash (\$) ⁽¹⁾	Option Awards (\$) ⁽²⁾	Total (\$)
Allen J. Berning ⁽⁴⁾	17,950	-	17,950
Allan R. DeBoer ⁽³⁾	9,150	-	9,150
Michael J. Fogarty	28,750	-	28,750
Timothy R. Geisler ⁽³⁾	28,583	-	28,583
Karen L. Himle	27,700	-	27,700
Malcolm W. McDonald	35,500	-	35,500
Bernard R. Nigon ⁽⁴⁾	24,050	-	24,050
Mahlon C. Schneider	31,800	-	31,800
Hugh C. Smith	59,167	-	59,167

(1) Pursuant to our Directors Deferred Compensation Plan, we allow directors to defer receipt of their fees until January 30 of the calendar year immediately following the date in which they cease to be a member of the board. We pay deferred fees over a yearly period of ten years or less. Deferred fees earn interest at a rate equal to our bank subsidiary's cost of funds on November 30 of each year in which the fees are deferred. A director who is one of our employees receives no separate compensation for services as a director. As of December 31, 2011, Mr. DeBoer had a deferred fee balance of \$210,920, and Mr. Schneider had a deferred fee balance of \$133,372.

(2) The amount reported is the aggregate grant-date fair market value computed in accordance with FASB Accounting Standards Codification, or ASC, Topic 718. See footnote 13 in the notes to consolidated financial statements included in our annual report for the assumptions made in determining the fair value of option awards in accordance with ASC Topic 718. Prior to 2010, we granted 15,000 options to each director when they became a member of the board. Options outstanding as of December 31, 2011, totaled 15,000 for each of Mr. Fogarty, Mr. McDonald, Ms. Himle and Mr. Smith. The exercise prices of the outstanding options range from \$4.77 to \$30.00.

(3) Term on the board of directors expired on April 26, 2011.

(4) Elected to the board of directors on April 26, 2011.

COMPENSATION DISCUSSION AND ANALYSIS

Overview

This Compensation Discussion and Analysis provides information about the 2011 compensation program for our named executive officers, who are:

Bradley C. Krehbiel, President of the company and bank,

Jon J. Eberle, Chief Financial Officer, Senior Vice President and Treasurer of the company and bank,

Lawrence D. McGraw, Chief Credit Officer and Senior Vice President of the bank,

Dwain C. Jorgensen, Senior Vice President of Facilities and Compliance of the company and bank, and

Susan K. Kolling, Senior Vice President of the company and bank.

Compensation to our executive officers is provided by our banking subsidiary, whose primary regulator is the OCC. We have not separately provided compensation to our executive officers since our formation, and do not anticipate paying any compensation to these officers until we become actively involved in the operation or acquisition of businesses other than our banking subsidiary. As of December 31, 2011, we had no executive officers other than our five named executive officers.

The compensation committee of our board of directors establishes and administers the compensation and benefits program for executive officers and directors. The compensation committee has designed our executive compensation program to achieve the following primary goals:

to attract and retain a highly qualified and coordinated workforce of executives who have the skills, experience and work ethic required to effectively achieve our goals and objectives; and

to align executives' interests with the creation and maintenance of long-term stockholder value. Beginning in 2009, our compensation program for named executive officers has been significantly affected by our participation in the CPP. Under the CPP, we are limited in the types of compensation that we may offer to named executive officers and other highly compensated employees, as described below. Due largely to the CPP compensation limitations, the total direct compensation (salary plus incentive compensation) for our named executive officers in 2011 consisted of their base salaries, supplemented by restricted stock awards that ranged from 26% to 34% of their respective base salaries. In addition, as discussed in more detail below, our compensation actions are also limited by the Supervisory Agreements.

With the assistance of an independent compensation consulting firm retained, the compensation committee had also developed a performance-based compensation program for Mr. Krehbiel in 2011, payments under which would be made in the form of additional shares of restricted stock. No payments under this program were earned based on our 2011 performance, and the program was not extended to other named executive officers during the year. A similar program has not been adopted for Mr. Krehbiel in 2012.

Restrictions on Compensation Based on Participation in the Capital Purchase Program

On December 23, 2008, we sold preferred stock to the United States Treasury under the CPP. As a participant in the CPP, we must comply with certain limitations on executive compensation and compensation practices that affect our named executive officers and certain other highly compensated employees throughout the time the Treasury holds our preferred stock. These executive compensation requirements:

prohibit any bonus, retention award or incentive compensation to our five most highly compensated employees (who are not necessarily our five named executive officers) unless it is in the form of long-term restricted common stock that does not vest in the first two years after it is issued and that cannot be transferred except as permitted under a schedule based on the redemption of the preferred stock;

prohibit payment of severance for any reason to our named executive officers and our next five most highly compensated employees;

require us to recover from our named executive officers and the next 20 most highly compensated employees any bonus, retention award or incentive compensation when based on materially inaccurate earnings, revenues, gains or other criteria;

prohibit incentive compensation to named executive officers that encourages unnecessary and excessive risks that threaten the value of our company;

prohibit any compensation plan that would encourage manipulation of our reported earnings to enhance the compensation of any of our employees;

prohibit tax gross ups to any named executive officer or the next 20 most highly compensated employees;

preclude us from claiming a deduction in an applicable tax year for federal income tax purposes for remuneration in excess of \$500,000 to a named executive officer, as calculated in accordance with Section 162(m)(5) of the Internal Revenue Code; and

require the compensation committee to review incentive compensation arrangements for our named executive officers with our senior risk officer to assess and limit arrangements which encourage unnecessary or excessive risks that could threaten the value of our company, to meet semiannually with the senior risk officer to review the relationship between our company's risk management policies and practices and the named executive officers' incentive compensation arrangements, and to certify to the foregoing in our proxy statement.

Each of the requirements listed above still impacts the design of our compensation program and arrangements for our executive officers so long as the Treasury holds our preferred stock. We have structured our bonus and incentive compensation arrangements with our named executive officers to provide for the recovery of any payments based on materially inaccurate financial statements or any other materially inaccurate performance metrics, in accordance with these CPP requirements. The right to recover these payments is not dependent upon the occurrence of a restatement of our financial results or of any misconduct.

While most of these requirements apply to our named executive officers, and in many cases to some number of additional highly compensated employees, the limitation on bonuses, retention awards and incentive compensation applies to our five most highly compensated employees. Even though Mr. Jorgensen and Ms. Kolling are named executive officers, they are not among our five most highly compensated employees; therefore, they are eligible for bonus, retention, and other incentive compensation awards.

Restrictions on Compensation Based on Entry into Supervisory Agreements.

Under the Supervisory Agreements, we and our banking subsidiary are not permitted, without the prior written consent of the applicable regulator, to enter into any new contractual arrangement or to renew or revise any existing contractual arrangement related to compensation or benefits with any director or certain executive officers. The Supervisory Agreements also prohibits any golden parachute payment unless such payment complies with the applicable rules and regulations of the Federal Deposit Insurance Corporation.

Compensation Program Design and Operation

Program Design. Within the constraints of the requirements related to the CPP, the compensation committee seeks to achieve the goals of our executive compensation program by providing for a competitive base salary and long-term equity incentive awards. Under the CPP requirements, base salaries generally cannot represent less than two-thirds of our named executive officers' annual total direct compensation (which consists of base salary and the grant date value of equity compensation awards granted in a particular year). The compensation committee's philosophy is that over the long term, base salaries should be competitive with those of similarly-sized publicly held financial institutions that operate in the upper-Midwest and against whom we may compete for executive talent.

Subject to the restrictions imposed on compensation under the CPP, the compensation committee considers many factors in determining our compensation program for executive officers, including data on competitive compensation practices and amounts, our overall performance compared to expected results and the contributions of the executive officer to achieving our strategic goals. Although we do not have formal stock ownership guidelines, the compensation committee does consider the value and vesting timetable of outstanding equity awards held by executive officers in determining the timing and amount of new equity awards. While the compensation committee may from time to time establish specific performance objectives for the receipt of incentive compensation, our compensation program is essentially a discretionary system in which the compensation committee uses competitive compensation data and draws upon the business experience, business judgment and general knowledge of its members to evaluate compensation matters collaboratively and subjectively.

In designing our compensation program, we have also considered the accounting treatment in our financial statements and the tax impact on us and on our executive officers of various potential elements of compensation. In the past, we have modified the mix of our compensation elements based on changes in financial accounting treatment (such as changing the nature of equity compensation awards partially in response to changes in accounting for equity compensation) and included compensation elements with favorable tax treatment for our employees (such as employer 401(k) contributions), and we may do so again in the future, subject to the constraints of the requirements related to the CPP. However, we do not consider accounting and tax matters as primary factors in managing our compensation program.

At our last annual meeting of stockholders, as required by our participation in the CPP, we asked our stockholders to approve, by advisory vote, the compensation of our named executive officers, as disclosed in the Compensation Discussion and Analysis, the compensation tables, and the related disclosures contained in our proxy statement for that annual meeting. The proposal was approved by our stockholders.

In light of the approval by our stockholders of our named executive officers' compensation and the other limitations mentioned previously, the compensation committee did not make changes in our compensation policies and practices.

Roles of Committee and Management. The compensation committee consists exclusively of independent non-employee directors, and has the full authority to determine all elements of the compensation for Mr. Krehbiel and to approve all elements of the compensation of our other executive officers. In approving compensation actions for the other executive officers, the compensation committee receives regular input and recommendations from Mr. Krehbiel, and ascribes significant weight to his recommendations. Our chief financial officer and his staff, together with outside professionals, assist the compensation committee in evaluating the financial accounting and tax treatment of existing and potential elements of our executive compensation program.

Compensation Consultant. The compensation committee has the authority to retain independent compensation consultants to assist in the evaluation of executive officer compensation. In late 2010, the compensation committee engaged Blanchard Chase as its independent compensation consultant. Blanchard Chase is engaged to assist the compensation committee in refining the committee's compensation philosophy, defining characteristics of peer financial institutions and identifying particular peer group entities, compiling peer group compensation data, analyzing the elements of compensation, developing incentive compensation systems and ensuring compliance with the compensation restrictions under the CPP and other regulatory requirements. Prior to engaging Blanchard Chase, the compensation committee engaged Amalfi Consulting, LLC (Amalfi) to perform similar functions.

Determining Market Competitive Compensation. With Amalfi's assistance, in the fourth quarter of 2009, the compensation committee identified the following twenty-one publicly traded financial institutions in the Upper Midwest that are comparable to us in asset size and performance and with whom we may compete for executive talent for purposes of obtaining data on competitive compensation practices (the 2009 Peer Group):

QCR Holdings, Inc.	Princeton National Bancorp, Inc.	Ames National Corporation
Reliance Bancshares, Inc.	HF Financial Corp.	OAK Financial Corporation
Bank Financial Corporation	Baylake Corp.	United Bancorp, Inc.
West Bancorporation, Inc.	First Mid-Illinois Bancshares, Inc.	Meta Financial Group, Inc.
MidWestOne Financial Group, Inc.	Northern States Financial Corp.	First Clover Leaf Financial Corp.
Centrue Financial Corporation	Indiana Community Bancorp	BNCCORP, Inc.
Hawthorn Bancshares, Inc.	First Business Financial Services, Inc.	

At the time the 2009 Peer Group was identified, our total assets were at the 36th percentile within the 2009 Peer Group, and our number of branches was at the 37th percentile. Eleven members of the 2009 Peer Group were then participants in the CPP.

The compensation committee's philosophy is to generally target base salaries and total direct compensation for our named executive officers at or below the median for comparable positions at companies within the 2009 Peer Group, reserving to itself the discretion to position an individual's base salary or total direct compensation above or below the 2009 Peer Group's median based on the individual's experience, performance and level of responsibilities. The 2009 Peer Group compensation data was not updated during 2011, as the compensation committee determined, with the concurrence of its consultant, that the competitive data was not likely to have changed significantly.

Since the compensation committee tries to obtain updated competitive compensation data every two to three years, in the first quarter of 2012, the compensation committee engaged Blanchard Chase to review the 2009 Peer Group. Based on this review, the following twenty-one publicly traded financial institutions in the Upper Midwest that are comparable to us in asset size and with whom we may compete for executive talent for purposes of obtaining data on competitive compensation practice were identified and now comprise a revised peer group (the 2012 Peer Group):

Meta Financial Group, Inc.	First Business Financial Services, Inc.*	Community Bank Shares of Indiana, Inc.*
NASB Financial, Inc.*	Reliance Bancshares, Inc.	Southern Missouri Bancorp, Inc.*
MBT Financial Corp.*	Tri City Bankshares Corporation*	Blue Valley Ban Corp.*
West Bancorporation, Inc.	Baylake Corp.	Guaranty Federal Bancshares*
HF Financial Corp.	Ames National Corporation	Tower Financial Corporation*
Hawthorn Bancshares, Inc.	Indiana Community Bancorp	NorthWest Indiana Bancorp*
CFS Bancorp, Inc.*	United Bancorp, Inc.	PSB Holdings, Inc.*

*Companies that are new additions for the 2012 Peer Group.

Ten companies were removed from the 2009 Peer Group, therefore, ten new companies were added to the 2012 Peer Group. The primary reason these companies were removed is because such financial institutions are no longer in existence or no longer meet the asset size criteria that was established for the 2012 Peer Group. At the time the 2012 Peer Group was identified, our total assets were at the 36th percentile within the 2012 Peer Group, and our number of branches was at the 47th percentile. Six members of the 2012 Peer Group were participants in the CPP at the time of their selection for the 2012 Peer Group. The compensation committee will use the 2012 Peer Group as one of its tools for benchmarking the compensation paid to our executive officers and for purposes of making its compensation decisions in

Elements of Compensation and Compensation Actions

Executive officer compensation includes the following elements:

Base Salary. The base salary amount is the fixed portion of each executive's annual compensation and, under requirements related to the CPP, must represent 66%-100% of an executive's total annual potential compensation. Salary levels are based primarily on the executive's responsibilities and experience, and the

market compensation paid by similar sized financial institutions for similar positions. Ordinarily, base salaries are reviewed annually, and adjusted from time to time to realign salaries with market levels and individual responsibilities, performance and experience.

Based on our consultations with our compensation consultant and the 2009 Peer Group data received, the compensation limitations applicable to us due to our participation in the CPP and the Supervisory Agreements, and on general economic uncertainty, the compensation committee decided to make no changes to Mr. Krehbiel's base salary during 2011. For 2011, Mr. Krehbiel's base salary was approximately 75% of his total compensation. Mr. Krehbiel's base salary for 2012 is \$290,185.

All of our other named executive officers received raises in 2011. Mr. Jorgensen's and Ms. Kolling's raises are consistent with our 2011 salary guidelines for employees generally. Mr. McGraw's increase reflects the compensation committee's review of market compensation levels for comparable positions. Mr. Eberle's increase reflects both the compensation committee's considerations of internal pay equity among its named executive officers and general salary guidelines. For 2011, the percentage of base salary for these named executive officers as compared to total compensation ranged from 73% to 85%. For 2012, Messrs. Jorgensen, McGraw and Eberle and Ms. Kolling's base salaries have been set at \$117,053, \$190,000, \$190,000, and \$129,114, respectively. Mr. Jorgensen's and Ms. Kolling's raises are consistent with our 2012 salary guidelines for employees generally. Mr. McGraw and Mr. Eberle received increases reflecting increasing management duties.

Bonus, Retention Awards, and Incentive Compensation. Long-term restricted stock grants are granted under our 2009 Equity Incentive Plan and are the only form of bonus, retention award or incentive compensation that we are permitted to provide to our five most highly compensated employees, including three of our named executive officers, under requirements related to the CPP. In accordance with CPP requirements, restricted stock awards generally may not vest prior to the second anniversary of the applicable grant date. Even after a restricted stock award has vested, the shares of stock subject to the award may not be transferred any time earlier than is proportional, in 25% increments, to our repayment to the Treasury of the financial assistance we received under the CPP. We have not yet repaid any of the financial assistance that we received under the CPP.

The issuance of restricted stock is designed to provide a long-term retention incentive for executive officers, align their interests with the creation and maintenance of long-term stockholder value and reward them for managing our performance to increase stockholder value. The compensation committee's philosophy is that restricted stock grants also may encourage executive officers to balance the risk of losses in stockholder value against the potential for gains in stockholder values when evaluating business decisions. As a result, the executive officers may adopt strategies that strike a better balance between the potential for stock price appreciation and the risk that a failed strategy will lead to a stock price decline.

The compensation committee began using restricted stock grants as an element of the overall compensation program in 2004, when the accounting requirements for expensing stock options changed and the difference in the financial statement impact between granting awards of restricted stock and granting option awards was reduced. At that time, the compensation committee began issuing restricted stock grants instead of stock options due to the change in accounting treatment of stock options, the relatively long remaining vesting and exercise periods of the then outstanding stock options, and the committee's belief that grants of restricted stock awards provide a stronger retention incentive than stock options because executives are assured of realizing value as the stock vests over time. No stock options have been issued to executive officers since 2004.

On January 27, 2011, in order to retain the services of our executive officers and to provide them with long-term incentive compensation within the limitations of the CPP, the compensation committee authorized a grant to Messrs. Krehbiel, Eberle, and McGraw of restricted stock of 25,000 shares, 15,000 shares, and 20,000 shares, respectively. The grant date value of each restricted stock award to these named executive officers is limited under the CPP requirements and may not exceed one-half of the executive officer's base salary for the calendar year. Based on competitive data and analyses provided by our compensation consultant and other considerations involved with the named executive officer's respective position, the compensation committee decided to provide 2011 restricted stock awards with a grant date value of 28% of base salary to Mr. Krehbiel, 26% of base salary to Mr. Eberle, and 34% of base salary to Mr. McGraw. For 2012, our compensation

committee made restricted stock grants to our named executive officers equal to 10% of their base salary on similar terms. The OCC has stated it has no objections to the grant of these awards for 2012. The compensation committee generally approves equity-based awards at a meeting early in the first quarter of each fiscal year, after our year-end financial results have been released.

Historically, we have also awarded nominal cash bonuses based on years of service and annual holiday bonuses to all employees, including our executives. Holiday bonuses were discontinued in 2011. We also reserve the right to pay bonus compensation under other circumstances.

In 2011, the compensation committee approved a grant of discretionary cash retention awards to Mr. Jorgensen and Ms. Kolling, neither of whom are subject to the CPP limitation on bonus, retention and incentive awards because, while they are named executive officers, they are not among our five most highly paid employees. The compensation committee approved a total award for Mr. Jorgensen of \$16,800 and a total award for Ms. Kolling of \$24,720. These cash-based awards, which are payable in three equal annual installments, are provided for retention purposes and to lessen the usage of shares under our equity-based compensation plan. An installment will vest and be paid if the officer remains employed on December 31 of each year and has been continuously employed throughout the year, subject to accelerated vesting of an installment in the event of death or disability during the calendar year. The vested portion of the cash retention award will be paid on January 31 in the year following the year in which vesting occurs. On January 23, 2012, the compensation committee approved a grant of discretionary cash retention awards of \$5,738 and \$9,494 to Mr. Jorgensen and Ms. Kolling, respectively. The OCC has stated it has no objections to the grant of these awards for 2012. These cash-based awards are payable and vest on the same terms as the cash awards granted to these individuals in 2011.

The compensation committee worked with its compensation consultant to develop, within the limitations imposed by the CPP, an incentive compensation plan for Mr. Krehbiel in 2011 to more closely link his compensation with individual and bank performance. The plan is based on the achievement of annual financial and non-financial objectives, which were established by the compensation committee at the beginning of 2011. The allocation of incentives between financial and non-financial objectives for the 2011 incentive compensation plan was split 20% for attainment of certain percentages of budgeted earnings per share, which was \$0.64, and 80% for attainment of certain percentages of budgeted non-performing assets of \$42.1 million, certain percentages of budgeted provision for loan losses of \$10.2 million, and meeting other strategic objectives. For 2011, our actual earnings per share was (\$3.47), our non-performing assets balance was \$50.6 million, and our provision for loan losses was \$17.3 million. Because the performance objectives were not achieved, Mr. Krehbiel did not receive an additional award of performance-based restricted stock in 2011.

Benefits. The compensation committee's philosophy is that a competitive benefits package contributes to executive retention. Our executive officers participate on an equal, nondiscriminatory basis with all other employees in our medical insurance plan, medical reimbursement plan, childcare plan, long-term disability plan and group life insurance plan. If an executive officer retires after 15 years of service, we will continue to pay the employer portion of his or her health insurance coverage until he or she reaches the age of 65.

Our executive officers also participate along with other employees, on a nondiscriminatory basis, in a 401(k) plan with a 25% match on employee contributions up to 8% of the employee's salary.

Our executive officers also participate on a nondiscriminatory basis in our Employee Stock Ownership Plan (ESOP). All of our employees are eligible to participate in the ESOP after they complete one year of service as defined by the plan. The ESOP holds shares of our common stock that secure a loan for the funds that were used to acquire the ESOP shares. Each year the security interest is released from a fixed number of shares as a fixed amount of the loan is amortized. The shares that are released from the security interest are allocated to eligible participant accounts based on the percentage of the participant's compensation (subject to limits) to the entire compensation of all plan participants. The value of the ESOP contributions vary based on the price of our common stock and represents less than 1% of each executive's base salary amount.

The compensation committee considers the benefits granted to executive officers when determining executive officer compensation amounts and comparing compensation amounts to other executives at similar companies, and considers the value of the ESOP contributions when it considers the mix between

cash and equity compensation.

Change in Control Compensation. We also have entered into change-in-control agreements with each of our named executive officers, other than Mr. McGraw, that, subject to CPP requirements, provide for a cash payment equal to 200% of the employee's prior year base salary and bonus if, following a change in control, his or her employment is involuntarily terminated or the employee terminates his or her employment for good reason. The compensation committee's philosophy is that change-in-control agreements are appropriate to induce executives to remain with our company in the event of a proposed or anticipated change in control or through a change in control to facilitate an orderly transition to new ownership. The change-in-control agreements also assist us in recruiting and retaining executives by providing executives with appropriate economic security, given the relatively limited number of alternative employers in our industry and geographic area, against loss of employment following a change in control. However, until we have repaid all of the financial assistance we received under the CPP, we may not make any payment to our named executive officers in connection with a change in control, except for payments for services performed or benefits accrued.

Recovery of Performance-Based Compensation

The Sarbanes-Oxley Act requires recovery of certain incentive and equity compensation from our principal executive officer and principal financial officer in the event of restatement of financial results due to misconduct. The audit committee is responsible for determining if bonus or stock compensation paid to the principal executive officer or principal financial officer should be recovered in the event of a restatement.

COMPENSATION COMMITTEE REPORT

The compensation committee certifies that at least every six months, it has

discussed, evaluated and reviewed with the senior risk officer the named executive officer compensation plans in an effort to ensure that such plans do not encourage the named executive officers to take unnecessary and excessive risks that threaten the value of our company;

discussed, evaluated and reviewed with the senior risk officer the employee compensation plans in light of the risks posed to our company by such plans and how to limit such risks; and

discussed, evaluated and reviewed employee compensation plans in an effort to ensure that these plans do not encourage the manipulation of reported earnings of our company to enhance the compensation of any of our company's employees.

In addition, the compensation committee certifies that it has made reasonable efforts to identify and limit any features of the named executive officer compensation plans that could lead named executive officers to take unnecessary and excessive risks that could threaten the value of our company and has made reasonable efforts to identify and limit any features of the employee compensation plans that pose risks to our company in an effort to ensure that our company is not unnecessarily exposed to risks.

Based on, among other factors, the committee's assessment of the principal risks to which our company is subject, its evaluation of the existing compensation arrangements for our named executive officers in accordance with the limitations imposed under the CPP and the Supervisory Agreements, the relatively significant portion of total compensation represented by base salary and the CPP limitation on the use of variable forms of compensation, the discretion to award incentive compensation exercisable by the company, the customary use of non-financial objectives in determining a significant portion of any incentive compensation, the use of restricted stock as a significant component of equity incentive compensation and the sole component in recent years, the required vesting periods included in equity awards, the holding period required after vesting for restricted stock grants subject to the requirements related to the CPP, and the clawback requirements to which incentive compensation is now subject, the compensation committee concluded that our compensation plans for our named executive officers are not reasonably likely to encourage unnecessary or excessive risk, including behavior focused on short-term results rather than long-term value creation, that would threaten the value of our company.

Based on, among other factors, the elements of our employees' compensation, the relatively significant portion of total compensation represented by base salary for our employees, the discretion to award incentive compensation exercisable by the company, the use of non-financial objectives in determining a significant portion of any incentive compensation, the use of restricted stock as a significant component of equity incentive compensation and the sole component in recent years, the required vesting periods included in equity awards, executive and management oversight of our operations and our systems of internal controls over financial reporting, the compensation committee concluded that our employee compensation plans are not reasonably likely to encourage behavior focused on short-term results rather than long-term value creation or encourage the manipulation of our reported earnings to enhance the compensation of any of our employees.

The compensation committee has discussed and reviewed the compensation discussion and analysis with management. Based upon this review and discussion, the compensation committee recommended to the board of directors that the compensation discussion and analysis be included in this proxy statement.

Members of The Compensation Committee

Karen L. Himle

Hugh C. Smith

Michael J. Fogarty

Allen J. Berning

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2011 EXECUTIVE COMPENSATION

Summary Compensation Table

Name and Principal Position	Year	Salary (\$)	Bonus (\$) ⁽¹⁾⁽²⁾	Stock Awards (\$) ⁽³⁾	All Other Compensation (\$) ⁽⁴⁾	Total (\$)
Bradley C. Krehbiel <i>President</i>	2011	264,500	0	75,000	13,360	352,860
	2010	264,500	150	92,400	19,051	376,101
	2009	231,327	150	70,620	10,401	312,498
Jon J. Eberle <i>Senior Vice President, Chief Financial Officer and Treasurer</i>	2011	175,000	0	45,000	5,388	225,388
	2010	165,500	150	57,750	7,655	231,055
	2009	156,333	300	49,500	7,709	213,842
Lawrence D. McGraw <i>Senior Vice President and Chief Credit Officer</i>	2011	175,000	0	60,000	3,842	238,842
	2010	139,202	20,050	0	3,221	162,473
	2009					
Dwain C. Jorgensen <i>Senior Vice President, Facilities and Compliance Services</i>	2011	114,758	5,600	0	3,620	123,970
	2010	112,508	150	16,800	4,495	133,953
Susan K. Kolling <i>Senior Vice President, Business Development</i>	2011	126,582	8,240	0	3,994	138,816
	2010	124,100	150	24,720	5,699	154,669
	2009	123,683	550	40,788	6,216	171,237

(1) Other than the \$20,000 signing bonus paid to Mr. McGraw upon the commencement of his employment in 2010 and the retention awards that vested to Mr. Jorgensen and Ms. Kolling in 2011, these amounts represent the nominal cash bonuses we paid to all employees for holidays and years of service. In 2011, holiday bonuses for all employees were eliminated. We generally pay bonuses for a fiscal year in the first quarter of the following fiscal year. Holiday and years of service bonuses are generally paid in December.

(2) Mr. Jorgensen was granted a cash retention bonus of \$16,800 and Ms. Kolling was granted a cash retention bonus of \$24,720. These cash retention awards vest equally over a 3 year period provided the officer remains employed with us on December 31st of each year.

(3) The amount reported is the aggregate grant-date fair market value computed in accordance with FASB Accounting Standards Codification, or ASC, Topic 718. See footnote 13 in the notes to consolidated financial statements included in our annual report for the assumptions made in determining the fair value of stock awards in accordance with ASC Topic 718.

(4) All other compensation consists of the following:

Name	Employer 401(k) Contribution (\$)	Value of Common Stock Allocated to ESOP (\$)	Employer Paid Life Insurance Premiums (\$)	Dividends Received on Vested Restricted Stock (\$)	Perquisites and Other Personal Benefits (\$) ^(a)	Total (\$)
Bradley C. Krehbiel						
2011	4,900	1,369	347	640	6,104	13,360
2010	3,732	1,929	350	1,596	11,444	19,051
2009	4,630	2,610	428	2,733	0	10,401

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Jon J. Eberle						
2011	3,500	978	345	565	0	5,388
2010	2,794	1,319	342	1,410	1,790	7,655
2009	3,133	1,764	416	2,396	0	7,709
Lawrence D. McGraw						
2011	3,500	0	342	0	0	3,842
2010	2,984	0	237	0	0	3,221
Dwain C. Jorgensen						
2011	2,296	641	235	448	0	3,620
2010	2,253	887	233	1,122	0	4,495
2009	2,252	1,265	284	1,923	0	5,724
Susan K. Kolling						
2011	2,532	707	259	476	20	3,994
2010	2,500	985	258	1,185	771	5,699
2009	2,485	1,396	312	2,023	0	6,216

(a) Perquisites and other personal benefits include the payment of unused personal time off in excess of carryover limits in 2010 and 2011.

Change-In-Control Agreements

Under regulations related to the CPP, until we have repaid all of the financial assistance we received under the CPP, we may not make any payment to our named executive officers upon a change in control, except for payments for services performed or benefits accrued. Prior to our receipt of funds under the CPP, our banking subsidiary entered into a change-in-control agreement with each of Messrs. Krehbiel, Eberle and Jorgensen and Ms. Kolling as of May 27, 2008. These original agreements expired on May 30, 2010, but they provide for an automatic extension for one year and from year to year thereafter unless either applicable party gives contrary written notice 180 days prior to the expiration date each year. No such notice was given as of December 31, 2011. Therefore, by their terms, these agreements were extended to May 30, 2013. These agreements were designed to assist us in maintaining a stable and competent management team.

If permitted, the agreements provide for a cash payment equal to 200% of the employee's prior year base salary and bonus prior to termination in the event that their employment is terminated in connection with a change of control. A change of control occurs under the agreements if any person other than the executive, us, or one of our benefit plans acquires or becomes the beneficial owner of 35% or more of our outstanding stock entitled to vote in a general election of directors; a majority of the members of our board are replaced as a result of an actual or threatened election contest; a reorganization, merger or consolidation of us is consummated that changes our ownership by 35% or more; or our stockholders approve a complete liquidation or dissolution of us or disposition of substantially all of our assets. If permitted, these named executive officers would also be eligible for the cash payment if they voluntarily terminate employment within one year after a change in control has occurred if their duties, responsibilities, base salary, or benefits are reduced or if their principal place of employment is relocated more than 35 miles from its current location. These agreements also provide that these named executive officers, if permitted, would participate in the health, disability and life insurance plans and programs that they were entitled to immediately prior to termination for one year after termination. If payment under these agreements were permitted, the amounts payable pursuant to these agreements would be reduced by the amount of any severance pay that the employees receive from the bank, its subsidiaries or its successors. Based on their prior year base salary and bonus amounts, if their employment had been terminated as of December 31, 2011, under circumstances giving rise to the salary payment described above and the payments were permitted, Mr. Krehbiel would have been entitled to receive approximately \$529,000, Mr. Eberle would have been entitled to receive approximately \$350,000, Mr. Jorgensen would have been entitled to receive approximately \$240,716 and Ms. Kolling would have been entitled to receive approximately \$269,644. The agreements provide that if the cash payments under the agreements together with any other compensation payments triggered by the change in control would constitute a parachute payment under Section 280G of the internal revenue code, the cash payments under the agreements would be reduced to the largest amount as would result in no portion of the payment being subject to an excise tax under the code. Pursuant to the Supervisory Agreements, any payment made under the change-in-control agreements must comply with the applicable rules and regulations of the Federal Deposit Insurance Corporation.

Grants of Plan-Based Awards in 2011

Name	Grant Date	All Other Stock Awards: Number of Shares of Stock or Units (#) ⁽¹⁾	Grant Date Fair Value of Stock (\$) ⁽²⁾
Bradley C. Krehbiel	January 27, 2011	25,000	75,000
Jon J. Eberle	January 27, 2011	15,000	45,000
Lawrence D. McGraw	January 27, 2011	20,000	60,000
Dwain C. Jorgensen			
Susan K. Kolling			

⁽¹⁾ Of Mr. Krehbiel's stock award, 12,500 shares will vest on January 27, 2014 and 12,500 shares will vest on January 27, 2015. Of Mr. Eberle's stock award, 7,500 will vest on January 27, 2014 and 7,500 shares will vest on January 27, 2015. Of Mr. McGraw's stock award, 10,000 shares will vest on January 27, 2014 and 10,000 shares will vest on January 27, 2015.

⁽²⁾ Based on a market value of \$3.00 on January 27, 2011.

Outstanding Equity Awards

The following tables summarize the outstanding option grants and stock awards at December 31, 2011, of the named executive officers and the value of the restricted stock that vested in 2011.

Outstanding Equity Awards at December 31, 2011

Name	Option Awards				Stock Awards	
	Number of Securities Underlying Unexercised Options (#)	Number of Securities Underlying Unexercisable ⁽¹⁾ Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested ⁽²⁾	Market Value of Shares or Units of Stock That Have Not Vested ⁽³⁾
Bradley C. Krehbiel	5,643	6,199	16.13	04/15/2012	46,735	90,666
	4,540	0	27.66	03/02/2014		
Jon J. Eberle	3,654	6,199	16.13	04/15/2012	28,959	56,180
	3,640	0	27.66	03/02/2014		
Lawrence D. McGraw	0	0	0		20,000	38,800
Dwain C. Jorgensen	6,301	6,199	16.13	04/15/2012	4,620	8,963
	3,580	0	27.66	03/02/2014		
Susan K. Kolling	2,990	6,199	16.13	04/15/2012	7,346	14,251
	3,780	0	27.66	03/02/2014		

⁽¹⁾ Mr. Krehbiel received a grant of options on April 16, 2002, of which 5,643 options vested on April 16, 2011 and 6,199 options will vest on January 1, 2012. Mr. Eberle received a grant of options on April 16, 2002, of which 3,654 options vested on April 16, 2011, and 6,199 options will vest on January 1, 2012. Mr. Jorgensen received a grant of options on April 16, 2002, of which 102 options vested on April 16, 2010, 6,199 options vested April 16, 2011 and 6,199 options will vest on January 1, 2012. Ms. Kolling received a grant of options on April 16, 2002, of which 2,990

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options vested on April 16, 2011, and 6,199 options will vest on January 1, 2012.

- (2) Of Mr. Krehbiel's unvested stock awards, 11,200 shares will vest on January 26, 2012, 4,935 shares will vest on May 8, 2012, 5,600 shares will vest on January 26, 2013, 12,500 shares will vest on January 27, 2013 and 12,500 shares will vest on January 27, 2014. Of Mr. Eberle's unvested stock awards, 7,000 shares will vest on January 26, 2012, 3,459 shares will vest on May 8, 2012, 3,500 shares will vest on January 26, 2013, 7,500 shares will vest on January 27, 2013 and 7,500 shares will vest on January 27, 2014. Of Mr. McGraw's unvested stock awards, 10,000 shares will vest on January 27, 2013 and 10,000 shares will vest on January 27, 2014. Of Mr. Jorgensen's unvested stock awards, 1,018 shares will vest on January 26, 2012, 2,583 shares will vest on May 8, 2012 and 1,019 shares will vest on January 26, 2013. Of Ms. Kolling's unvested stock awards, 2,997 shares will vest on January 26, 2012, 2,851 shares will vest on May 8, 2012 and 1,498 shares will vest on January 26, 2013.
- (3) Represents market value of underlying securities at year end of \$1.94, which is the closing price of the common stock on the last trading day of 2011.

2011 Restricted Stock Vesting

Name	Stock Awards	
	Number of Shares Acquired on Vesting (#) ⁽¹⁾	Value Realized on Vesting (\$) ⁽²⁾
Bradley C. Krehbiel	10,723	32,033
Jon J. Eberle	7,671	22,893
Lawrence D. McGraw	0	0
Dwain C. Jorgensen	6,779	20,018
Susan K. Kolling	6,333	18,898

(1) Mr. Krehbiel's stock awards vested as follows: 853 shares on January 25, 2011 and 9,870 shares on May 8, 2011. Mr. Eberle's stock awards vested as follows: 753 shares on January 25, 2011 and 6,918 shares on May 8, 2011. Mr. Jorgensen's stock awards vested as follows: 596 shares on January 25, 2011, 1,018 shares on January 26, 2011, and 5,165 shares on May 8, 2011. Ms. Kolling's stock awards vested as follows: 633 shares on January 25, 2011 and 5,700 shares on May 8, 2011.

(2) Based on market value of our common stock on the relevant vesting date.

2011 Pension Benefits

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit (\$)	Payments During Last Fiscal Year (\$)
Bradley C. Krehbiel	FIRF	3 years, 2 months	13,554	0
Jon J. Eberle	FIRF	6 years, 11 months	14,452	0
Dwain C. Jorgensen	FIRF	27 years, 1 month	270,606	0
Susan K. Kolling	FIRF	28 years, 9 months	203,548	0

Our employees are included in the Financial Institutions Retirement Fund (FIRF), a multi-employer comprehensive pension plan. This non-contributory defined benefit retirement plan covers all employees who have met minimum service requirements. Employees become 100% vested in the pension plan after five years of eligible service. Our policy is to fund the minimum amounts required by the plan, and for 2011, we made a contribution of \$291,000 to the plan. On September 1, 2002, benefits for all of the existing participants under the plan were frozen, and as a result, no additional benefits have been earned and no new employees have been enrolled in the plan after that date. At age 65, Mr. Krehbiel will be entitled to annual payments of \$2,567, Mr. Eberle will be entitled to annual payments of \$4,141, Mr. Jorgensen will be entitled to annual payments of \$28,247, and Ms. Kolling will be entitled to annual payments of \$23,779. The annual benefit amount is calculated based on the employees' base salary for the five years prior to the plan being frozen.

OTHER EQUITY COMPENSATION PLAN INFORMATION

The following table provides information as of December 31, 2011 for compensation plans under which equity securities may be issued.

Plan Category	(a) Number of Securities to be issued upon	(b) Weighted-average exercise price of outstanding	(c) Number of securities remaining available for
---------------	--------------------------------------------------------	----------------------------------------------------------------	--------------------------------------------------------------

	exercise of outstanding options, warrants and rights	options, warrants and rights	future issuance under equity compensation plans (excluding securities reflected in column (a)) ⁽¹⁾
Equity compensation plans approved by stockholders	169,450	18.38	70,821
Equity compensation plans not approved by stockholders	0	0	0
Total	169,450	18.38	70,821

⁽¹⁾ Includes securities available for future issuance under stockholder approved compensation plans other than upon the exercise of an option, warrant or right, as follows: 70,821 shares under the company's 2009 Equity Incentive Plan.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Exchange Act requires our directors and executive officers to file initial reports of ownership and reports of changes in ownership with the Securities and Exchange Commission. Directors and executive officers are required by Securities and Exchange Commission regulations to furnish us with copies of all Section 16(a) forms they file. Based solely on a review of the copies of the forms furnished to us and written representations from our directors and executive officers, all Section 16(a) filing requirements were met for 2011, except that Hugh C. Smith filed a late Form 4 on December 2, 2011 to report a stock purchase that he made on November 29, 2011.

ADDITIONAL INFORMATION

We are furnishing our annual report, including financial statements, for the year ended December 31, 2011, to each stockholder with this proxy statement. **Stockholders who wish to obtain an additional copy of our annual report, or a copy of our Current Report on Form 10-K filed with the Securities and Exchange Commission, for the year ended December 31, 2011, may do so without charge by writing to Chief Financial Officer, 1016 Civic Center Drive N.W., Rochester, Minnesota 55901-6057. The annual report is also available online at www.hmnf.com or www.proxydocs.com/hmnf.**

HMN FINANCIAL, INC.
By Order of the Board of Directors

Cindy K. Hamlin

Secretary

Dated: March 22, 2012

HMN FINANCIAL, INC.

**ANNUAL MEETING OF
STOCKHOLDERS**

Tuesday, April 24, 2012

10:00 a.m.

Rochester Golf & Country Club

3100 W. Country Club Road

Rochester, Minnesota

HMN Financial, Inc.

1016 Civic Center Drive N.W.

Rochester, Minnesota 55901-6057

PROXY

**This proxy is solicited by the Board of Directors for use at the Annual Meeting on
Tuesday, April 24, 2012.**

The shares of stock you hold in your account will be voted as you specify on the reverse side.

If no choice is specified, the proxy will be voted FOR Items 1, 2 and 3.

By signing the proxy, you revoke all prior proxies and appoint Bradley C. Krehbiel and Jon J. Eberle, and each of them with full power of substitution, to vote your shares on the matters shown on the reverse side and any other matters which may come before the Annual Meeting and all adjournments.

See reverse for voting instructions.

Shareowner Services

P.O. Box 64945

St. Paul, MN 55164-0945

COMPANY #

**Vote by Internet, Telephone or
Mail**

24 Hours a Day, 7 Days a Week

Your phone or Internet vote authorizes the named proxies to vote your shares in the same manner as if you marked, signed and returned your proxy card.

INTERNET www.eproxy.com/hmnf

Use the Internet to vote your proxy until 11:59 p.m. (CT) on April 23, 2012. Please have your proxy card and the last four digits of your Social Security Number or Tax Identification Number available. Follow the simple instructions to obtain your records and create an electronic ballot.

PHONE 1-800-560-1965

Use a touch-tone telephone to vote your proxy until 11:59 p.m. (CT) on April 23, 2012. Please have your proxy card and the last four digits of your Social Security Number or Tax Identification Number available. Follow the simple instructions the voice provides you.

MAIL Mark, sign and date your proxy card and return it in the postage-paid envelope provided.

If you vote your proxy by Internet or by Telephone, you do NOT need to mail back your Proxy Card.

TO VOTE BY MAIL AS THE BOARD OF DIRECTORS RECOMMENDS ON ALL ITEMS BELOW,

SIMPLY SIGN, DATE, AND RETURN THIS PROXY CARD.

Ò Please detach here Ò

The Board of Directors Recommends a Vote FOR Items 1, 2 and 3.

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1. Election of directors:	01 Bradley C. Krehbiel	☐	Vote FOR	☐	Vote WITHHELD
	02 Hugh C. Smith		all nominees		from all nominees
	03 Mark E. Utz		(except as marked)		

(Instructions: To withhold authority to vote for any indicated nominee, write the

number(s) of the nominee(s) in the box provided to the right.)

2. The approval, in an advisory (non-binding) vote, of the compensation of executives, as disclosed in the proxy statement	☐	☐	☐	☐	☐
	For	Against		Abstain	

3. The ratification of the appointment of KPMG LLP as the independent registered public accounting firm of the Company for the fiscal year ending December 31, 2012	☐	☐	☐	☐	☐
	For	Against		Abstain	

4. In their discretion, the proxies are authorized to vote on any other business that may properly come before the Annual Meeting, or any adjournments or postponements thereof.

THIS PROXY WHEN PROPERLY EXECUTED WILL BE VOTED AS DIRECTED OR, IF NO DIRECTION IS GIVEN, WILL BE VOTED FOR EACH PROPOSAL.

Address Change? Mark box, sign, and indicate changes below: ☐ Date _____

Signature(s) in Box
Please sign exactly as your name(s) appears on Proxy. If held in joint tenancy, all persons should sign. Trustees, administrators, etc., should include title and authority. Corporations should provide full name of corporation and title of authorized officer signing the Proxy.