Steve H. Powell & Company

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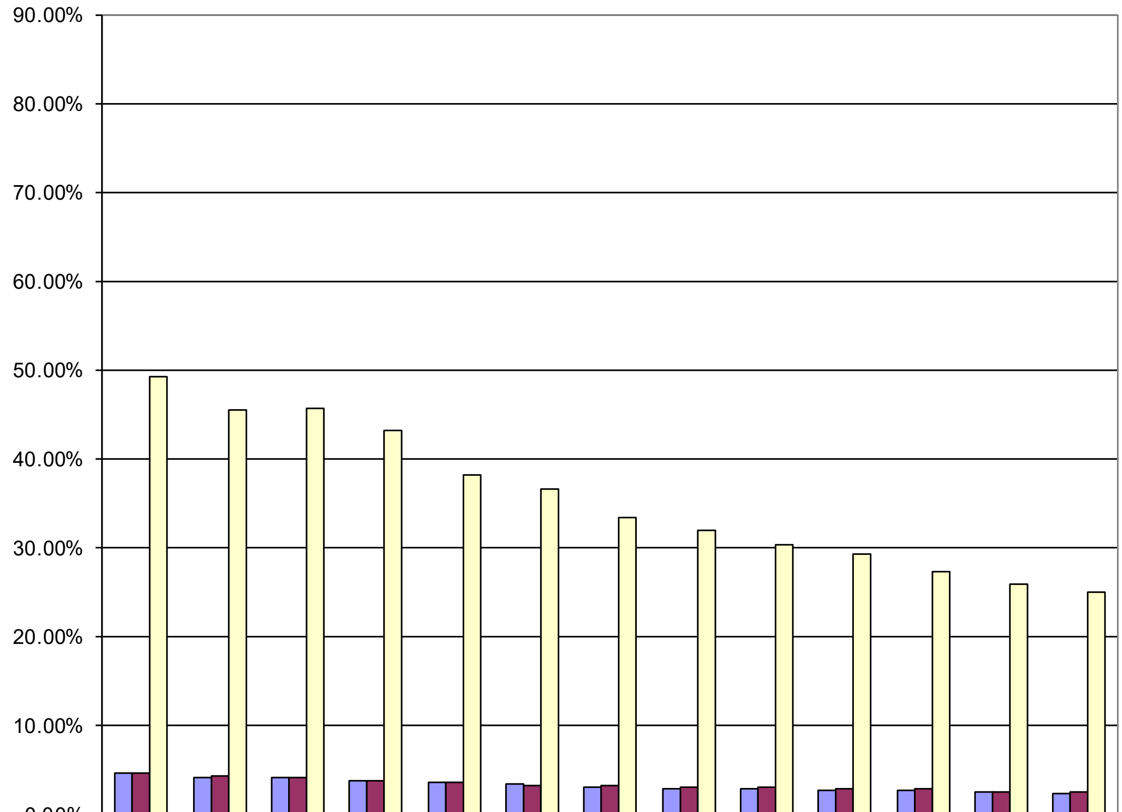
Asset Quality Update – Q3 2018 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Third Quarter 2018, the average level of adversely graded assets decreased as a percentage of total assets and capital. Also, the average level of adversely graded loans decreased as a percentage of total loans. Problem assets averaged 2.41% of total assets and 25.04% of tier-one capital plus loan loss reserve as compared to 2.49% of total assets and 25.92% of tier-one capital plus loan loss reserve while problem loans averaged 2.55% of total loans as compared to 2.61% of total loans during the Second Quarter 2018.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS



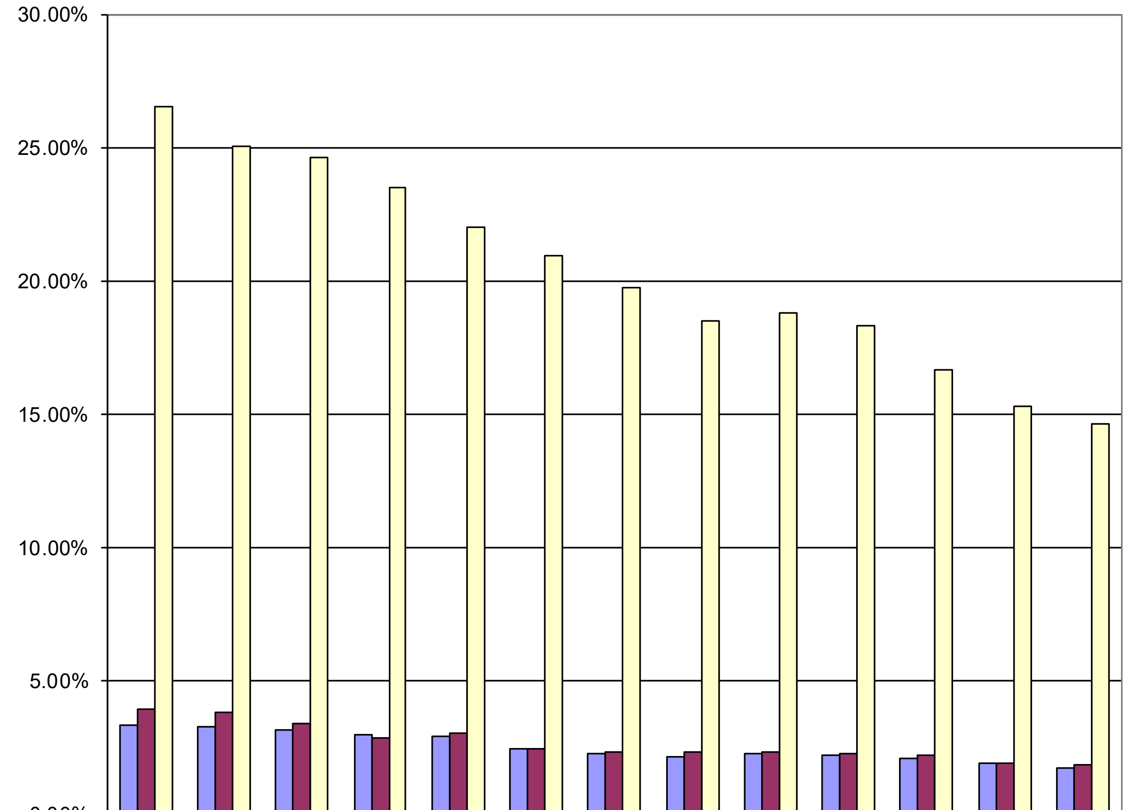
	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18
- Adversely Graded Assets / Total Assets	4.59%	4.22%	4.09%	3.78%	3.57%	3.36%	3.12%	2.97%	2.90%	2.77%	2.65%	2.49%	2.41%
- Adversely Graded Loans / Total Loans	4.75%	4.28%	4.06%	3.74%	3.55%	3.27%	3.23%	3.10%	3.09%	2.90%	2.82%	2.61%	2.55%
- Adversely Graded Assets / Tier 1 Cap' + LLR	49.21%	45.46%	45.62%	43.28%	38.23%	36.65%	33.39%	31.99%	30.45%	29.26%	27.27%	25.92%	25.04%

Steve H. Powell & Company was founded in August of 1993 by former banker and regulator, Steve H. Powell. With the goal of providing unparalleled asset quality monitoring and regulatory compliance services, the company's clientele base has grown and now exceeds 100 different financial institutions. We also provide our clients with bank charter consulting, due diligence support, regulatory applications, financial analysis, and strategic planning. The staff of Steve H. Powell & Company is comprised of former bankers & regulators who understand the complexities of today's regulatory environment. The unique skill sets possessed by our specialists are derived from extensive review experience in institutions of various sizes and charter types.

Trends in Asset Quality – Median Levels

The median level of problem assets as of Q3 2018 decreased to 14.65% of tier-one capital plus loan loss reserve as compared to 15.31% during Q2 2018. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS



	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18
- Adversely Graded Assets / Total Assets	3.36%	3.28%	3.14%	2.96%	2.91%	2.47%	2.28%	2.15%	2.27%	2.22%	2.08%	1.90%	1.74%
- Adversely Graded Loans / Total Loans	3.92%	3.79%	3.37%	2.84%	3.03%	2.42%	2.34%	2.35%	2.30%	2.27%	2.22%	1.93%	1.85%
- Adversely Graded Assets / Tier 1 Cap' + LLR	26.52%	25.06%	24.60%	23.51%	22.03%	20.91%	19.77%	18.48%	18.81%	18.34%	16.68%	15.31%	14.65%

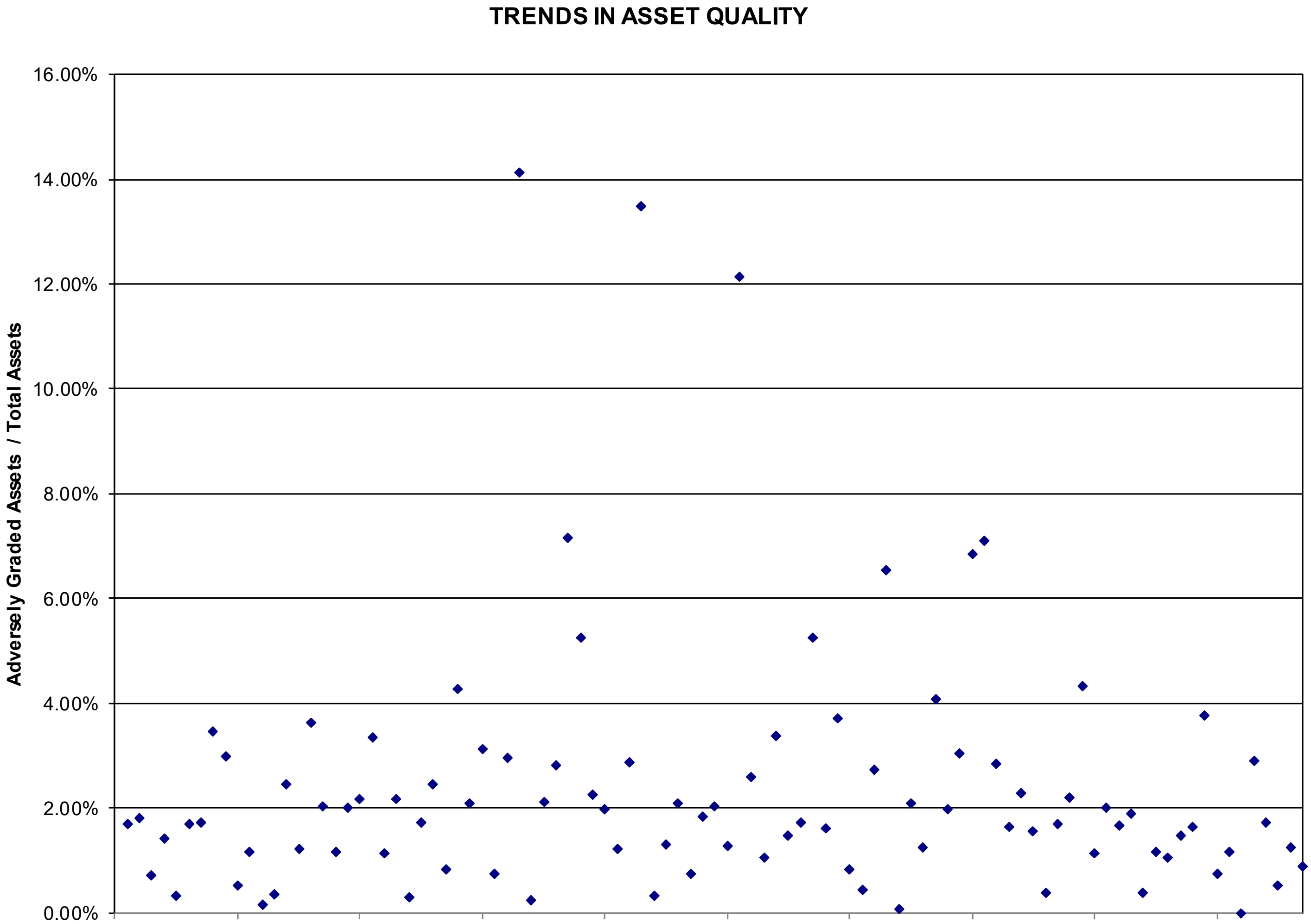
Historical Comparisons

During Q3 2018, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 16% of our clients. This quarter's increase compares to:

- 20% during the Second Quarter 2018
- 15% during the First Quarter 2018
- 21% during the Fourth Quarter 2017
- 13% during the Third Quarter 2017
- 18% during the Second Quarter 2017
- 18% during the First Quarter 2017

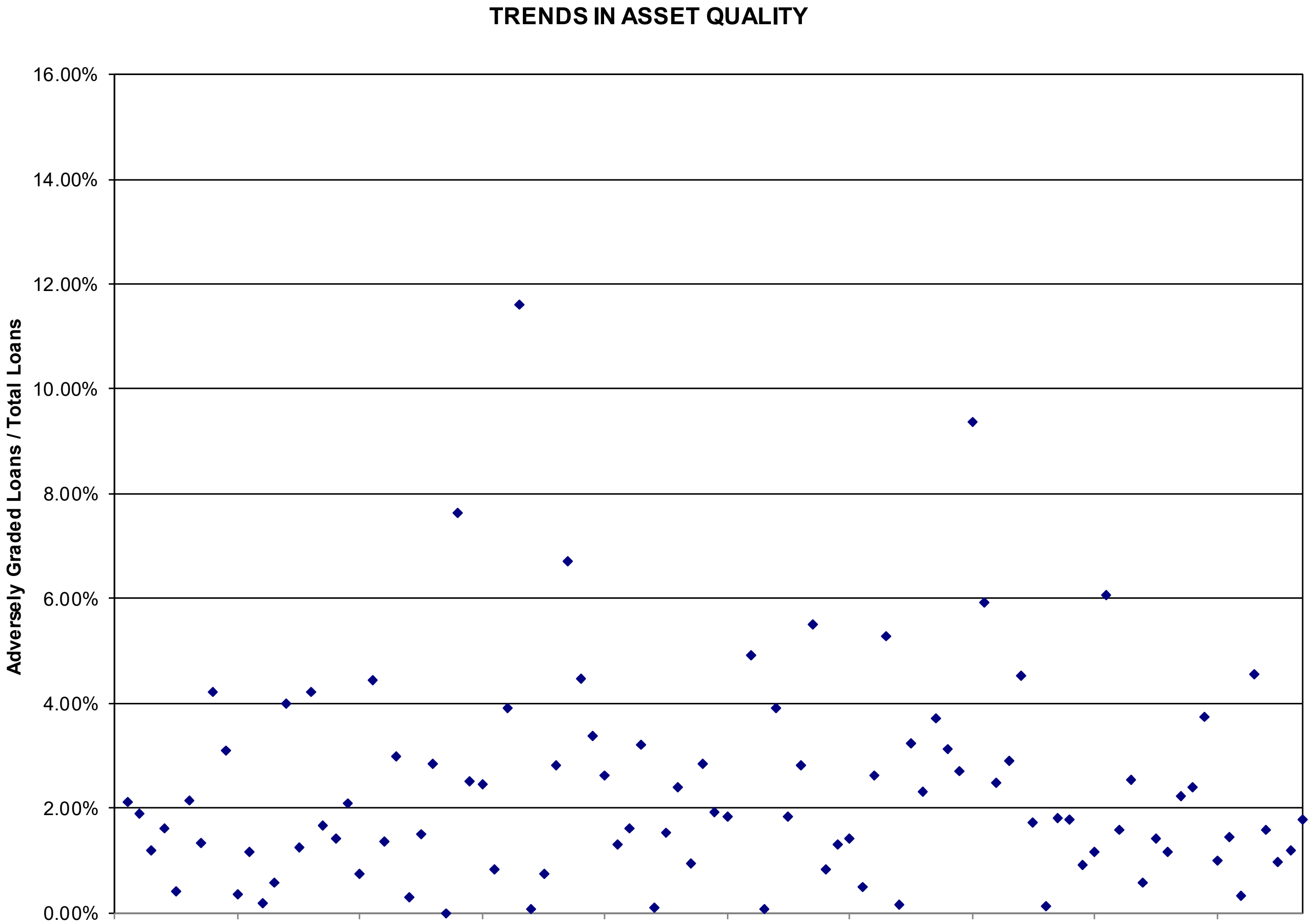
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



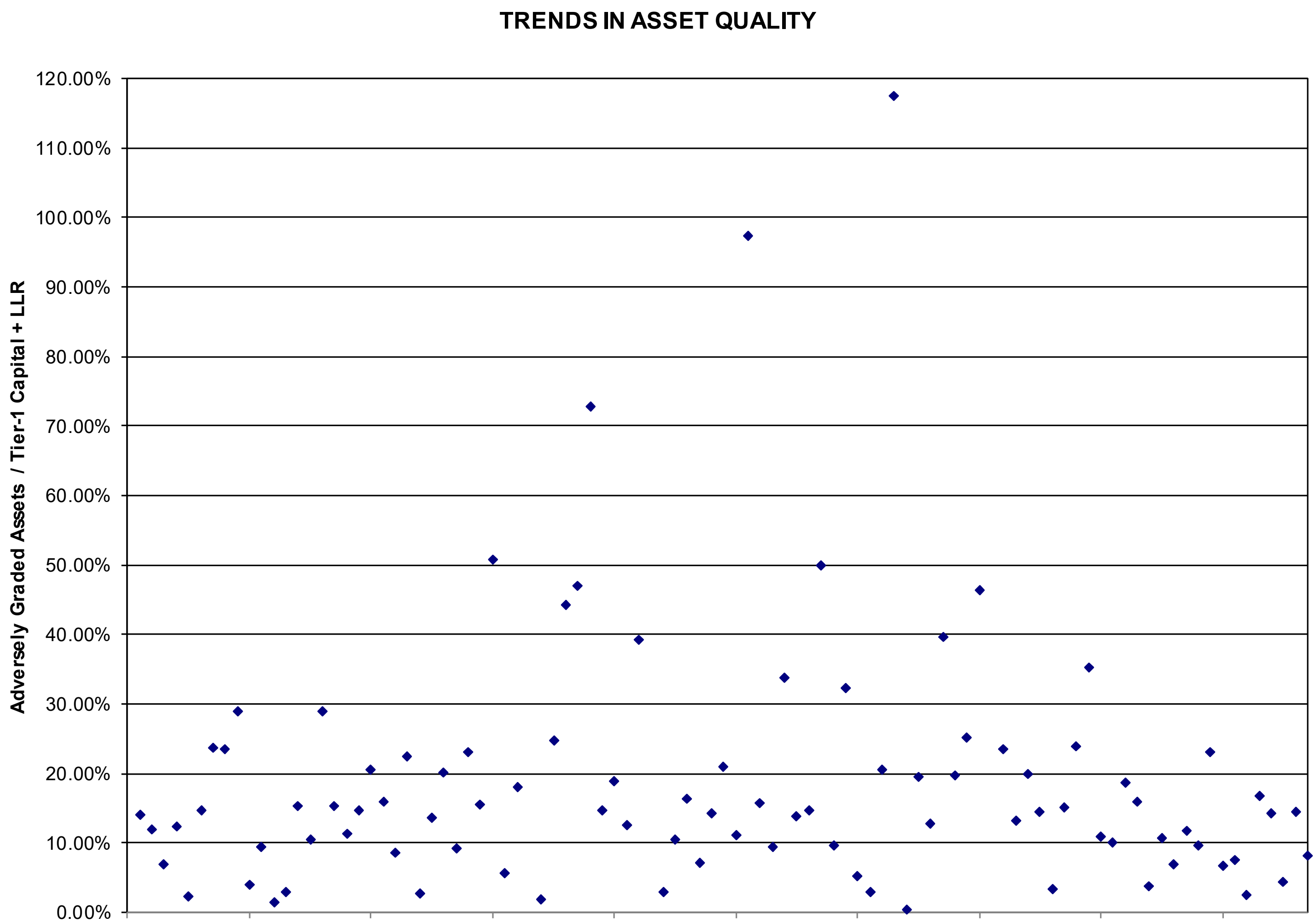
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

Dispersion of Problem Loans – as a Percentage of Total Loans



A traditional benchmark for significant asset quality concern is adversely graded loans that exceed 10% of total loans.

Dispersion of Problem Assets – as a Percentage of Tier-One Capital & Reserves



Note that three data points exceeding 120% are not included in the graph above for aesthetic reasons.

Historical Comparisons

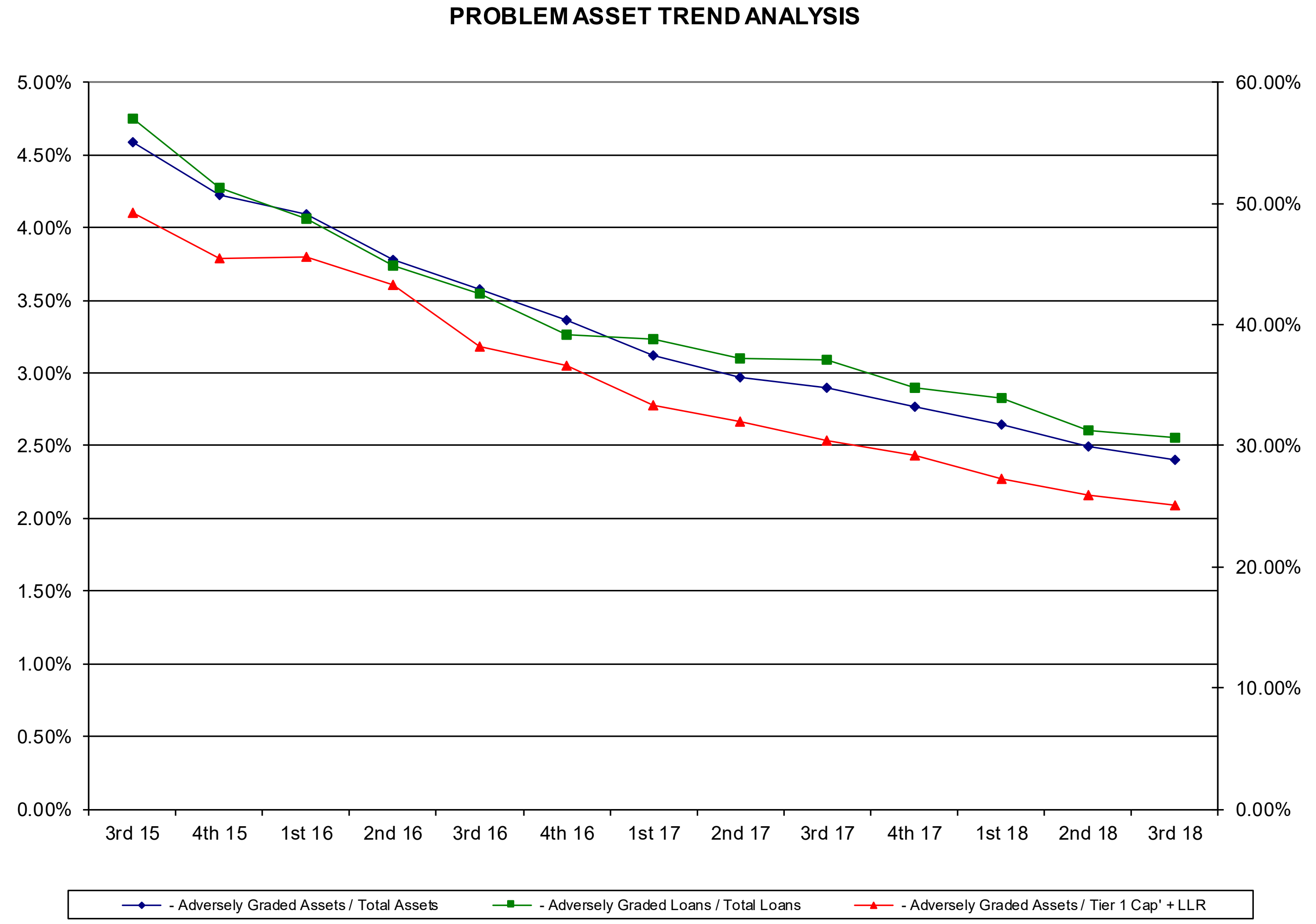
Our sample group includes six (6) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Seven (7) during the Second Quarter 2018
- Eight (8) during the First Quarter 2018
- Ten (10) during the Fourth Quarter 2017

Five (5) banks now exceed 80% of tier-one capital plus loan loss reserve – a level normally associated with some form of formal regulatory action – as compared to:

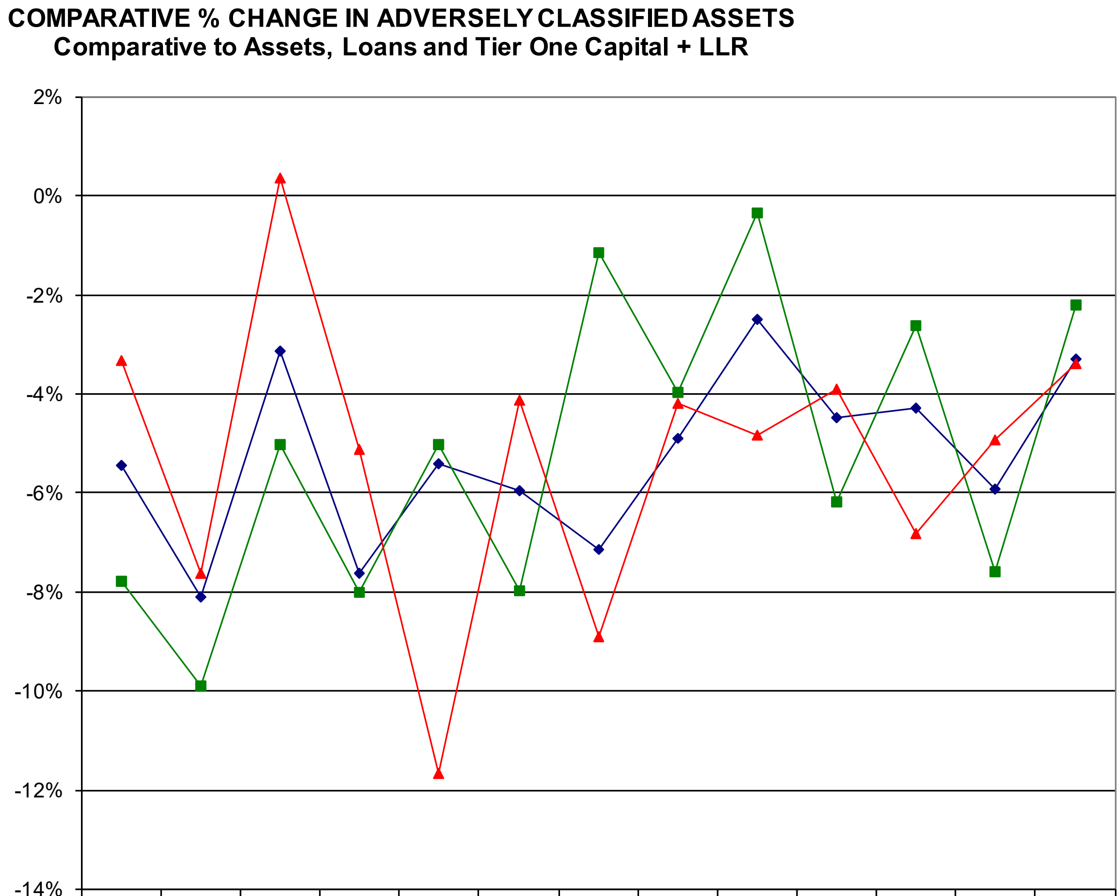
- Five (5) during the Second Quarter 2018
- Five (5) during the First Quarter 2018
- Five (5) during the Fourth Quarter 2017

Problem Asset Trend Analysis



The above graph again shows the trend in asset quality over the past three years as measured by adversely graded assets to total assets, adversely graded loans to total loans, and adversely graded assets to tier-one capital plus LLR.

Problem Asset Comparative Change Analysis



	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18
% Change in ACA/TA	-5.44%	-8.10%	-3.13%	-7.62%	-5.40%	-5.94%	-7.14%	-4.89%	-2.48%	-4.47%	-4.28%	-5.93%	-3.30%
% Change in ACL/TL	-7.79%	-9.90%	-5.04%	-8.02%	-5.01%	-7.99%	-1.13%	-3.98%	-0.35%	-6.19%	-2.61%	-7.60%	-2.21%
% Change in ACA/Tier 1 Cap' + LLR	-3.33%	-7.63%	0.35%	-5.13%	-11.66%	-4.12%	-8.90%	-4.19%	-4.83%	-3.90%	-6.81%	-4.93%	-3.39%

The above graph shows the pace of asset quality deterioration or improvement. The calculation is based on the percent change of problem asset levels from one quarter to the next. The graph indicates a favorable trend in asset quality ratios. Please note any data points below 0% indicate improvement in asset quality.

Modified Peer Data Analysis

We again performed an analysis in which a total of six outlier data points were excluded – the three lowest and the three highest data points, as based on classifications as a percentage of tier-one capital plus loan loss reserve.

With the outlier data points excluded, problem assets (or loans when compared to total loans) averaged 2.18% of total assets, 2.49% of total loans, and 19.38% of tier-one capital plus loan loss reserve. Third Quarter 2018 modified data compares to the following Second Quarter 2018 modified average data set:

- 2.26% of total assets
- 2.54% of total loans, and
- 20.20% of tier-one capital plus loan loss reserve

Commercial Real Estate Stress Testing

By: Stephen Rountree

Commercial Real Estate (CRE) underwriting and repayment analysis should incorporate various stress testing scenarios. In the current rising interest rate environment, prudent underwriting should evaluate the effect rising interest rates will have on borrower repayment ability. Stressing appraisal cap rates is also recommended to evaluate the effect rising rates will have on collateral values. SHPCO is available to assist in loan underwriting and stress testing.

Within our client bank's underwriting, we are seeing various interest rate stressing assumptions – from 100 to 300 basis point shocks. Cap rates are also being shocked from 100 to 250 basis points.

The following is a sample stressed underwriting analysis for a $3.5 million dollar CRE loan. This analysis includes a graduated $80,000 reduction in project net operating income. The loan interest rate is stressed 200 basis points on both a thirty and twenty year repayment structure. As seen below, debt coverage under the assumptions range from 1.56x to a stressed 0.83x.

Net Operating Income	$ 350,000	$ 330,000	$ 310,000	$ 290,000	$ 270,000
Debt Service (4.95%, 30 Years)	$ 224,183	$ 224,183	$ 224,183	$ 224,183	$ 224,183
Debt Service Coverage Ratio	1.56	1.47	1.38	1.29	1.20
Debt Service (6.95%, 30 Years)	$ 278,018	$ 278,018	$ 278,018	$ 278,018	$ 278,018
Debt Service Coverage Ratio	1.26	1.19	1.12	1.04	0.97
Debt Service (4.95%, 20 Years)	$ 276,023	$ 276,023	$ 276,023	$ 276,023	$ 276,023
Debt Service Coverage Ratio	1.27	1.20	1.12	1.05	0.98
Debt Service (6.95%, 20 Years)	$ 324,366	$ 324,366	$ 324,366	$ 324,366	$ 324,366
Debt Service Coverage Ratio	1.08	1.02	0.96	0.89	0.83

The following analysis was performed on a $9.9 million hotel loan. Stabilized income was stressed assuming a 15%, 25%, and 35% reduction in revenue per available room (REVPAR). Debt service coverage was stressed based on an assumed 200 basis point interest rate shock with repayment terms of thirty and twenty years. Property valuation was stressed based on a 250 basis point increase to the appraisal cap rate. As seen below, debt service coverage ranged from 1.93x to a stressed 0.73x. The stress of the capitalization rate resulted in a range of values for the project from $20.4 million to $11.2 million utilizing a 6% cap rate and from $14.4 million to $7.9 million utilizing an 8.5% cap rate.

	2020	Reduction in Revenue Per Available Room (REVPAR)		
Occupancy	90%	(15%)	(25%)	(35%)
ADR	$ 113.68			
REVPAR	$ 102.31	$ 86.97	$ 76.73	$ 66.50
Revenues:				
Rooms	$ 3,510,325	$ 2,983,776	$ 2,632,744	$ 2,281,711
Food & Beverage	$ 10,734	$ 9,124	$ 8,051	$ 6,977
Retail Rent	$ -	$ -	$ -	$ -
Total Revenues	**$ 3,521,059**	**$ 2,992,900**	**$ 2,640,794**	**$ 2,288,688**
Total Departmental Expenses (26%)	$ 927,799	$ 788,629	$ 695,849	$ 603,069
Gross Operating Income	$ 2,593,260	$ 2,204,271	$ 1,944,945	$ 1,685,619
Total Operating Expenses (25%)	$ 880,307	$ 748,225	$ 660,199	$ 572,172
Cash Flow from Operations	$ 1,712,953	$ 1,456,046	$ 1,284,746	$ 1,113,447
Fixed Charges	$ 348,585	$ 348,585	$ 348,585	$ 348,585
Cash Flow (before Reserves)	$ 1,364,368	$ 1,107,461	$ 936,161	$ 764,862
Replacement Reserves (4%)	$ 140,842	$ 119,716	$ 105,632	$ 91,548
Total Expenses	**$ 2,297,533**	**$ 2,005,155**	**$ 1,810,265**	**$ 1,615,374**
Net Operating Income	**$ 1,223,526**	**$ 987,745**	**$ 830,530**	**$ 673,314**
Debt Service (4.95%, 30 Years)	**$ 634,119**	**$ 634,119**	**$ 634,119**	**$ 634,119**
Debt Service Coverage Ratio	**1.93**	**1.56**	**1.31**	**1.06**
Debt Service (6.95%, 30 Years)	**$ 786,394**	**$ 786,394**	**$ 786,394**	**$ 786,394**
Debt Service Coverage Ratio	**1.56**	**1.26**	**1.06**	**0.86**
Debt Service (4.95%, 20 Years)	**$ 780,750**	**$ 780,750**	**$ 780,750**	**$ 780,750**
Debt Service Coverage Ratio	**1.57**	**1.27**	**1.06**	**0.86**
Debt Service (6.95%, 20 Years)	**$ 917,493**	**$ 917,493**	**$ 917,493**	**$ 917,493**
Debt Service Coverage Ratio	**1.33**	**1.08**	**0.91**	**0.73**
Rooms	94	94	94	94
ADR	$ 132.82	$ 120.00	$ 110.00	$ 105.00
Occupancy	70.0%	70.0%	65.0%	60.0%
Cap Rate - 6.0%	**$ 20,392,100**	**$ 16,462,414**	**$ 13,842,159**	**$ 11,221,904**
Cap Rate - 6.5%	**$ 18,823,477**	**$ 15,196,074**	**$ 12,777,378**	**$ 10,358,681**
Cap Rate - 7.0%	**$ 17,478,943**	**$ 14,110,640**	**$ 11,864,708**	**$ 9,618,775**
Cap Rate - 7.5%	**$ 16,313,680**	**$ 13,169,931**	**$ 11,073,727**	**$ 8,977,524**
Cap Rate - 8.0%	**$ 15,294,075**	**$ 12,346,810**	**$ 10,381,619**	**$ 8,416,428**
Cap Rate - 8.5%	**$ 14,394,424**	**$ 11,620,527**	**$ 9,770,936**	**$ 7,921,344**
Debt Yield	**12.36%**	**9.98%**	**8.39%**	**6.80%**
Unadjusted DSCR (4.5%, 25 Years)	**1.93**	**1.56**	**1.31**	**1.06**

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For more information about Steve H. Powell & Company, please visit us on the web at www.shpco.net.

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