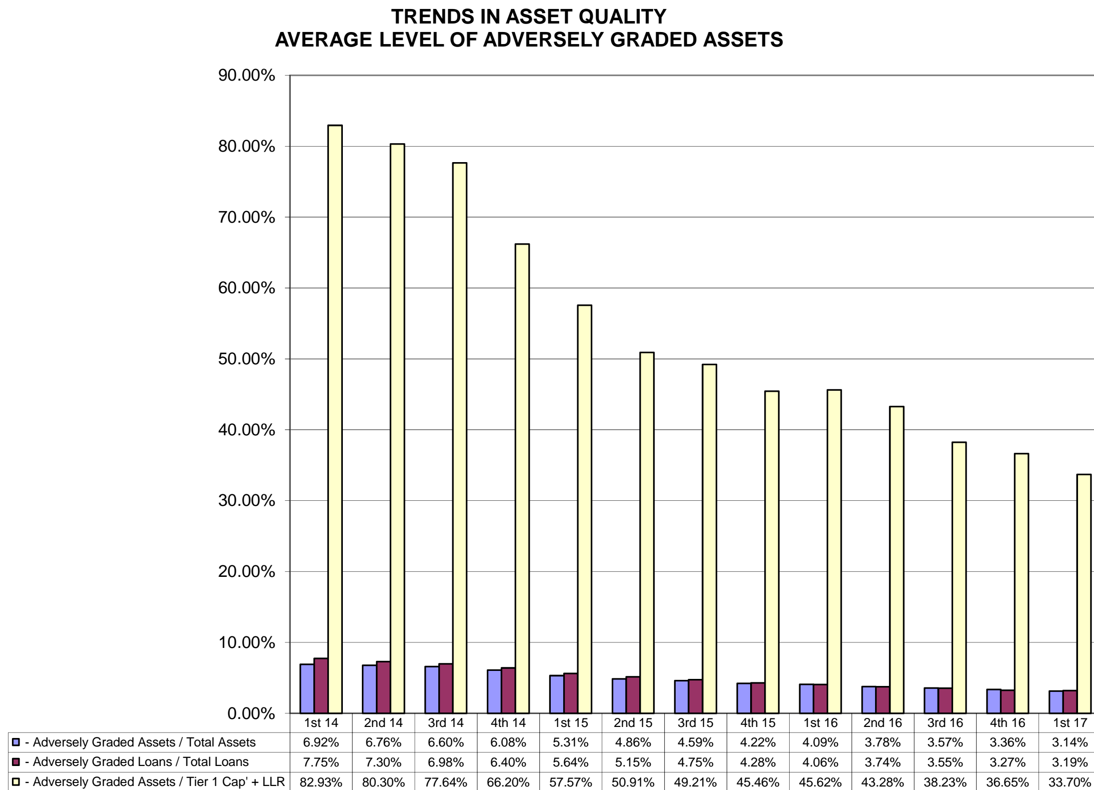
Steve H.
Powell & Company

Asset Quality Update – Q1 2017 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the First Quarter 2017, 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 3.14% of total assets and 33.70% of tier-one capital plus loan loss reserve as compared to 3.36% of total assets and 36.65% of tier-one capital plus loan loss reserve while problem loans averaged 3.19% of total loans as compared to 3.27% of total loans during the Fourth Quarter 2016.



	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17
- Adversely Graded Assets / Total Assets	6.92%	6.76%	6.60%	6.08%	5.31%	4.86%	4.59%	4.22%	4.09%	3.78%	3.57%	3.36%	3.14%
- Adversely Graded Loans / Total Loans	7.75%	7.30%	6.98%	6.40%	5.64%	5.15%	4.75%	4.28%	4.06%	3.74%	3.55%	3.27%	3.19%
- Adversely Graded Assets / Tier 1 Cap' + LLR	82.93%	80.30%	77.64%	66.20%	57.57%	50.91%	49.21%	45.46%	45.62%	43.28%	38.23%	36.65%	33.70%

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.

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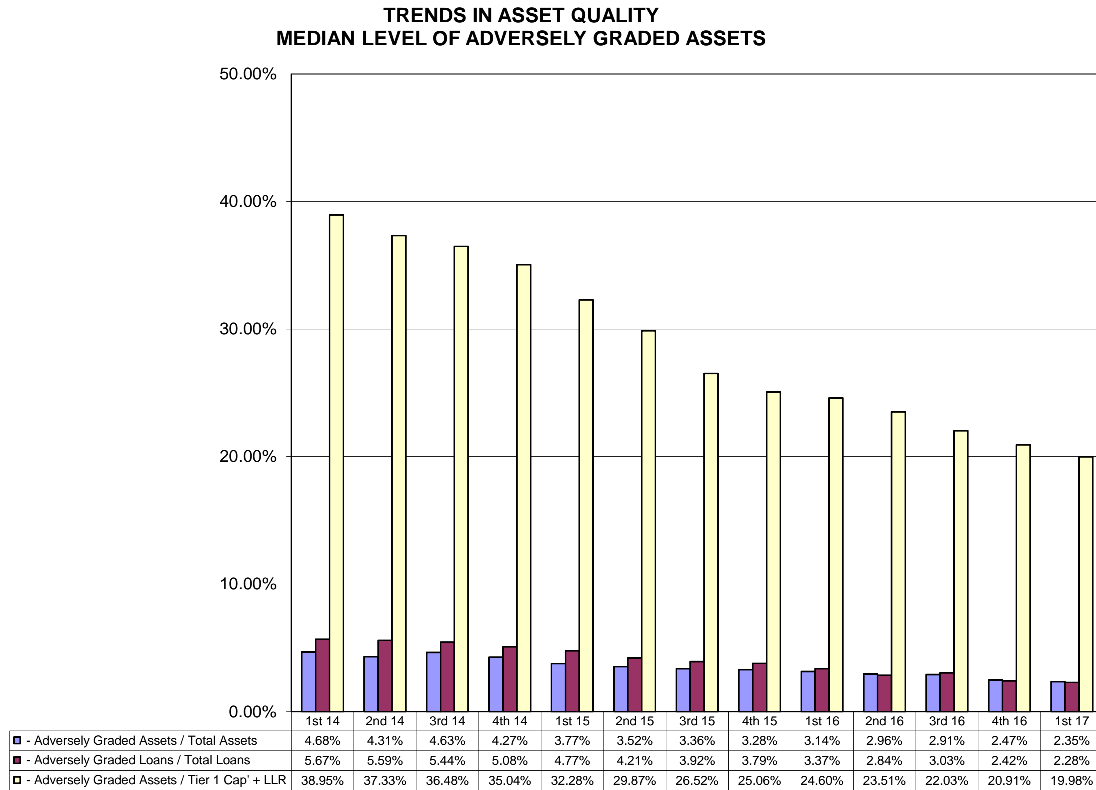
Trends in Asset Quality – Median Levels

The median level of problem assets as of Q1 2017 decreased to 19.98% of tier-one capital plus loan loss reserve as compared to 20.91% during Q3 2016. Note the downward trend as overall asset quality continues to improve.



	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17
- Adversely Graded Assets / Total Assets	4.68%	4.31%	4.63%	4.27%	3.77%	3.52%	3.36%	3.28%	3.14%	2.96%	2.91%	2.47%	2.35%
- Adversely Graded Loans / Total Loans	5.67%	5.59%	5.44%	5.08%	4.77%	4.21%	3.92%	3.79%	3.37%	2.84%	3.03%	2.42%	2.28%
- Adversely Graded Assets / Tier 1 Cap' + LLR	38.95%	37.33%	36.48%	35.04%	32.28%	29.87%	26.52%	25.06%	24.60%	23.51%	22.03%	20.91%	19.98%

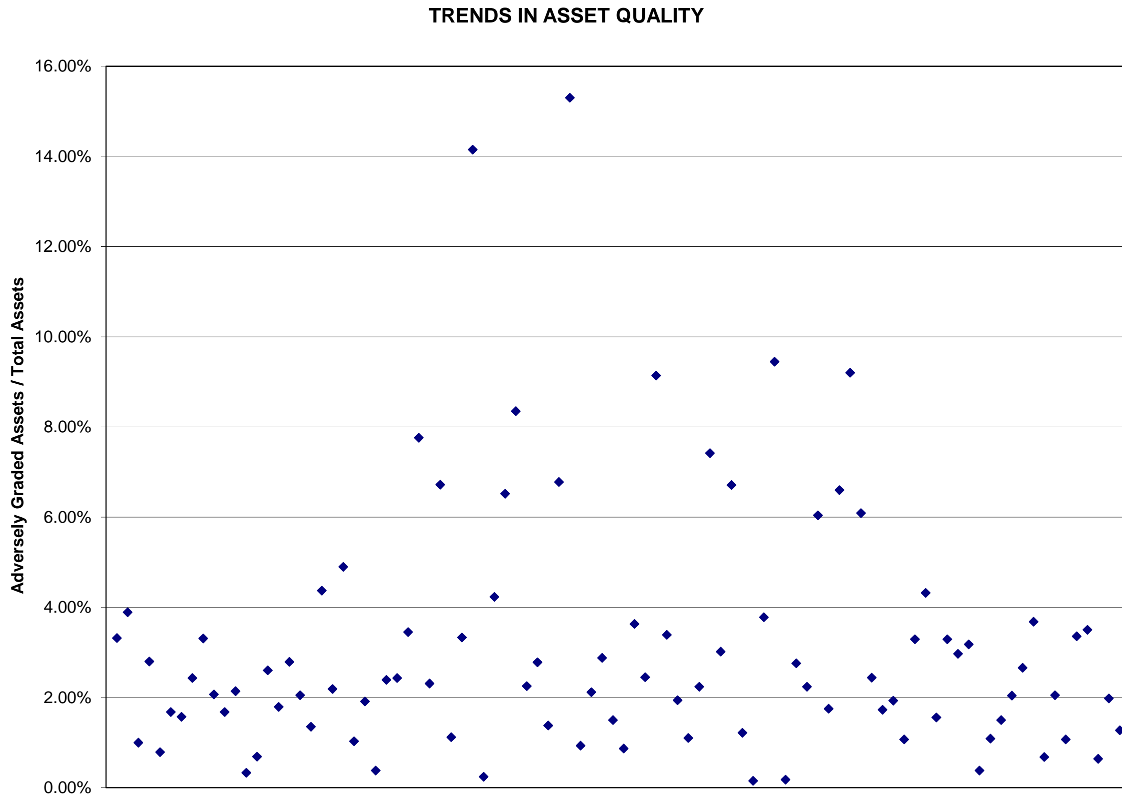
Historical Comparisons

During Q1 2017, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 18% of our clients. This quarter's increase compares to:

- 18% during the Fourth Quarter 2016
- 16% during the Third Quarter 2016
- 19% during the Second Quarter 2016
- 23% during the First Quarter 2016
- 18% during the Fourth Quarter 2015, and
- 8% during the Third Quarter 2015

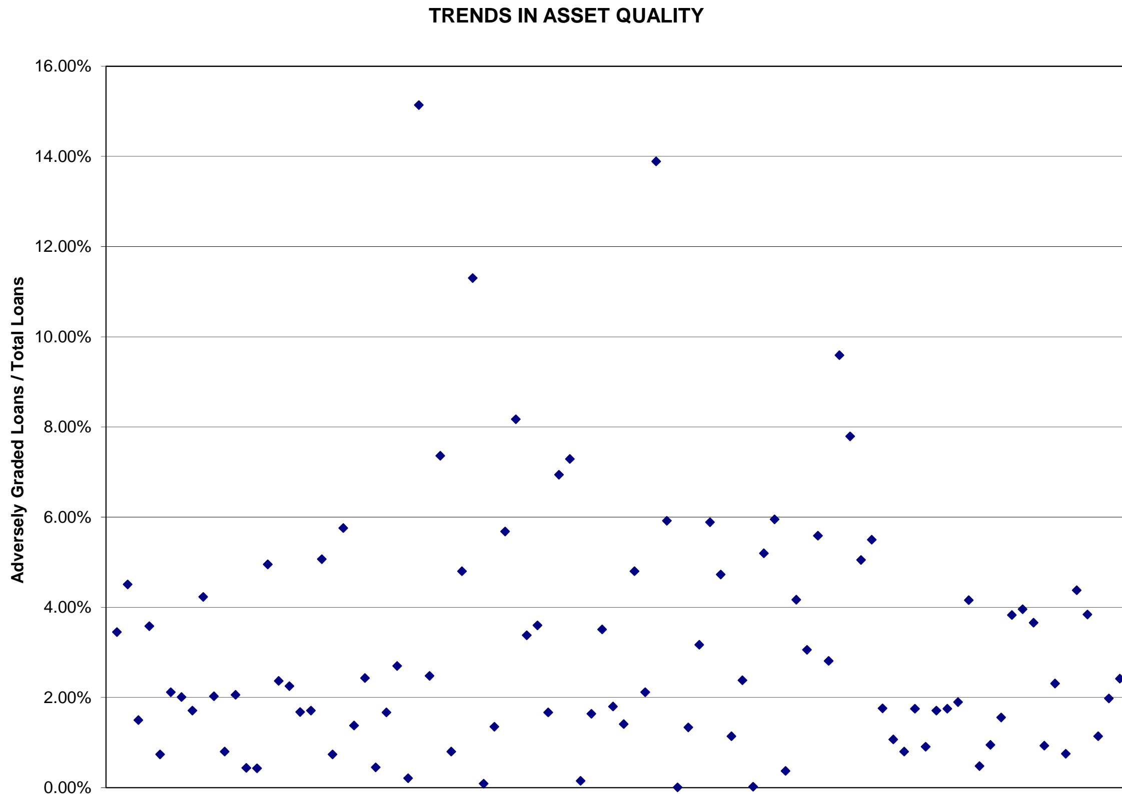
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



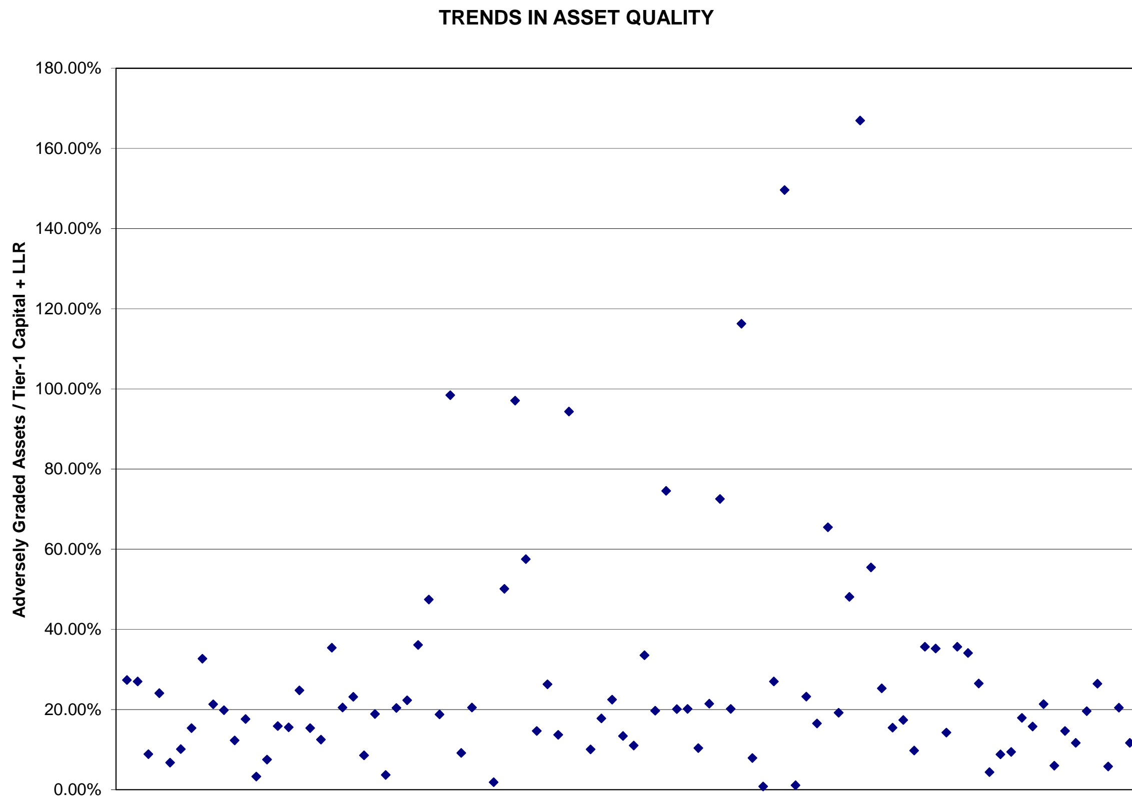
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

Dispersion of Problem Assets – 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 two data points exceeding 180% are not included in the graph above for aesthetic reasons.

Historical Comparisons

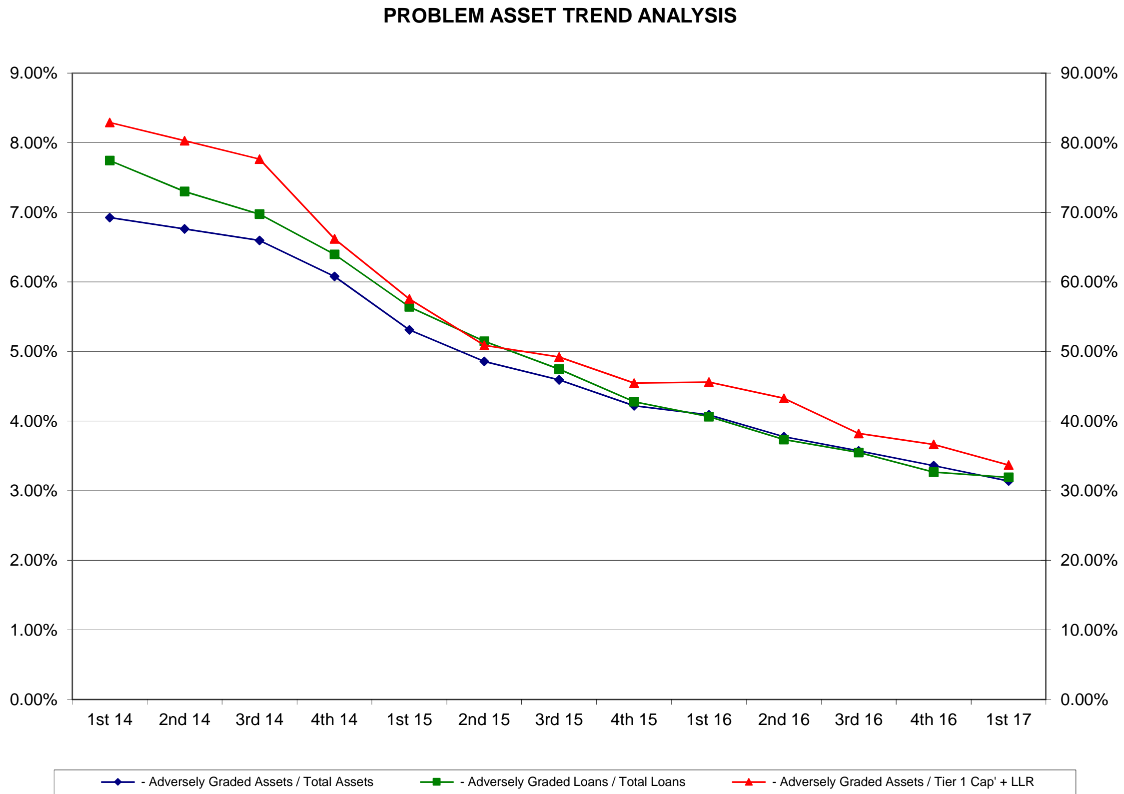
Our sample group includes eleven (11) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Eleven (11) during the Fourth Quarter 2016
- Thirteen (13) during the Third Quarter 2016, and
- Fourteen (14) during the Second Quarter 2016

Eight (8) 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:

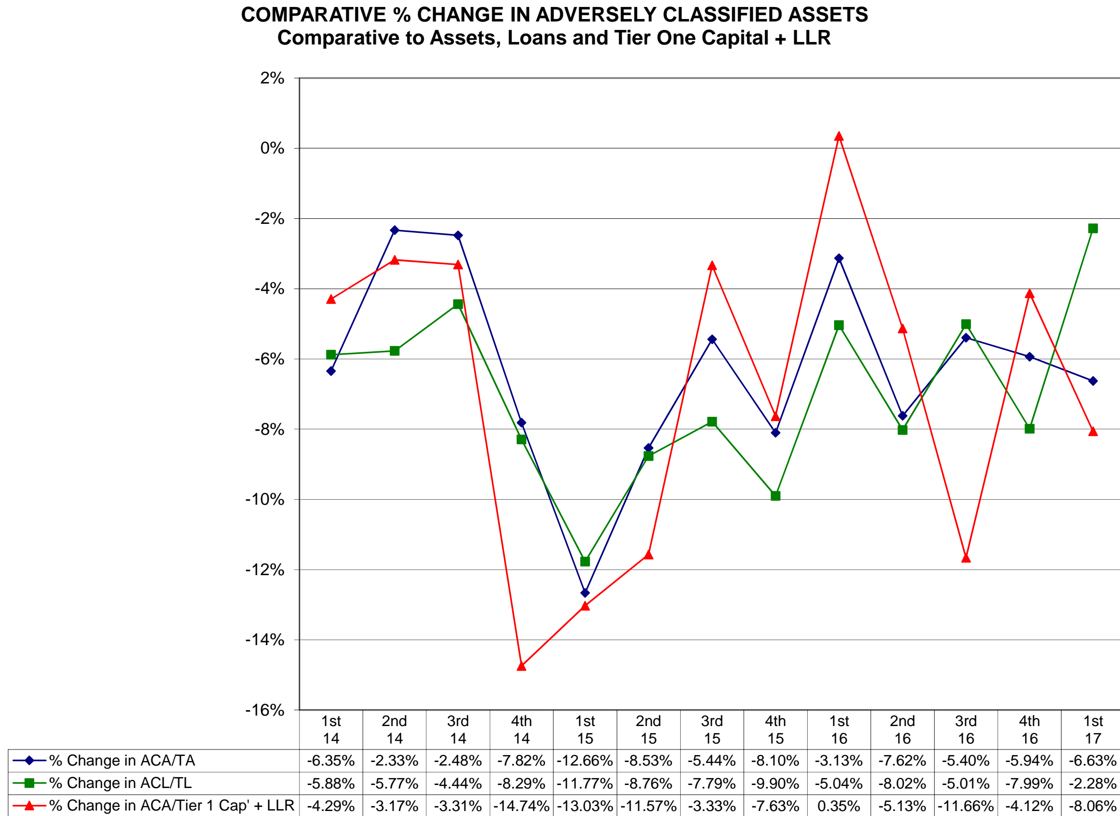
- Eight (8) during the Fourth Quarter 2016
- Nine (9) during the Third Quarter 2016, and
- Ten (10) during the Second Quarter 2016

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



	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17
% Change in ACA/TA	-6.35%	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%	-7.62%	-5.40%	-5.94%	-6.63%
% Change in ACL/TL	-5.88%	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%	-8.02%	-5.01%	-7.99%	-2.28%
% Change in ACA/Tier 1 Cap' + LLR	-4.29%	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%	-5.13%	-11.66%	-4.12%	-8.06%

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 2.91% of total assets, 3.10% of total loans, and 27.21% of tier-one capital plus loan loss reserve. First Quarter 2017 modified data compares to the following Fourth Quarter 2016 modified average data set:

- 3.07% of total assets
- 3.23% of total loans, and
- 28.50% of tier-one capital plus loan loss reserve

Concentrations of Credit

We have noted increasing concentrations of credit within the SHP & Co. peer group. Many clients have expanded their non-farm non-residential portfolios (both owner & non-owner occupied) as well as their AD&C loans. Readers are reminded of the joint 2006 Regulatory publication (Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices) in which the Regulatory bodies detailed CRE concentration levels at which heightened scrutiny could result:

(1) Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
(2) Total commercial real estate loans as defined in the Guidance* represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months.

*Per the Guidance: *"This Guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. Thus, for the purposes of this Guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including 1- to 4-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to real estate investment trusts (REITs) and unsecured loans to developers also should be considered CRE loans for purposes of this Guidance if their performance is closely linked to performance of the CRE markets. Excluded from the scope of this Guidance are loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property."*

The most recent Supervisory Insight issue focuses on three areas of loan concentrations, CRE, agriculture and oil & gas, and indicates its discussion is applicable to other loan portfolio segments representing concentrations. In reading the Winter SI issue, a look back at the OIG's Comprehensive Study on the Impact of the Failure of Insured Depository Institutions will provide some useful background information. The Report's findings included:

- The markets drove behaviors that were not always prudent. Banks expanded lending to keep pace with rapid growth in construction and real estate development, rising mortgage demands, and increased competition. Many of the banks that failed did so because management relaxed underwriting standards and did not implement adequate oversight and controls.
- …[Regulators] could have provided earlier and greater supervisory attention to troubled institutions that failed.
- The majority of community banks failed as a result of aggressive growth, asset concentrations, poor underwriting, and deficient credit administration coupled with declining real estate values.

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The SI highlights the following weaknesses (in addition to some other weaknesses noted) within CRE portfolios:

- The absence of, or unsupported or excessive, board-approved limits for CRE portfolios or segments thereof;
- Inadequate reporting of concentrations to the institution's board or relevant committee and lack of documented discussion regarding concentrations in board or relevant committee meetings;
- Weaknesses in underwriting practices, including the following:
    - Numerous exceptions to the institution's loan policy;
    - Inadequate tracking of loan policy exceptions;
    - Unsupported cash flow projections;
    - Lack of global cash flow analysis of guarantors; and
    - Excessive or inappropriate use of cash-out financing and interest only payment terms;
- Insufficient internal loan review coverage of CRE activities or improper risk ratings;
- Appraisal review programs lacking adequate independence or expertise of reviewers
- Ineffective construction loan oversight, including lack of timely inspections or adequate disbursement controls…

The SI includes what could be considered a 'word to the wise': '*When management cannot or does not achieve reasonable diversification, risk-management programs that may otherwise be adequate may require increased oversight; stronger credit- and liquidity-management practices; enhanced management information systems and reporting; more robust loan review and allowance for loan and lease losses (ALLL) policies and practices; and possibly, higher capital levels.*'

For reference, the following concentration information was derived from Uniform Bank Performance data (as of December 31, 2016 for all institutions chartered in the states of Alabama, Florida, Georgia, South Carolina, and Tennessee, as well as national averages):

Concentrations of Credit	AL	FL	GA	SC	TN	NATIONAL
Loan & Leases as a % of Total Capital:	12/31/16					
Real Estate Loans	343.67	534.05	463.08	498.45	471.43	418.12
Construction & Development	37.17	41.17	54.12	58.24	58.66	28.93
Secured by Farmland	22.31	5.40	33.69	8.65	21.06	34.93
1-4 Family Residential	133.04	191.28	156.18	209.06	195.90	162.89
Multifamily	9.58	22.96	10.96	6.62	11.65	14.34
Non-Farm Non-Residential	126.01	253.08	187.04	206.09	167.40	136.53
Agricultural Loans	5.60	0.77	8.05	3.17	4.92	26.76
Commercial & Industrial Loans	71.54	67.82	61.74	62.78	74.41	66.40
Commercial Real Estate Loans as a % of Total Capital:						
Non-owner Occ Commercial Real Estate	106.02	213.61	161.37	154.87	157.87	121.76
Total Commercial Real Estate	178.18	323.67	260.68	274.28	244.99	192.63
Commercial Real Estate Loans as a % of Total LN&LS:						
Total Commercial Real Estate	36.26	52.05	43.41	45.98	39.90	32.92

This information can be found using tools from the FFIEC at https://www.ffiec.gov or please contact us for assistance with or request for additional detail / trends, or overall detail regarding other states.

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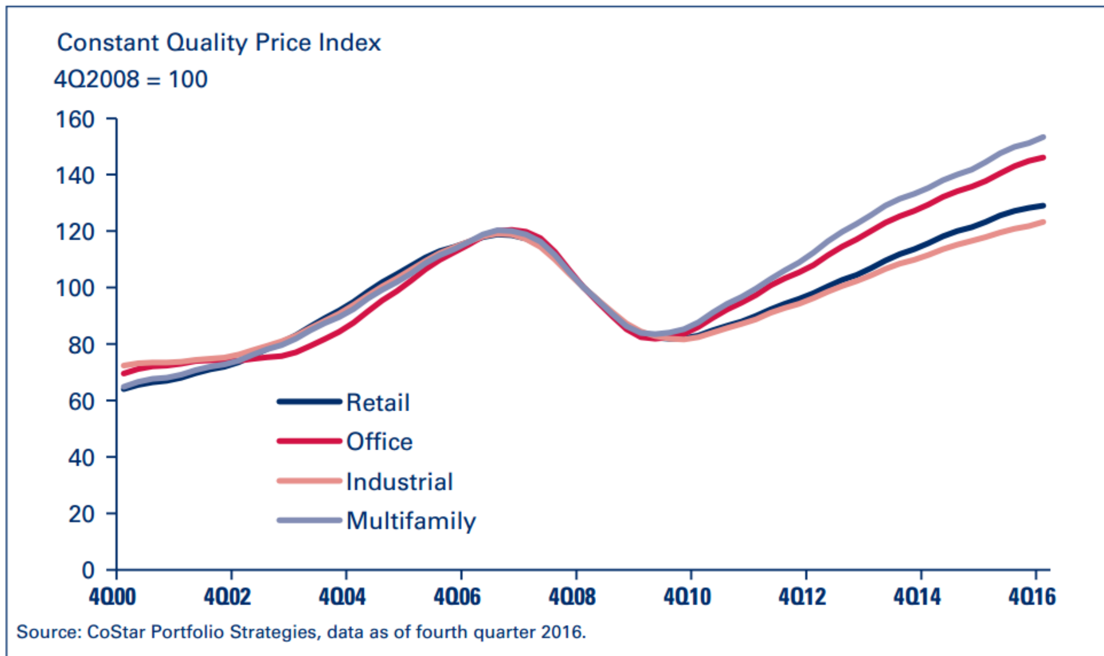
Trends in Capitalization Rates

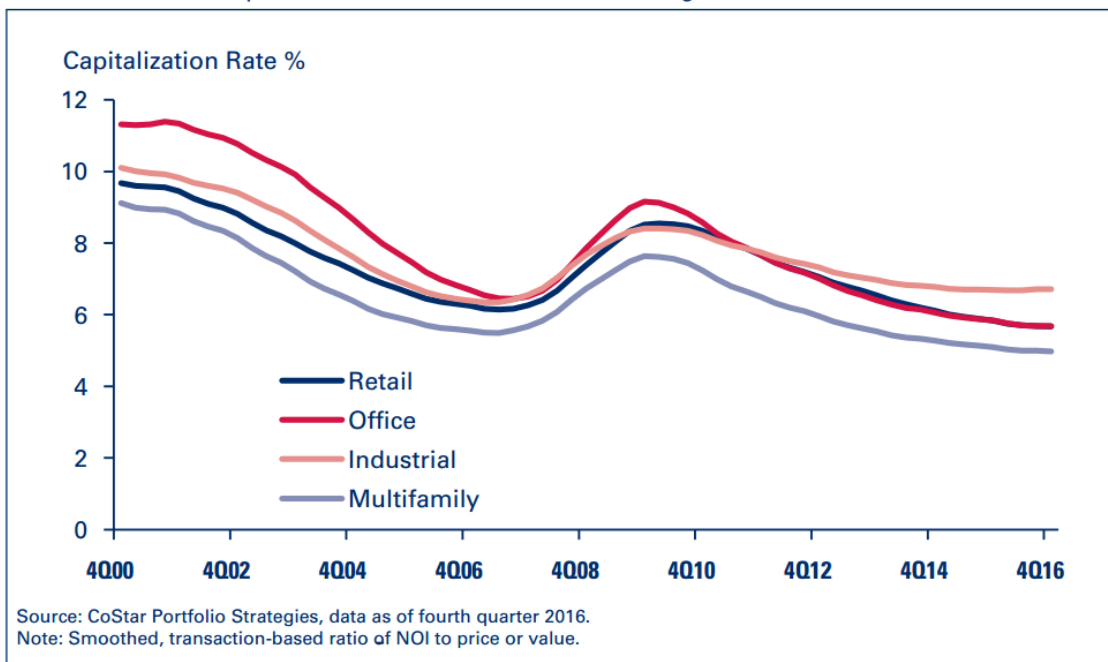
The graphs below detail the trends in Commercial Real Estate ("CRE") prices and CRE capitalization rates. Note that, as of data through the fourth quarter of 2016, CRE prices are noted to be at historic highs and CRE cap rates are shown to be below pre-crisis levels (per [CoStar](), from the [Winter 2016 Supervisory Insights issue]()).

Chart 2: CRE Prices at Historic Highs



Source: CoStar Portfolio Strategies, data as of fourth quarter 2016.

Chart 3: Most CRE Capitalization Rates Below Pre-Crisis Troughs



Source: CoStar Portfolio Strategies, data as of fourth quarter 2016.
Note: Smoothed, transaction-based ratio of NOI to price or value.

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The trends of the two graphs, viewed in comparison, is logical given the price and capitalization rate relationship. Decreasing capitalization rates and increasing prices may prove to strengthen, at least temporarily, portions of the existing portfolio; however, new originations may be subjected to additional risks as it is unclear how far acceptable investor yields for CRE will fall in a rising interest rate environment. Rising interest rates could deter CRE investing through increasing financing costs as well as making other investment asset classes more attractive due to higher yields.

Conservative and prudent underwriting for CRE projects can include a stress test of market capitalization rates to determine the effect on property value. Escalating rents (and increasing NOI) also help to offset potential changes in investor returns. For example, investor requires returns of 7.0% for a property with a Net Operating Income ("NOI") of $100,000, yields a $1,429,000 value. If the loan was underwritten when investor required yields were only 6.0% (a $1,667,000 property value), then the subsequent value decrease could jeopardize a lending institution's collateral margin. In this example (which inherently assumes a short time frame in changes in investor expectations and/or flat rental income), an original Loan-To-Value ("LTV") ratio of 75% would increase to 87% (in the absence of principal reductions).

As part of prudent underwriting and decision making for CRE lending, the appraisal review processes should analyze the reasonableness of appraisal inputs and assumptions. In regard to the income approach to value, applied rents should be well supported with respect to the current income of the property and any encumbrances/leases as well as income of other comparable properties in the market. Vacancy and collection rates, as well as appropriate capitalization rates, should be well-supported in the same manner.

A source of national capitalization rate data can be found at http://mapping.cbre.com/maps/caprate/custom/index.html.

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

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