HOME BANCSHARES INC
Form 10-Q
November 08, 2011

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended September 30, 2011

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Transition period from __________to__________

Commission File Number: 000-51904

HOME BANCSHARES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Arkansas	71-0682831
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
719 Harkrider, Suite 100, Conway, Arkansas	72032
(Address of principal executive offices)	(Zip Code)

(501) 328-4770

(Registrant s telephone number, including area code)

Not Applicable

Former name, former address and former fiscal year, if changed since last report

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 þ No o

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 þ No o

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practical date.

Common Stock Issued and Outstanding: 28,268,186 shares as of October 31, 2011.

HOME BANCSHARES, INC.
FORM 10-Q
September 30, 2011
INDEX

Exhibit List

12.1	Computation of Ratios of Earnings to Fixed Charges
15	Awareness of Independent Registered Public Accounting Firm
31.1	CEO Certification Pursuant to 13a-14(a)/15d-14(a)
31.2	CFO Certification Pursuant to 13a-14(a)/15d-14(a)
32.1	CEO Certification Pursuant to 18 U.S.C. Section 1350
32.2	CFO Certification Pursuant to 18 U.S.C. Section 1350
101	XBRL Documents

Table of Contents

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Some of our statements contained in this document, including matters discussed under the caption Management s Discussion and Analysis of Financial Condition and Results of Operation are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements relate to future events or our future financial performance and include statements about the competitiveness of the banking industry, potential regulatory obligations, our entrance and expansion into other markets, our other business strategies and other statements that are not historical facts. Forward-looking statements are not guarantees of performance or results. When we use words like may, plan, contemplate, anticipate, believe, intend, continue, expect, project, predict, estimate, could, shou expressions, you should consider them as identifying forward-looking statements, although we may use other phrasing. These forward-looking statements involve risks and uncertainties and are based on our beliefs and assumptions, and on the information available to us at the time that these disclosures were prepared. These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to, the following:

- the effects of future economic conditions, including inflation or a continued decrease in commercial real estate and residential housing values;
- governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- the impact of the recently enacted Dodd-Frank financial regulatory reform act and regulations to be issued thereunder;
- the risks of changes in interest rates or the level and composition of deposits, loan demand and the values of loan collateral, securities and interest sensitive assets and liabilities;
- the effects of terrorism and efforts to combat it;
- credit risks;
- the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally and internationally, together with competitors offering banking products and services by mail, telephone and the Internet;
- the effect of any mergers, acquisitions or other transactions to which we or our subsidiaries may from time to time be a party, including our ability to successfully integrate any businesses that we acquire;
- the failure of assumptions underlying the establishment of our allowance for loan losses; and
- the failure of assumptions underlying the estimates of the fair values for our covered assets and FDIC indemnification receivable.

All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Note. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, see the Risk Factors section of our Form 10-K filed with the Securities and Exchange Commission on March 10, 2011.

Table of Contents

PART I: FINANCIAL INFORMATION
Item 1: Financial Statements

Home BancShares, Inc.
Consolidated Balance Sheets

(In thousands, except share data)	September 30, 2011 (Unaudited)	December 31, 2010
Assets		
Cash and due from banks	$ 48,748	$ 49,927
Interest-bearing deposits with other banks	104,053	237,605
Cash and cash equivalents	152,801	287,532
Federal funds sold	3,670	27,848
Investment securities available for sale	610,522	469,864
Loans receivable not covered by loss share	1,826,373	1,892,374
Loans receivable covered by FDIC loss share	511,326	575,776
Allowance for loan losses	(54,508)	(53,348)
Loans receivable, net	2,283,191	2,414,802
Bank premises and equipment, net	89,894	81,939
Foreclosed assets held for sale not covered by loss share	16,541	11,626
Foreclosed assets held for sale covered by FDIC loss share	32,183	21,568
FDIC indemnification asset	201,211	227,258
Cash value of life insurance	52,422	51,970
Accrued interest receivable	15,038	16,176
Deferred tax asset, net	21,998	18,586
Goodwill	59,663	59,663
Core deposit and other intangibles	9,325	11,447
Other assets	73,707	62,367
Total assets	$ 3,622,166	$ 3,762,646
Liabilities and Stockholders Equity		
Deposits:		
Demand and non-interest-bearing	$ 479,512	$ 392,622
Savings and interest-bearing transaction accounts	1,143,335	1,108,309
Time deposits	1,262,202	1,460,867
Total deposits	2,885,049	2,961,798
Securities sold under agreements to repurchase	62,407	74,459
FHLB borrowed funds	142,901	177,270
Accrued interest payable and other liabilities	24,339	27,863
Subordinated debentures	44,331	44,331
Total liabilities	3,159,027	3,285,721

Stockholders equity:		
Preferred stock; $0.01 par value; 5,500,000 shares authorized:		
Series A fixed rate cumulative perpetual; liquidation preference of $1,000 per share; zero shares issued or outstanding at September 30, 2011; 50,000 shares issued and outstanding at December 31, 2010.		49,456
Common stock, par value $0.01; shares authorized 50,000,000; shares issued and outstanding 28,259,044 in 2011 and 28,452,411 in 2010	283	285
Capital surplus	425,852	432,962
Retained earnings (deficit)	28,218	(6,079)
Accumulated other comprehensive income	8,786	301
Total stockholders equity	463,139	476,925
Total liabilities and stockholders equity	$ 3,622,166	$ 3,762,646

See Condensed Notes to Consolidated Financial Statements. 4

Table of Contents

Home BancShares, Inc.
Consolidated Statements of Income

(In thousands, except per share data)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	(Unaudited)			
Interest income:				
Loans	$ 39,199	$ 35,673	$ 117,844	$ 98,675
Investment securities				
Taxable	2,429	1,802	6,793	5,364
Tax-exempt	1,546	1,492	4,617	4,471
Deposits other banks	84	92	331	258
Federal funds sold	1	3	9	13
Total interest income	43,259	39,062	129,594	108,781
Interest expense:				
Interest on deposits	5,638	6,319	17,884	17,486
FHLB borrowed funds	1,250	1,854	3,768	6,113
Securities sold under agreements to repurchase	120	137	384	349
Subordinated debentures	539	599	1,620	1,796
Total interest expense	7,547	8,909	23,656	25,744
Net interest income	35,712	30,153	105,938	83,037
Provision for loan losses		3,000	1,250	9,850
Net interest income after provision for loan losses	35,712	27,153	104,688	73,187
Non-interest income:				
Service charges on deposit accounts	3,638	3,551	10,428	10,275
Other service charges and fees	2,489	1,816	7,375	5,353
Mortgage lending income	783	760	2,089	1,822
Mortgage servicing income				314
Insurance commissions	428	248	1,505	904
Income from title services	126	98	327	353
Increase in cash value of life insurance	323	330	849	1,106
Dividends from FHLB, FRB & bankers bank	184	151	506	419
Gain on acquisitions				9,334
Gain on sale of SBA loans			259	18
Gain (loss) on sale of premises and equipment, net	6	2	79	221
Gain (loss) on OREO, net	69	(1,063)	(1,032)	(1,308)
Gain (loss) on securities, net	5	(37)	5	(37)
FDIC indemnification asset	1,314	1,895	4,614	2,631
Other income	595	556	2,123	1,767
Total non-interest income	9,960	8,307	29,127	33,172

Non-interest expense:				
Salaries and employee benefits	10,691	9,637	32,449	27,251
Occupancy and equipment	3,562	3,264	10,923	9,036
Data processing expense	1,185	848	3,607	2,664
Other operating expenses	8,298	7,545	24,474	19,888
Total non-interest expense	23,736	21,294	71,453	58,839
Income before income taxes	21,936	14,166	62,362	47,520
Income tax expense	7,624	4,606	21,788	16,122
Net income available to all stockholders	14,312	9,560	40,574	31,398
Preferred stock dividends and accretion of discount on preferred stock	488	670	1,828	2,010
Net income available to common stockholders	$ 13,824	$ 8,890	$ 38,746	$ 29,388
Basic earnings per common share	$ 0.48	$ 0.32	$ 1.36	$ 1.04
Diluted earnings per common share	$ 0.48	$ 0.31	$ 1.35	$ 1.03

See Condensed Notes to Consolidated Financial Statements. 5

Home BancShares, Inc.
Consolidated Statements of Stockholders Equity
Nine Months Ended September 30, 2011 and 2010

(In thousands, except share data)	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2010	$ 49,275	$ 257	$ 363,519	$ 51,746	$ 176	$ 464,973
Comprehensive income:						
Net income				31,398		31,398
Other comprehensive income:						
Unrealized gain on investment securities available for sale, net of tax effect of $3,872					5,995	5,995
Comprehensive income						37,393
Accretion of discount on preferred stock	136			(136)		
Net issuance of 156,069 shares of common stock from exercise of stock options		2	1,411			1,413
Disgorgement of profits			11			11
Tax benefit from stock options exercised			863			863
Share-based compensation			324			324
Cash dividend Preferred Stock - 5%				(1,875)		(1,875)
Cash dividends Common Stock, $0.1625 per share				(4,623)		(4,623)
Stock dividend Common Stock 10%		25	66,540	(66,576)		(11)
Balances at September 30, 2010 (unaudited)	49,411	284	432,668	9,934	6,171	498,468
Comprehensive income:						
Net income				(13,807)		(13,807)
Other comprehensive income:						
Unrealized loss on investment securities available for sale, net of tax effect of $(3,792)					(5,870)	(5,870)
Comprehensive income						(19,677)
Accretion of discount on preferred stock	45			(45)		
		1	141			142

Net issuance of 18,829 shares of common stock from exercise of stock options						
Tax benefit from stock options exercised			101			101
Share-based compensation			52			52
Cash dividends Preferred stock - 5%				(625)		(625)
Cash dividends Common Stock, $0.054 per share				(1,536)		(1,536)
Balances at December 31, 2010	49,456	285	432,962	(6,079)	301	476,925

See Condensed Notes to Consolidated Financial Statements. 6

Table of Contents

Home BancShares, Inc.
Consolidated Statements of Stockholders Equity Continued
Nine Months Ended September 30, 2011 and 2010

(In thousands, except share data)	Preferred Stock	Common Stock	Capital Surplus	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Comprehensive income:						
Net income				40,574		40,574
Other comprehensive income:						
Unrealized gain on investment securities available for sale, net of tax effect of $5,478					8,485	8,485
Comprehensive income						49,059
Repurchase of 50,000 shares of preferred stock and common stock warrant	(50,000)		(2,206)	906		(51,300)
Accretion of discount on preferred stock	544			(544)		
Net issuance of 24,477 shares of common stock from exercise of stock options			227			227
Repurchase of common stock		(2)	(5,542)			(5,544)
Tax benefit from stock options exercised			126			126
Share-based compensation			285			285
Cash dividends Preferred stock - 5%				(1,286)		(1,286)
Cash dividends Common Stock, $0.188 per share				(5,353)		(5,353)
Balances at September 30, 2011 (unaudited)	$	$ 283	$ 425,852	$ 28,218	$ 8,786	$ 463,139

See Condensed Notes to Consolidated Financial Statements. 7

Table of Contents

Home BancShares, Inc.
Consolidated Statements of Cash Flows

(In thousands)	Period Ended September 30, 2011	2010
	(Unaudited)	
Operating Activities		
Net income	$ 40,574	$ 31,398
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	4,943	3,945
Amortization/(accretion)	489	52
Share-based compensation	285	324
Tax benefits from stock options exercised	(126)	(863)
(Gain) loss on assets	645	969
Gain on acquisitions		(9,334)
Provision for loan losses	1,250	9,850
Deferred income tax effect	(8,890)	2,100
Increase in cash value of life insurance	(849)	(1,106)
Originations of mortgage loans held for sale	(82,239)	(94,415)
Proceeds from sales of mortgage loans held for sale	85,562	79,856
Changes in assets and liabilities:		
Accrued interest receivable	1,138	(2,132)
Other assets	19,326	9,913
Accrued interest payable and other liabilities	(3,398)	5,397
Net cash provided by (used in) operating activities	58,710	35,954
Investing Activities		
Net (increase) decrease in federal funds sold	24,178	14,039
Net (increase) decrease in loans net, excluding loans acquired	79,214	10,019
Purchases of investment securities available for sale	(262,286)	(113,721)
Proceeds from maturities of investment securities available for sale	132,044	107,855
Proceeds from sale of investment securities available for sale	566	5,539
Proceeds from foreclosed assets held for sale	26,738	14,879
Proceeds from sale of SBA loans	4,524	268
Sale of mortgage servicing portfolio		225
Purchases of premises and equipment, net	(12,819)	(7,722)
Death benefits received	700	1,585
Net cash proceeds received in FDIC-assisted acquisitions		160,587
Net cash provided by (used in) investing activities	(7,141)	193,553
Financing Activities		
Net increase (decrease) in deposits, net of deposits acquired	(76,749)	(90,829)
Net increase (decrease) in securities sold under agreements to repurchase	(12,052)	11,015
Net increase (decrease) in FHLB and other borrowed funds, net of acquired	(34,369)	(107,642)
Retirement of subordinated debentures		(3,252)

Proceeds from exercise of stock options	227	1,413
Repurchase of common stock	(5,544)	
Repurchase of preferred stock and common stock warrant	(51,300)	
Disgorgement of profits		11
Tax benefits from stock options exercised	126	863
Dividends paid on preferred stock	(1,286)	(1,875)
Dividends paid on common stock	(5,353)	(4,634)
Net cash provided by (used in) financing activities	(186,300)	(194,930)
Net change in cash and cash equivalents	(134,731)	34,577
Cash and cash equivalents beginning of year	287,532	173,490
Cash and cash equivalents end of period	$ 152,801	$ 208,067

See Condensed Notes to Consolidated Financial Statements. 8

Table of Contents

Home BancShares, Inc.
Condensed Notes to Consolidated Financial Statements
(Unaudited)

1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Home BancShares, Inc. (the Company or HBI) is a bank holding company headquartered in Conway, Arkansas. The Company is primarily engaged in providing a full range of banking services to individual and corporate customers through its wholly owned community bank subsidiary Centennial Bank (the Bank). The Bank has locations in central Arkansas, north central Arkansas, southern Arkansas, the Florida Keys, central Florida, southwestern Florida and the Florida Panhandle. The Company is subject to competition from other financial institutions. The Company also is subject to the regulation of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

A summary of the significant accounting policies of the Company follows:

Operating Segments

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Bank is the only significant subsidiary upon which management makes decisions regarding how to allocate resources and assess performance. Each of the branches of the Bank provide a group of similar community banking services, including such products and services as commercial, real estate and consumer loans, time deposits, checking and savings accounts. The individual bank branches have similar operating and economic characteristics. While the chief decision maker monitors the revenue streams of the various products, services and branch locations, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the community banking services and branch locations are considered by management to be aggregated into one reportable operating segment, community banking.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of foreclosed assets, the valuations of covered loans and the related indemnification asset. In connection with the determination of the allowance for loan losses and the valuation of foreclosed assets, management obtains independent appraisals for significant properties.

Principles of Consolidation

The consolidated financial statements include the accounts of HBI and its subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

Reclassifications

Various items within the accompanying consolidated financial statements for previous years have been reclassified to provide more comparative information. These reclassifications had no effect on net income or stockholders equity.

Table of Contents

Loans Receivable Not Covered by Loss Share and Allowance for Loan Losses

Loans receivable not covered by loss share that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balance adjusted for any charge-offs, deferred fees or costs on originated loans. Interest income on loans is accrued over the term of the loans based on the principal balance outstanding. Loan origination fees and direct origination costs are capitalized and recognized as adjustments to yield on the related loans.

The allowance for loan losses is established through a provision for loan losses charged against income. The allowance represents an amount that, in management s judgment, will be adequate to absorb probable credit losses on existing loans that may become uncollectible and probable credit losses inherent in the remainder of the loan portfolio. The amounts of provisions to the allowance for loan losses are based on management s analysis and evaluation of the loan portfolio for identification of problem credits, internal and external factors that may affect collectability, relevant credit exposure, particular risks inherent in different kinds of lending, current collateral values and other relevant factors.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical charge-off experience and expected loss given default derived from the Bank s internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risking rating data.

Loans considered impaired, under FASB ASC 310-10-35, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The aggregate amount of impairment of loans is utilized in evaluating the adequacy of the allowance for loan losses and amount of provisions thereto. Losses on impaired loans are charged against the allowance for loan losses when in the process of collection it appears likely that such losses will be realized. The accrual of interest on impaired loans is discontinued when, in management s opinion, the collection of interest is doubtful, or generally when loans are 90 days or more past due. When accrual of interest is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group s historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans.

Loans are placed on non-accrual status when management believes that the borrower s financial condition, after giving consideration to economic and business conditions and collection efforts, is such that collection of interest is doubtful, or generally when loans are 90 days or more past due. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely. Accrued interest related to non-accrual loans is generally charged against the allowance for loan losses when accrued in prior years and reversed from interest income if accrued in the current year. Interest income on non-accrual loans may be recognized to the extent cash payments are received, but payments received are usually applied to principal. Non-accrual loans are generally returned to accrual status when principal and interest payments are less than 90 days past due, the customer has made required payments for at least six months, and the Company reasonably expects to collect all principal and interest.

Table of Contents

Trouble Debt Restructurings

The Company accounts for troubled debt restructurings (TDRs) using ASC Topic 310-40, *Troubled Debt Restructurings by Creditors*. Restructuring of a debt constitutes a troubled debt restructuring if the Company, for economic or legal reasons related to the debtor s financial difficulties, grants a concession to the debtor that it would not otherwise consider. Common concessions granted to borrowers include interest rate and/or term modifications. As a result, the Bank will work with the borrower to prevent further difficulties, and ultimately to improve the likelihood of recovery on the loan. All TDRs are considered to be impaired loans.

A loan modification does not result in a TDR unless the borrower is in financial difficulty and a concession has been granted. In determining whether a concession has been granted, the Company takes into account the extent to which the nature and amount of any additional collateral or guarantees received as part of the modifications do not serve as adequate compensation for other terms of the restructuring. If the additional collateral or guarantees received adequately compensate the Company for the concessions granted, the loan is not classified as a TDR.

Interim financial information

The accompanying unaudited consolidated financial statements as of September 30, 2011 and 2010 have been prepared in condensed format, and therefore do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

The information furnished in these interim statements reflects all adjustments, which are, in the opinion of management, necessary for a fair statement of the results for each respective period presented. Such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results that may be expected for any other quarter or for the full year. The interim financial information should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s 2010 Form 10-K, filed with the Securities and Exchange Commission.

Earnings per Share

Basic earnings per common share are computed based on the weighted average number of shares outstanding during each year. Diluted earnings per common share are computed using the weighted average common shares and all potential dilutive common shares outstanding during the period. The following table sets forth the computation of basic and diluted earnings per common share (EPS) for the three-month and nine-month periods ended September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(In thousands)			
Net income available to stockholders	$ 13,824	$ 8,890	$ 38,746	$ 29,388
Average shares outstanding	28,434	28,403	28,464	28,334
Effect of common stock options	199	241	201	246
Diluted shares outstanding	28,633	28,644	28,665	28,580
Basic earnings per common share	$ 0.48	$ 0.32	$ 1.36	$ 1.04
Diluted earnings per common share	$ 0.48	$ 0.31	$ 1.35	$ 1.03

Table of Contents

2: Business Combinations

Acquisition Old Southern Bank

On March 12, 2010, Centennial Bank entered into a purchase and assumption agreement (Old Southern Agreement) with the FDIC, as receiver, pursuant to which Centennial Bank acquired certain assets and assumed substantially all of the deposits and certain liabilities of Old Southern Bank (Old Southern).

Prior to the acquisition, Old Southern operated 7 banking centers in the Orlando, Florida metropolitan area. The Company has kept open all of these locations except for one location in downtown Orlando. Including the effects of purchase accounting adjustments, Centennial Bank acquired $342.6 million in assets and assumed approximately $328.5 million of the deposits of Old Southern. Additionally, Centennial Bank purchased covered loans with an estimated fair value of $179.1 million, $3.0 million of foreclosed assets and $30.4 million of investment securities.

See Note 2 Business Combinations of Form 10-K filed with the Securities and Exchange Commission (SEC) in March 2011 for additional discussion related to the acquisition of Old Southern.

Acquisition Key West Bank

On March 26, 2010, Centennial Bank, entered into a purchase and assumption agreement (Key West Bank Agreement) with the FDIC, as receiver, pursuant to which Centennial Bank acquired certain assets and assumed substantially all of the deposits and certain liabilities of Key West Bank (Key West).

Prior to the acquisition, Key West operated one banking center located in Key West, Florida. Including the effects of purchase accounting adjustments, Centennial Bank acquired $89.6 million in assets and assumed approximately $66.7 million of the deposits of Key West. Additionally, Centennial Bank purchased covered loans with an estimated fair value of $46.9 million, $5.7 million of foreclosed assets and assumed $20.0 million of FHLB advances.

See Note 2 Business Combinations of Form 10-K filed with the SEC in March 2011 for additional discussion related to the acquisition of Key West.

Acquisition Coastal Community Bank and Bayside Savings Bank

On July 30, 2010, Centennial Bank entered into separate purchase and assumption agreements with the FDIC (collectively, the Coastal-Bayside Agreements), as receiver for each bank, pursuant to which Centennial Bank acquired the loans and certain assets and assumed the deposits and certain liabilities of Coastal Community Bank (Coastal) and Bayside Savings Bank (Bayside), respectively. These two institutions had been under common ownership of Coastal Community Investments, Inc.

Prior to the acquisition, Coastal and Bayside operated 12 banking centers in the Florida Panhandle area. Including the effects of purchase accounting adjustments, Centennial Bank acquired $436.8 million in assets and assumed approximately $424.6 million of the deposits of Coastal and Bayside. Additionally, Centennial Bank purchased covered loans with an estimated fair value of $200.6 million, non-covered loans with an estimated fair value of $4.1 million, $9.6 million of foreclosed assets and $18.5 million of investment securities.

See Note 2 Business Combinations of Form 10-K filed with the SEC in March 2011 for additional discussion related to the acquisition of Coastal and Bayside.

Table of Contents

Acquisition Wakulla Bank

On October 1, 2010, Centennial Bank entered into a purchase and assumption agreement with the FDIC, as receiver, pursuant to which Centennial Bank acquired the performing loans and certain assets and assumed substantially all of the deposits and certain liabilities of Wakulla Bank (Wakulla).

Prior to the acquisition, Wakulla operated 12 banking centers in the Florida Panhandle. Including the effects of purchase accounting adjustments, Centennial Bank acquired approximately $377.9 million in assets and assumed approximately $356.2 million in deposits of Wakulla. Additionally, Centennial Bank purchased performing covered loans of approximately $148.2 million, performing non-covered loans with an estimated fair value of $17.6 million, $45.9 million of marketable securities and $27.6 million of federal funds sold.

See Note 2 Business Combinations of Form 10-K filed with the SEC in March 2011 for additional discussion related to the acquisition of Wakulla.

Acquisition Gulf State Community Bank

On November 19, 2010, Centennial Bank entered into a purchase and assumption agreement with the FDIC, as receiver, pursuant to which Centennial Bank acquired the loans and certain assets and assumed substantially all of the deposits and certain liabilities of Gulf State Community Bank (Gulf State).

Prior to the acquisition, Gulf State operated 5 banking centers in the Florida Panhandle. Including the effects of purchase accounting adjustments, Centennial Bank acquired approximately $118.2 million in assets and assumed approximately $97.7 million in deposits of Gulf State. Additionally, Centennial Bank purchased covered loans with an estimated fair value of $41.2 million, non-covered loans with an estimated fair value of $1.7 million, $4.7 million of foreclosed assets and $10.8 million of investment securities.

See Note 2 Business Combinations of Form 10-K filed with the SEC in March 2011 for additional discussion related to the acquisition of Gulf State.

FDIC-Assisted Acquisitions Other Matters

The Company s operating results for 2010, include the operating results of the acquired assets and assumed liabilities subsequent to the respective acquisition dates. Due to the significant fair value adjustments recorded, as well as the nature of the FDIC loss sharing agreements in place, historical results are not believed to be relevant to the Company s results, and thus no pro forma information is presented.

In an FDIC-assisted acquisition, we acquire certain assets and assume certain liabilities of the former institution under a loss share agreement with the FDIC. Any regulatory agreements or orders that existed for the former institution do not apply to the assuming institution. We, as the assuming institution, are evaluated separately by our regulators and any weaknesses of the former institution are considered in the separate evaluation. Also, the loss share agreement helps to mitigate any weaknesses that may have existed in the former institution.

Table of Contents

3: Investment Securities

The amortized cost and estimated market value of investment securities were as follows:

	September 30, 2011 Available for Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
U.S. government-sponsored enterprises	$ 295,765	$ 4,085	$ (58)	$ 299,792
Mortgage-backed securities	125,974	4,323	(3)	130,294
State and political subdivisions	160,035	6,190	(29)	166,196
Other securities	14,291		(51)	14,240
Total	$ 596,065	$ 14,598	$ (141)	$ 610,522

	December 31, 2010 Available for Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
	(In thousands)			
U.S. government-sponsored enterprises	$ 198,248	$ 977	$ (1,932)	$ 197,293
Mortgage-backed securities	113,557	2,820	(300)	116,077
State and political subdivisions	154,706	1,458	(2,457)	153,707
Other securities	2,858		(71)	2,787
Total	$ 469,369	$ 5,255	$ (4,760)	$ 469,864

Assets, principally investment securities, having a carrying value of approximately $370.4 million and $268.0 million at September 30, 2011 and December 31, 2010, respectively, were pledged to secure public deposits and for other purposes required or permitted by law. Also, investment securities pledged as collateral for repurchase agreements totaled approximately $62.4 million and $74.5 million at September 30, 2011 and December 31, 2010, respectively.

During the three-month and nine-month periods ended September 30, 2011 $561,000 of available for sale securities were sold. The gross realized gains on these sales totaled approximately $5,000. The income tax expense/benefit to net security gains and losses was 39.225% of the gross amounts.

During the three-month and nine-month periods ended September 30, 2010 approximately $5.6 million of available for sale securities were sold. The gross realized gains and losses on these sales totaled approximately $34,000 and $1,000 respectively. The income tax expense/benefit to net security gains and losses was 39.225% of the gross amounts.

The amortized cost and estimated fair value of securities at September 30, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-Sale	
	Amortized Cost	Estimated Fair Value
	(In thousands)	
Due in one year or less	$ 249,870	$ 252,399
Due after one year through five years	247,072	253,423
Due after five years through ten years	74,110	78,419
Due after ten years	25,013	26,281
Total	$ 596,065	$ 610,522

For purposes of the maturity tables, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on anticipated maturities. The mortgage-backed securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

The Company evaluates all securities quarterly to determine if any unrealized losses are deemed to be other than temporary. In completing these evaluations the Company follows the requirements of FASB ASC 320, *Investments Debt and Equity Securities.* Certain investment securities are valued less than their historical cost. These declines are primarily the result of the rate for these investments yielding less than current market rates. Based on evaluation of available evidence, management believes the declines in fair value for these securities are temporary. The Company does not intend to sell or believe it will be required to sell these investments before recovery of their amortized cost bases, which may be maturity. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

During the three and nine month periods ended September 30, 2011, no securities were deemed to have other-than-temporary impairment besides securities for which impairment was taken in prior periods.

For the period ended September 30, 2011, the Company had $42,000 in unrealized losses, which have been in continuous loss positions for more than twelve months. Excluding impairment write downs taken in prior periods, the Company s assessments indicated that the cause of the market depreciation was primarily the change in interest rates and not the issuer s financial condition, or downgrades by rating agencies. In addition, approximately 83.4% of the Company s investment portfolio matures in five years or less. As a result, the Company has the ability and intent to hold such securities until maturity.

The following shows gross unrealized losses and estimated fair value of investment securities available for sale, aggregated by investment category and length of time that individual investment securities have been in a continuous loss position as of September 30, 2011 and December 31, 2010:

	September 30, 2011					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. government-sponsored enterprises	$ 18,578	$ (40)	$ 2,058	$ (18)	$ 20,636	$ (58)
Mortgage-backed securities	4,094	(3)			4,094	(3)
State and political subdivisions	960	(5)	1,348	(24)	2,308	(29)
Other securities	9,761	(51)			9,761	(51)
Total	$ 33,393	$ (99)	$ 3,406	$ (42)	$ 36,799	$ (141)

15

Table of Contents

	December 31, 2010					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
U.S. government-sponsored enterprises	$ 126,862	$ (1,932)	$	$	$ 126,862	$ (1,932)
Mortgage-backed securities	27,427	(300)			27,427	(300)
State and political subdivisions	57,272	(1,970)	4,069	(487)	61,341	(2,457)
Other securities			2,667	(71)	2,667	(71)
Total	$ 211,561	$ (4,202)	$ 6,736	$ (558)	$ 218,297	$ (4,760)

4: Loans Receivable Not Covered by Loss Share and Allowance for Loan Losses

The various categories of loans not covered by loss share are summarized as follows:

	September 30, 2011	December 31, 2010
	(In thousands)	
Real estate:		
Commercial real estate loans		
Non-farm/non-residential	$ 744,749	$ 805,635
Construction/land development	366,926	348,768
Agricultural	26,683	26,798
Residential real estate loans		
Residential 1-4 family	353,110	371,381
Multifamily residential	59,974	59,319
Total real estate	1,551,442	1,611,901
Consumer	40,225	51,642
Commercial and industrial	170,695	184,014
Agricultural	35,238	16,549
Other	28,773	28,268
Loans receivable not covered by loss share	$ 1,826,373	$ 1,892,374

Table of Contents

The following tables present the balance in the allowance for loan losses for the three-month and nine-month periods ended September 30, 2011, and the allowance for loan losses and recorded investment in loans based on portfolio segment by impairment method as of September 30, 2011. Allocation of a portion of the allowance to one type of loans does not preclude its availability to absorb losses in other categories.

	Three Months Ended September 30, 2011						
	Construction/ Land Development	Other Commercial Real Estate	Residential Real Estate	Commercial & Industrial	Consumer & Other	Unallocated	Total
				(In thousands)			
Allowance for loan losses:							
Beginning balance	$ 11,318	$ 19,141	$ 14,324	$ 7,119	$ 2,450	$ 2,432	$ 56,784
Loans charged off	(3,166)	(645)	(1,778)	(140)	(641)		(6,370)
Recoveries of loans previously charged off	741	41	2,030	1,161	121		4,094
Net loans recovered (charged off)	(2,425)	(604)	252	1,021	(520)		(2,276)
Provision for loan losses	(850)	4,258	(1,748)	(1,704)	62	(18)	
Balance, September 30	$ 8,043	$ 22,795	$ 12,828	$ 6,436	$ 1,992	$ 2,414	$ 54,508

	Nine Months Ended September 30, 2011						
	Construction/ Land Development	Other Commercial Real Estate	Residential Real Estate	Commercial & Industrial	Consumer & Other	Unallocated	Total
				(In thousands)			
Allowance for loan losses:							
Beginning balance	$ 12,002	$ 17,247	$ 14,297	$ 6,357	$ 1,022	$ 2,423	$ 53,348
Loans charged off	(3,397)	(665)	(2,562)	(292)	(2,636)		(9,552)
Recoveries of loans previously charged off	747	204	2,278	5,777	456		9,462
Net loans recovered (charged off)	(2,650)	(461)	(284)	5,485	(2,180)		(90)
	(1,309)	6,009	(1,185)	(5,406)	3,150	(9)	1,250

Provision for loan losses							
Balance, September 30	$ 8,043	$ 22,795	$ 12,828	$ 6,436	$ 1,992	$ 2,414	$ 54,508

	As of September 30, 2011						
	Construction/ Land Development	**Other Commercial Real Estate**	**Residential Real Estate**	**Commercial & Industrial**	**Consumer & Other**	**Unallocated**	**Total**
Allowance for loan losses:							
Period end amount allocated to:							
Loans individually evaluated for impairment	$ 4,301	$ 17,174	$ 8,981	$ 3,510	$ 918	$	$ 34,884
Loans collectively evaluated for impairment	3,742	5,621	3,847	2,926	1,074	2,414	19,624
Balance, September 30	$ 8,043	$ 22,795	$ 12,828	$ 6,436	$ 1,992	$ 2,414	$ 54,508
Loans receivable:							
Period end amount allocated to:							
Loans individually evaluated for impairment	$ 17,050	$ 84,746	$ 26,752	$ 10,175	$ 1,945	$	$ 140,668
Loans collectively evaluated for impairment	349,876	686,686	386,332	160,520	102,291		1,685,705
Balance, September 30	$ 366,926	$ 771,432	$ 413,084	$ 170,695	$ 104,236	$	$ 1,826,373

As of September 30, 2011, no loans acquired with deteriorated credit quality have required a provision for loan loss.

Table of Contents

The following tables present the balance in the allowance for loan losses for the year ended December 31, 2010, and the recorded investment in allowance for loan losses and loans based on portfolio segment by impairment method as of December 31, 2010. Allocation of a portion of the allowance to one type of loans does not preclude its availability to absorb losses in other categories.

	As of December 31, 2010						
	Construction/ Land Development	Other Commercial Real Estate	Residential Real Estate	Commercial & Industrial	Consumer & Other	Unallocated	Total
	(In thousands)						
Allowance for loan losses:							
Beginning balance	$ 9,624	$ 13,568	$ 11,348	$ 6,067	$ 1,984	$ 377	$ 42,968
Loans charged off	(1,113)	(858)	(3,550)	(3,315)	(1,983)		(10,819)
Recoveries of loans previously charged off	55	851	416	39	424		1,785
Net loans recovered (charged off)	(1,058)	(7)	(3,134)	(3,276)	(1,559)		(9,034)
Provision for loan losses	2,343	424	5,666	902	807	(292)	9,850
Balance, September 30	10,909	13,985	13,880	3,693	1,232	85	43,784
Loans charged off	(9,161)	(15,847)	(7,181)	(20,912)	(533)		(53,634)
Recoveries of loans previously charged off		17	76	11	94		198
Net loans recovered (charged off)	(9,161)	(15,830)	(7,105)	(20,901)	(439)		(53,436)
Provision for loan losses	10,254	19,092	7,522	23,565	229	2,338	63,000
Balance, end of year	$ 12,002	$ 17,247	$ 14,297	$ 6,357	$ 1,022	$ 2,423	$ 53,348
Period end amount allocated to:							
Loans individually	$ 7,602	$ 9,912	$ 9,843	$ 2,625	$ 438	$	$ 30,420

evaluated for impairment							
Loans collectively evaluated for impairment	4,400	7,335	4,454	3,732	584	2,423	22,928
Balance, end of year	$ 12,002	$ 17,247	$ 14,297	$ 6,357	$ 1,022	$ 2,423	$ 53,348
Loans receivable:							
Period end amount allocated to:							
Loans individually evaluated for impairment	$ 25,556	$ 69,010	$ 35,077	$ 16,939	$ 1,136	$	$ 147,718
Loans collectively evaluated for impairment	323,212	763,423	395,623	167,075	95,323		1,744,656
Balance, end of year	$ 348,768	$ 832,433	$ 430,700	$ 184,014	$ 96,459	$	$ 1,892,374

As of December 31, 2010, no loans acquired with deteriorated credit quality have required a provision for loan loss.

Table of Contents

The following is an aging analysis for the non-covered loan portfolio as of September 30, 2011 and December 31, 2010:

	September 30, 2011						
	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due	Current Loans	Total Loans Receivable	Accruing Loans Past Due 90 Days or More
	(In thousands)						
Real estate:							
Commercial real estate loans							
Non-farm/non-residential	$ 5,491	$ 1,595	$ 5,028	$ 12,114	$ 732,635	$ 744,749	$
Construction/land development	244	770	1,752	2,766	364,160	366,926	50
Agricultural			939	939	25,744	26,683	
Residential real estate loans							
Residential 1-4 family	1,053	2,022	14,310	17,385	335,725	353,110	277
Multifamily residential					59,974	59,974	
Total real estate	6,788	4,387	22,029	33,204	1,518,238	1,551,442	327
Consumer	702	218	1,928	2,848	37,377	40,225	105
Commercial and industrial	57	138	1,808	2,003	168,692	170,695	
Agricultural and other	383	15	2,089	2,487	61,524	64,011	2,049
Total	$ 7,930	$ 4,758	$ 27,854	$ 40,542	$ 1,785,831	$ 1,826,373	$ 2,481

	December 31, 2010						
	Loans Past Due 30-59 Days	Loans Past Due 60-89 Days	Loans Past Due 90 Days or More	Total Past Due	Current Loans	Total Loans Receivable	Accruing Loans Past Due 90 Days or More
	(In thousands)						
Real estate:							
Commercial real estate loans							
Non-farm/non-residential	$ 1,903	$ 4,833	$ 16,535	$ 23,271	$ 782,364	$ 805,635	$
	5,055		6,809	11,864	336,904	348,768	1

Construction/land development							
Agricultural			220	220	26,578	26,798	
Residential real estate loans							
Residential 1-4 family	1,513	2,354	16,530	20,397	350,984	371,381	535
Multifamily residential		2,887	5,122	8,009	51,310	59,319	
Total real estate	8,471	10,074	45,216	63,761	1,548,140	1,611,901	536
Consumer	154	60	1,342	1,556	50,086	51,642	34
Commercial and industrial	283	395	2,943	3,621	180,393	184,014	8
Agricultural and other	156	20	1	177	44,640	44,817	
Total	$ 9,064	$ 10,549	$ 49,502	$ 69,115	$ 1,823,259	$ 1,892,374	$ 578

Non-accruing loans not covered by loss share at September 30, 2011 and December 31, 2010 were $25.4 million and $48.9 million, respectively.

The Company did not sell any of the guaranteed portions of SBA loans during the three-month month period ended September 30, 2011. During the nine-month period ended September 30, 2011, the Company sold $4.2 million of the guaranteed portion of certain SBA loans, which resulted in a gain of approximately $259,000. The Company did not sell any of the guaranteed portions of SBA loans during the three-month month period ended September 30, 2010. The Company sold $250,000 of the guaranteed portions of SBA loans during the nine-month period ended September 30, 2010, resulting in a gain of $18,000.

Table of Contents

Mortgage loans held for sale of approximately $10.7 million and $14.0 million at September 30, 2011 and December 31, 2010, respectively, are included in residential 1-4 family loans. Mortgage loans held for sale are carried at the lower of cost or fair value, determined using an aggregate basis. Gains and losses resulting from sales of mortgage loans are recognized when the respective loans are sold to investors. Gains and losses are determined by the difference between the selling price and the carrying amount of the loans sold, net of discounts collected or paid. The Company obtains forward commitments to sell mortgage loans to reduce market risk on mortgage loans in the process of origination and mortgage loans held for sale. The forward commitments acquired by the Company for mortgage loans in process of origination are not mandatory forward commitments. These commitments are structured on a best efforts basis; therefore the Company is not required to substitute another loan or to buy back the commitment if the original loan does not fund. Typically, the Company delivers the mortgage loans within a few days after the loans are funded. These commitments are derivative instruments and their fair values at September 30, 2011 and December 31, 2010 were not material.

The following is a summary of the non-covered impaired loans as of September 30, 2011 and December 31, 2010:

	September 30, 2011						
				Three Months Ended		Nine Months Ended	
	Unpaid Contractual Principal Balance	Total Recorded Investment	Allocation of Allowance for Loan Losses	Average Recorded Investment	Interest Recognized	Average Recorded Investment	Interest Recognized
	(In thousands)						
Real estate:							
Commercial real estate loans							
Non-farm/non-residential	$ 64,143	$ 59,147	$ 16,775	$ 52,523	$ 802	$ 45,901	$ 1,974
Construction/land development	21,117	20,942	4,301	19,669	276	18,945	787
Agricultural	598	598	399	598		598	10
Residential real estate loans							
Residential 1-4 family	23,228	20,366	6,366	20,673	188	19,832	515
Multifamily residential	6,586	6,586	2,615	7,045	84	7,154	266
Total real estate	115,672	107,639	30,456	100,508	1,350	92,430	3,552
Consumer	1,178	1,178	918	1,622	8	1,286	34
Commercial and industrial	11,324	9,573	3,510	11,109	140	11,575	528
Agricultural and other							
Total	$ 128,174	$ 118,390	$ 34,884	$ 113,239	$ 1,498	$ 105,291	$ 4,114

	December 31, 2010				
	Unpaid Contractual	Total Recorded	Allocation of Allowance	Average Recorded	Interest

	Principal Balance	Investment	for Loan Losses	Investment	Recognized
			(In thousands)		
Real estate:					
Commercial real estate loans					
Non-farm/non-residential	$ 40,078	$ 36,884	$ 9,697	$ 18,366	$ 1,922
Construction/land development	19,617	17,282	7,602	14,272	823
Agricultural	598	598	215	120	40
Residential real estate loans					
Residential 1-4 family	20,894	18,416	6,884	17,137	602
Multifamily residential	7,251	7,251	2,959	5,149	325
Total real estate	88,438	80,431	27,357	55,044	3,712
Consumer	658	658	438	799	
Commercial and industrial	11,284	11,208	2,625	6,218	749
Agricultural and other					
Total	$ 100,380	$ 92,297	$ 30,420	$ 62,061	$ 4,461

Table of Contents

All of the Company s non-covered impaired loans have a specific allocation of the allowance for loan losses, with the exception of certain TDRs where the discounted cash flows under the restructuring are greater than or equal to those under the original terms of the loan. Interest recognized on non-covered impaired loans during the nine months ended September 30, 2011 and 2010 was approximately $4.1 million and $1.9 million, respectively. The amount of interest recognized on non-covered impaired loans on the cash basis is not materially different than the accrual basis.

Credit Quality Indicators. As part of the on-going monitoring of the credit quality of the Company s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk rating of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in Florida and Arkansas.

The Company utilizes a risk rating matrix to assign a risk rating to each of its loans. Loans are rated on a scale from 1 to 8. A description of the general characteristics of the 8 risk ratings are as follows:

Risk rating 1 Excellent. Loans in this category are to persons or entities of unquestionable financial strength, a highly liquid financial position, with collateral that is liquid and well margined. These borrowers have performed without question on past obligations, and the Bank expects their performance to continue. Internally generated cash flow covers current maturities of long-term debt by a substantial margin. Loans secured by bank certificates of deposit and savings accounts, with appropriate holds placed on the accounts, are to be rated in this category.

Risk rating 2 Good. These are loans to persons or entities with strong financial condition and above-average liquidity that have previously satisfactorily handled their obligations with the Bank. Collateral securing the Bank s debt is margined in accordance with policy guidelines. Internally generated cash flow covers current maturities of long-term debt more than adequately. Unsecured loans to individuals supported by strong financial statements and on which repayment is satisfactory may be included in this classification.

Risk rating 3 Satisfactory. Loans to persons or entities with an average financial condition, adequate collateral margins, adequate cash flow to service long-term debt, and net worth comprised mainly of fixed assets are included in this category. These entities are minimally profitable now, with projections indicating continued profitability into the foreseeable future. Closely held corporations or businesses where a majority of the profits are withdrawn by the owners or paid in dividends are included in this rating category. Overall, these loans are basically sound.

Risk rating 4 Watch. Borrowers who have marginal cash flow, marginal profitability or have experienced an unprofitable year and a declining financial condition characterize these loans. The borrower has in the past satisfactorily handled debts with the Bank, but in recent months has either been late, delinquent in making payments, or made sporadic payments. While the Bank continues to be adequately secured, margins have decreased or are decreasing, despite the borrower s continued satisfactory condition. Other characteristics of borrowers in this class include inadequate credit information, weakness of financial statement and repayment capacity, but with collateral that appears to limit exposure. Included in this category are loans to borrowers in industries that are experiencing elevated risk.

Risk rating 5 Other Loans Especially Mentioned (OLEM). A loan criticized as OLEM has potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution s credit position at some future date. OLEM assets are not adversely classified and do not expose the institution to sufficient risk to warrant adverse classification.

Risk rating 6 Substandard. A loan classified as substandard is inadequately protected by the sound worth and paying capacity of the borrower or the collateral pledged. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual assets.

21

Risk rating 7 Doubtful. A loan classified as doubtful has all the weaknesses inherent in a loan classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. These are poor quality loans in which neither the collateral, if any, nor the financial condition of the borrower presently ensure collectability in full in a reasonable period of time; in fact, there is permanent impairment in the collateral securing the loan.

Risk rating 8 Loss. Assets classified as loss are considered uncollectible and of such little value that the continuance as bankable assets is not warranted. This classification does n