

ServisFirst Bancshares, Inc.  
Form 10-K  
March 07, 2014

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-K**

**(Mark One)**

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

**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013**

**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 number 000-53149**

**SERVISFIRST BANCSHARES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of  
Incorporation or Organization)

**26-0734029**

(I.R.S. Employer  
Identification No.)

**850 Shades Creek Parkway, Birmingham, Alabama**

(Address of Principal Executive Offices)

**35209**

(Zip Code)

**(205) 949-0302**

(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

**NONE**

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, par value \$.001 per share**

(Titles of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  
Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or 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

Edgar Filing: ServisFirst Bancshares, Inc. - Form 10-K

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K.

..

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 definition of "large accelerated filer", "accelerated filer", and small reporting company" in Rule 12b-2 of the Exchange Act (Check one):

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 Act). Yes  No

As of June 30, 2013, the aggregate market value of the voting common stock held by non-affiliates of the registrant, based on a stock price of \$41.50 per share of Common Stock, was \$257,793,684.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Class</u>	<u>Outstanding as of February 28, 2014</u>
Common stock, \$.001 par value	7,420,812

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission in connection with its 2014 Annual Meeting of Stockholders are incorporated by reference into Part III of this annual report on Form 10-K.

**SERVISFIRST BANCSHARES, INC.**

**TABLE OF CONTENTS**

**FORM 10-K**

**DECEMBER 31, 2013**

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS		3
<b><u>PART I.</u></b>		4
ITEM 1.	BUSINESS	4
ITEM 1A.	RISK FACTORS	25
ITEM 1B.	UNRESOLVED STAFF COMMENTS	38
ITEM 2.	PROPERTIES	38
ITEM 3.	LEGAL PROCEEDINGS	39
ITEM 4.	MINE SAFETY DISCLOSURES	40
<b><u>PART II.</u></b>		40
ITEM 5	MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES	40
ITEM 6.	SELECTED FINANCIAL DATA	42
ITEM 7.	MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	44
ITEM 7A.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	62
ITEM 8.	FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA	65
ITEM 9.	CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES	107
ITEM 9A.	CONTROLS AND PROCEDURES	107
ITEM 9B.	OTHER INFORMATION	108
<b><u>PART III.</u></b>		108
ITEM 10.	DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE	108
ITEM 11.	EXECUTIVE COMPENSATION	108
ITEM 12.	SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS	108
ITEM 13.	CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE	108
ITEM 14.	PRINCIPAL ACCOUNTANT FEES AND SERVICES	108
<b><u>PART IV.</u></b>		109
ITEM 15.	EXHIBITS AND FINANCIAL STATEMENT SCHEDULES	109

SIGNATURES	111
EXHIBIT INDEX	112

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This annual report on Form 10-K contains 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. These “forward-looking statements” reflect our current views with respect to, among other things, future events and our financial performance. The words “may,” “plan,” “contemplate,” “anticipate,” “believe,” “intend,” “continue,” “expect,” “project,” “predict,” “estimate,” “should,” “would,” “will,” and similar expressions are intended to identify such forward-looking statements, but other statements not based on historical information may also be considered forward-looking. All forward-looking statements are subject to risks, uncertainties and other factors that may cause our actual results, performance or achievements to differ materially from any results expressed or implied by such forward-looking statements. These statements should be considered subject to various risks and uncertainties, and are made based upon management’s belief as well as assumptions made by, and information currently available to, management pursuant to “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Such risks include, without limitation:

- the effects of the continued slow economic recovery and high unemployment;
- the effects of continued deleveraging of United States citizens and businesses;
- the effects of potential federal spending cuts due to the United States financial budgetary “sequester”;
- the effects of continued depression of residential housing values and the slow market for sales and resales;
- credit risks, including credit risks resulting from the devaluation of collateralized debt obligations (CDOs) and/or structured investment vehicles to which we currently have no direct exposure;
- the effects of governmental monetary and fiscal policies and legislative and regulatory changes;
- the effects of hazardous weather such as the tornados that struck the state of Alabama in April 2011 and January 2012;
- 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 merger, acquisition or other transaction to which we or any of our subsidiaries may from time to time be a party, including our ability to successfully integrate any business that we acquire;
- deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses;
- the effect of changes in interest rates on 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;
- the results of regulatory examinations;
- changes in state and federal legislation, regulations or policies applicable to banks and other financial service providers, including regulatory or legislative developments arising out of current unsettled conditions in the economy, including implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”);
- the effect of inaccuracies in our assumptions underlying the establishment of our loan loss reserves; and
- other factors that are discussed in the section titled “Risk Factors” in Item 1A.

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this annual report on Form 10-K. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise. New factors emerge from time to time, and it is not possible for us to predict which will

arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

**PART I**

*Unless this Form 10-K indicates otherwise, the terms “we,” “our,” “us,” “the Company,” “ServisFirst Bancshares” or “ServisFirst Bank” as used herein refer to ServisFirst Bancshares, Inc., and its subsidiaries, including ServisFirst Bank, which sometimes is referred to as “our bank subsidiary” or “the Bank” and its other subsidiaries. References herein to the fiscal years 2009, 2010, 2011, 2012 and 2013 mean our fiscal years ended December 31, 2009, 2010, 2011, 2012 and 2013, respectively.*

**ITEM 1. BUSINESS**

## Overview

We are a bank holding company within the meaning of the Bank Holding Company Act of 1956 and are headquartered in Birmingham, Alabama. Our wholly-owned subsidiary, ServisFirst Bank, an Alabama banking corporation, provides commercial banking services through 12 full-service banking offices located in Alabama and the panhandle of Florida, as well as a loan production office in Nashville, Tennessee. Through the Bank, we originate commercial, consumer and other loans and accept deposits, provide electronic banking services, such as online and mobile banking, including remote deposit capture, deliver treasury and cash management services and provide correspondent banking services to other financial institutions. As of December 31, 2013, we had total assets of approximately \$3.5 billion, total loans of approximately \$2.9 billion, total deposits of approximately \$3.0 billion and total stockholders' equity of approximately \$297 million.

We operate the Bank using a simple business model based on organic loan and deposit growth, generated by high quality customer service, delivered by a team of experienced bankers focused on developing and maintaining long-term banking relationships with our target customers. We utilize a uniform, centralized back office risk and credit platform to support a decentralized decision-making process executed locally by our regional chief executive officers. Rather than relying on a more typical traditional, retail bank strategy of operating a broad base of multiple brick and mortar branch locations in each market, our strategy focuses on operating a limited and efficient branch network with sizable aggregate balances of total loans and deposits housed in each branch office. We believe that this approach more appropriately addresses our customers' banking needs and reflects a best-of-class delivery strategy for commercial banking services. This strategy allows us to deliver targeted, high quality customer service, while achieving significantly lower efficiency ratios relative to the banking industry.

The holding company structure provides flexibility for expansion of our banking business through the possible acquisition of other financial institutions, the provision of additional banking-related services which a traditional commercial bank may not provide under current law, and additional financing alternatives such as the issuance of trust preferred securities. We have no current plans to acquire any operating subsidiaries in addition to the Bank, but we may make acquisitions in the future if we deem them to be in the best interest of our stockholders. Any such acquisitions would be subject to applicable regulatory approvals and requirements.

Our principal business is to accept deposits from the public and to make loans and other investments. Our principal sources of funds for loans and investments are demand, time, savings and other deposits (including negotiable orders of withdrawal, or NOW accounts) and the amortization and prepayment of loans and borrowings. Our principal sources of income are interest and fees collected on loans, interest and dividends collected on other investments, and service charges. Our principal expenses are interest paid on savings and other deposits (including NOW accounts), interest paid on our other borrowings, employee compensation, office expenses and other overhead expenses.

In January 2012, we formed SF Holding 1, Inc., an Alabama corporation, and its majority-owned subsidiary, SF Realty 1, Inc., an Alabama corporation. In November 2013, SF FLA Realty, Inc. was established as another majority-owned subsidiary of SF Holding 1, and is also an Alabama corporation. SF Realty 1 and SF FLA Realty both elected to be treated as a real estate investment trust ("REIT") for U.S. income tax purposes. The companies hold and manage participations in residential mortgages and commercial real estate loans originated by ServisFirst Bank. SF Holding 1, Inc. and its two subsidiaries are consolidated into the Company.

## History

The Bank was founded by our President and Chief Executive Officer, Thomas A. Broughton, III, and commenced banking operations in May 2005 following an initial capital raise of \$35 million. We were incorporated as a Delaware corporation in August 2007 for the purpose of acquiring all of the common stock of the Bank, and in November 2007 our holding company became the sole shareholder of the Bank by virtue of a plan of reorganization and agreement of merger. In May 2008, following our filing of a registration statement on Form 10 with the Securities and Exchange

Commission (or, “SEC”), we became a reporting company within the meaning of the Securities Exchange Act of 1934 (the “Exchange Act”) and have been filing annual, quarterly, and current reports, proxy statements and other information with the SEC since 2008.

Since inception, our bank has achieved significant growth, all of which has been generated organically. We achieved total asset milestones of \$1 billion in 2008, \$2 billion in 2011 and \$3 billion in 2013. In addition to total asset milestones, we have opened offices in six new markets, and raised an aggregate of approximately \$55.1 million to support our growth in these new locations through five separate private placements of our common stock to predominately local, individual investors.

### **Business Strategy**

We operate a full service commercial bank focused on providing competitive products, state of the art technology and quality service. Our business philosophy is to operate as a metropolitan community bank emphasizing prompt, personalized customer service to the individuals and businesses located in our primary markets. We aggressively market to our target customers, which include privately held businesses with \$2 million to \$250 million in annual sales, professionals and affluent consumers who we believe are underserved by the large regional banks that operate in our markets. We also seek to capitalize on the extensive relationships that our management, directors, advisory directors and stockholders have with the businesses and professionals in our markets. We believe this philosophy has attracted and will continue to attract customers and capture market share historically controlled by other financial institutions operating in our markets.

### ***Focus on Core Banking Business***

We deliver a broad array of core banking products to our customers. Our management and employees focus on recognizing customers' needs and providing products and services to meet those needs. We emphasize an internal culture of keeping our operating costs as low as possible, which in turn leads to greater operational efficiency. Additionally, our centralized technology and process infrastructure contribute to our low operating costs. We believe this combination of products, operating efficiency and technology make us attractive to customers in our markets. In addition, in 2011 we began providing correspondent banking services to various smaller community banks in our markets, and currently act as a correspondent bank to approximately 150 community banks located throughout the southeastern United States. We provide a source of clearing and liquidity to our correspondent bank customers, as well as a wide array of account, credit, settlement and international services. This service is of a scale and quality that is unique for a bank our size and provides us with a core deposit base, solid revenue stream and a low cost of funds.

### ***Commercial Bank Emphasis***

We have historically focused on people as opposed to places. This strategy translates into a smaller number of brick and mortar branch locations relative to our size, but larger overall branch sizes in terms of total deposits. As a result, our branches (excluding those branches that have been open less than three years) average approximately \$341 million in total deposits. Whereas, in the more typical retail banking model, branch banks continue to lose traffic to other banking channels which may prove to be an impediment to earnings growth for those banks that have invested in large branch networks. We place a strong emphasis on commercial and industrial loans, which comprised 44.7% of our total loan portfolio as of December 31, 2013. Our focus has been to expand opportunistically when we identify a strong banking team in a market with appropriate economies and market demographics where we believe we can achieve a minimum of \$300 million in deposits. We seek to differentiate the Bank through our people, processes and technology. We do not believe that a traditional brick and mortar, retail-oriented branch network model is required to succeed in the current marketplace. Our experience is that our services and operating philosophy are attractive to customers in our markets who do not require numerous branch banks in a single market.

### ***Scalable, Decentralized Business Model***

We emphasize local decision-making by experienced bankers supported by centralized risk and credit oversight. We believe that the delivery by our bankers of in-market customer decisions coupled with risk and credit support from our corporate headquarters, allows us to serve customers directly and in person, while managing risk centrally and on a

uniform basis. We intend to grow by repeating this scalable model in each market where we are able to identify a strong banking team. Our goal in each market is to employ the highest quality bankers in that market. We then empower those bankers to implement our operating strategy, grow our customer base and provide the highest level of customer service possible. We focus on a geographic model of organizational structure as opposed to a line of business model employed by most regional banks. This structure gives significant responsibility and accountability to our regional chief executive officers which we believe will aid in our growth and success. We have developed a business culture whereby our management, from the top down, is actively involved in sales, which is a key differentiator from our competition. All calling officers are required to actively solicit new customers, who are primarily non-borrowers from our bank, to build core deposits.

### ***Identify Opportunities in Vibrant Markets***

Since opening our original banking facility in Birmingham in 2005, we have expanded into six additional markets. There are two primary factors we consider when determining whether to enter a new market:

- the availability of successful, experienced bankers with strong reputations in the market; and

- the economic attributes of the market necessary to drive quality lending opportunities coupled with deposit-related attributes of the potential market.

Prior to entering a new market, we identify and build a team of experienced, successful bankers with market-specific knowledge to lead the bank's operations in that market, including a regional chief executive officer. Generally, we or members of our senior management are familiar with these individuals based on prior work experience and reputation, and strongly believe in the ability of such individuals to successfully execute our business model. We also identify and build a non-voting advisory board of directors in each market, comprised of directors representing a broad spectrum of business experience and community involvement in the market. We currently have advisory boards in each of the Huntsville, Montgomery, Dothan, Mobile and Pensacola markets. While we currently have a loan production office in Nashville, Tennessee with three experienced bankers (one of whom was hired in January 2014), we anticipate expanding this office into a full-service branch in the future, assuming that we are able to identify and retain a full team of experienced bankers whom we believe can effectively execute our business model.

Prior to opening a full-service banking office in a new market, historically we have raised capital through private placements to investors in the local market, many of whom are also customers of our bank in such market. We believe having many of our customers as stockholders provides us with a strong source of core deposits, aligns our and our customers' interests, and fosters a platform for developing and maintaining the long-term banking relationships we seek.

In addition to organic expansion, we may seek to expand through targeted acquisitions. Although we have not yet identified any specific acquisition opportunity that meets our strict requirements, including a limited number of branches serving a vibrant market with a strong deposit base, a premier banking team with individuals whom we believe can execute our business model, and at a price that we believe provides attractive risk-adjusted returns, we routinely evaluate potential acquisition opportunities that we believe would be complementary to our business. We do not, however, have any immediate plans, arrangements or understandings relating to any acquisition, and we do not believe an acquisition is necessary to successfully implement our business model.

### **Market Growth and Competition**



Edgar Filing: ServisFirst Bancshares, Inc. - Form 10-K

Our philosophy is to operate as a metropolitan community bank emphasizing prompt, personalized customer service to the individuals and businesses located in our primary markets. Our primary markets are broadly defined as the metropolitan statistical areas (“MSAs”) of Birmingham-Hoover, Huntsville, Montgomery, Dothan and Mobile, Alabama, Pensacola-Ferry Pass-Brent, Florida, and Nashville, Tennessee. We draw most of our deposits from, and conduct most of our lending transactions in, these markets.

The markets in which we operate have enjoyed steady expansion in their deposit base. We believe that the long-term growth potential of each of our markets is substantial, and further believe that many local affluent professionals and small business owners will do their banking with local, autonomous institutions that offer a higher level of personalized service. According to FDIC reports, total deposits in each of our market areas have expanded from 2003 to 2013 (deposit data reflects totals as reported by financial institutions as of June 30<sup>th</sup> of each year) as follows:

	2013 (Dollars in Billions)	2003	Compound Annual Growth Rate	
Jefferson/Shelby County, Alabama	\$ 24.8	\$ 16.3	4.29	%
Madison County, Alabama	6.1	3.7	5.13	%
Montgomery County, Alabama	6.5	3.6	6.09	%
Houston County, Alabama	2.2	1.3	5.40	%
Mobile County, Alabama	6.0	4.7	2.47	%
Escambia County, Florida	3.5	3.1	1.22	%

The Bank is subject to intense competition from various financial institutions and other financial service providers. The Bank competes for deposits with other local and regional commercial banks, savings and loan associations, credit unions and issuers of commercial paper and other securities, such as money-market and mutual funds. In making loans, the Bank competes with other commercial banks, savings and loan associations, consumer finance companies, credit unions, leasing companies and other lenders.

The following table illustrates our market share, by insured deposits, in our primary service areas at June 30, 2013, as reported by the FDIC:

Market	Number of Branches	Our Market Deposits (Dollars in Millions)	Total Market Deposits	Ranking	Market Share Percentage
Alabama:					
Birmingham-Hoover MSA	3	\$ 1,217.3	\$ 30,175.1	5	4.03 %
Huntsville MSA	2	540.8	6,805.7	5	7.95 %
Montgomery MSA	2	374.2	7,810.1	7	4.79 %
Dothan MSA	2	327.1	2,883.9	3	11.34 %
Mobile MSA	1	15.2	6,041.6	18	0.25 %
Florida:					
Pensacola-Ferry Pass-Brent MSA	2	202.9	4,638.0	8	4.38 %

Together, deposits for all institutions in Jefferson, Shelby, Madison, Montgomery, Houston and Mobile Counties represented approximately 56.04% of all the deposits in the State of Alabama at June 30, 2013. Deposits for all institutions in Escambia County represent approximately 0.79% of all the deposits in the state of Florida at June 30, 2013.

Our retail and commercial divisions operate in highly competitive markets. We compete directly in retail and commercial banking markets with other commercial banks, savings and loan associations, credit unions, mortgage brokers and mortgage companies, mutual funds, securities brokers, consumer finance companies, other lenders and insurance companies, locally, regionally and nationally. Many of our competitors compete by using offerings by mail, telephone, computer and/or the Internet. Interest rates, both on loans and deposits, and prices of services are significant competitive factors among financial institutions generally. Providing convenient locations, desired financial products and services, convenient office hours, quality customer service, quick local decision making, a strong community reputation and long-term personal relationships are all important competitive factors that we emphasize.

In our primary service areas, our five largest competitors are Regions Bank, Wells Fargo Bank, BBVA Compass Bank, BB&T and Synovus Bank. These institutions, as well as other competitors of ours, have greater resources, serve broader geographic markets, have higher lending limits, offer various services that we do not offer and can better afford, and make broader use of, media advertising, support services, and electronic technology than we can. To offset these competitive disadvantages, we depend on our reputation for greater personal service, consistency, and flexibility and the ability to make credit and other business decisions quickly.

## Lending Services

### *Lending Policy*

Our lending policies are established to support the credit needs of our primary market areas. Consequently, we aggressively seek high-quality borrowers within a limited geographic area and in competition with other well-established financial institutions in our primary service areas that have greater resources and lending limits than we have.

***Loan Approval and Review***

Our loan approval policies set various levels of officer lending authority. When the total amount of loans to a single borrower exceeds an individual officer's lending authority, further approval must be obtained from the Regional CEO and/or our Chief Executive Officer, Chief Risk Officer or Chief Credit Officer, based on our loan policies.

### ***Commercial Loans***

Our commercial lending activity is directed principally toward businesses and professional service firms whose demand for funds falls within our legal lending limits. We make loans to small- and medium-sized businesses in our primary service areas for the purpose of upgrading plant and equipment, buying inventory and for general working capital. Typically, targeted business borrowers have annual sales between \$2 million and \$250 million. This category of loans includes loans made to individual, partnership or corporate borrowers, and such loans are obtained for a variety of business purposes. We offer a variety of commercial lending products to meet the needs of business and professional service firms in our service areas. These commercial lending products include seasonal loans, bridge loans and term loans for working capital, expansion of the business, or acquisition of property, plant and equipment. We also offer commercial lines of credit. The repayment terms of our commercial loans will vary according to the needs of each customer.

Our commercial loans usually will be collateralized. Generally, collateral consists of business assets, including accounts receivable, inventory, equipment, or real estate. Collateral is subject to the risk that we may have difficulty converting it to a liquid asset if necessary, as well as risks associated with degree of specialization, mobility and general collectability in a default situation. To mitigate this risk, we underwrite collateral to strict standards, including valuations and general acceptability based on our ability to monitor its ongoing condition and value.

We underwrite our commercial loans primarily on the basis of the borrower's cash flow, ability to service debt, and degree of management expertise. As a general practice, we take as collateral a security interest in any available real estate, equipment or personal property. Under limited circumstances, we may make commercial loans on an unsecured basis. This type loan may be subject to many different types of risks, including fraud, bankruptcy, economic downturn, deteriorated or non-existent collateral, and changes in interest rates such as have occurred in the recent economic recession and credit market crisis. Perceived risks may differ depending on the particular industry in which a borrower operates. General risks to an industry, such as the recent economic recession and credit market crisis, or to a particular segment of an industry are monitored by senior management on an ongoing basis. When warranted, loans to individual borrowers who may be at risk due to an industry condition may be more closely analyzed and reviewed by the credit review committee or board of directors. Commercial and industrial borrowers are required to submit financial statements to us on a regular basis. We analyze these statements, looking for weaknesses and trends, and will assign the loan a risk grade accordingly. Based on this risk grade, the loan may receive an increased degree of scrutiny by management, up to and including additional loss reserves being required.

### ***Real Estate Loans***

We make commercial real estate loans, construction and development loans and residential real estate loans.

*Commercial Real Estate.* Commercial real estate loans are generally limited to terms of five years or less, although payments are usually structured on the basis of a longer amortization. Interest rates may be fixed or adjustable, although rates generally will not be fixed for a period exceeding five years. In addition, we generally will require personal guarantees from the principal owners of the property supported by a review by our management of the principal owners' personal financial statements.

Commercial real estate lending presents risks not found in traditional residential real estate lending. Repayment is dependent upon successful management and marketing of properties and on the level of expense necessary to maintain the property. Repayment of these loans may be adversely affected by conditions in the real estate market or the general economy. Also, commercial real estate loans typically involve relatively large loan balances to a single borrower. To mitigate these risks, we closely monitor our borrower concentration. These loans generally have shorter maturities than other loans, giving us an opportunity to reprice, restructure or decline renewal. As with other loans, all commercial real estate loans are graded depending upon strength of credit and performance. A higher risk grade will bring increased scrutiny by our management, the credit review committee and the board of directors.

*Construction and Development Loans.* We make construction and development loans both on a pre-sold and speculative basis. If the borrower has entered into an agreement to sell the property prior to beginning construction, then the loan is considered to be on a pre-sold basis. If the borrower has not entered into an agreement to sell the property prior to beginning construction, then the loan is considered to be on a speculative basis. Construction and development loans are generally made with a term of 12 to 24 months, and interest is paid monthly. The ratio of the loan principal to the value of the collateral as established by independent appraisal typically will not exceed 80% of residential construction loans. Speculative construction loans will be based on the borrower's financial strength and cash flow position. Development loans are generally limited to 75% of appraised value. Loan proceeds will be disbursed based on the percentage of completion and only after the project has been inspected by an experienced construction lender or third-party inspector. During times of economic stress, this type loan has typically had a greater degree of risk than other loan types, as has been evident in the recent credit crisis.

Beginning in 2008, there have been numerous construction loan defaults among many commercial bank loan portfolios, including a number of Alabama-based banks. To mitigate the risk of such defaults in our portfolio, the board of directors and management tracks and monitors these loans closely. Total construction loans decreased \$6.5 million in 2013. Our allocation of loan loss reserve for these loans decreased \$0.7 million to \$5.8 million at December 31, 2013 compared to \$6.5 million at the end 2012. Charge-offs for construction loans increased from \$3.1 million for 2012 to \$4.8 million for 2013, but the overall quality of the construction loan portfolio has improved with \$9.2 million rated as substandard at December 31, 2013 compared to \$14.4 million at December 31, 2012.

*Residential Real Estate Loans.* Our residential real estate loans consist primarily of residential second mortgage loans, residential construction loans and traditional mortgage lending for one-to-four family residences. We will originate fixed-rate mortgages with long-term maturities and balloon payments generally not exceeding five years. The majority of our fixed-rate loans are sold in the secondary mortgage market. All loans are made in accordance with our appraisal policy, with the ratio of the loan principal to the value of collateral as established by independent appraisal generally not exceeding 80%. Risks associated with these loans are generally less significant than those of other loans and involve fluctuations in the value of real estate, bankruptcies, economic downturn and customer financial problems. Real estate has recently experienced a period of declining prices which negatively affects real estate collateralized loans, but this negative effect has to date been more prevalent in regions of the United States other than our primary service areas; however, homes in our primary service areas may experience significant price declines in the future. We have not made and do not expect to make any "Alt-A" or subprime loans.

### ***Consumer Loans***

We offer a variety of loans to retail customers in the communities we serve. Consumer loans in general carry a moderate degree of risk compared to other loans. They are generally more risky than traditional residential real estate loans but less risky than commercial loans. Risk of default is usually determined by the well-being of the local economies. During times of economic stress, there is usually some level of job loss both nationally and locally, which directly affects the ability of the consumer to repay debt. Risk on consumer-type loans is generally managed through policy limitations on debt levels consumer borrowers may carry and limitations on loan terms and amounts depending upon collateral type.

Our consumer loans include home equity loans (open- and closed-end); vehicle financing; loans secured by deposits; and secured and unsecured personal loans. These various types of consumer loans all carry varying degrees of risk.

***Commitments and Contingencies***

As of December 31, 2013, we had commitments to extend credit beyond current fundings of approximately \$1.1 billion, had issued standby letters of credit in the amount of approximately \$40.4 million, and had commitments for credit card arrangements of approximately \$38.1 million.

***Policy for Determining the Loan Loss Allowance***

The allowance for loan losses represents our management's assessment of the risk associated with extending credit and its evaluation of the quality of the loan portfolio. In calculating the adequacy of the loan loss allowance, our management evaluates the following factors:

- the asset quality of individual loans;
- changes in the national and local economy and business conditions/development, including underwriting standards, collections, and charge-off and recovery practices;
- changes in the nature and volume of the loan portfolio;
- changes in the experience, ability and depth of our lending staff and management;
- changes in the trend of the volume and severity of past-due loans and classified loans, and trends in the volume of non-accrual loans, troubled debt restructurings and other modifications, as has occurred in the residential mortgage markets and particularly for residential construction and development loans;
- possible deterioration in collateral segments or other portfolio concentrations;
- historical loss experience (when available) used for pools of loans (i.e. collateral types, borrowers, purposes, etc.);
- changes in the quality of our loan review system and the degree of oversight by our board of directors; and
- the effect of external factors such as competition and the legal and regulatory requirement on the level of estimated credit losses in our current loan portfolio.

These factors are evaluated monthly, and changes in the asset quality of individual loans are evaluated as needed.

We assign all of our loans individual risk grades when they are underwritten. We have established minimum general reserves based on the risk grade of the loan. We also apply general reserve factors based on historical losses, management's experience and common industry and regulatory guidelines.

After a loan is granted, it is monitored by the account officer, management, internal loan review, and representatives of our independent external loan review firm over the life of the loan. Payment performance is monitored monthly for the entire loan portfolio; account officers contact customers during the regular course of business and may be able to ascertain whether weaknesses are developing with the borrower; independent loan consultants perform a review annually; and federal and state banking regulators perform annual reviews of the loan portfolio. If we detect weaknesses that have developed in an individual loan relationship, we downgrade the loan and assign higher reserves based upon management's assessment of the weaknesses in the loan that may affect full collection of the debt. We have established a policy to discontinue accrual of interest (non-accrual status) after any loan has become 90 days delinquent as to payment of principal or interest unless the loan is considered to be well collateralized and is actively in process of collection. In addition, a loan will be placed on non-accrual status before it becomes 90 days delinquent if management believes that the borrower's financial condition is such that the collection of interest or principal is doubtful. Interest previously accrued but uncollected on such loans is reversed and charged against current income when the receivable is determined to be uncollectible. Interest income on non-accrual loans is recognized only as received. If a loan will not be collected in full, we increase the allowance for loan losses to reflect our management's estimate of any potential exposure or loss.

Our net loan losses to average total loans increased to 0.33% for the year ended December 31, 2013 from 0.24% for the year ended December 31, 2012, which was down from 0.32% for the year ended December 31, 2011. Historical performance, however, is not an indicator of future performance, and our future results could differ materially. As of December 31, 2013, we had \$9.6 million non-accrual loans, of which 76% are secured real estate loans. We have allocated approximately \$5.8 million of our allowance for loan losses to real estate construction, acquisition and development, and lot loans and \$11.2 million to commercial and industrial loans, and have a total loan loss reserve as of December 31, 2013 allocable to specific loan types of \$25.4 million. We also currently maintain a portion of the allowance for loan losses, which is management's evaluation of potential future losses that would arise in the loan portfolio should management's assumption about qualitative and environmental conditions materialize. The qualitative factor portion of the allowance for loan losses is based on management's judgment regarding various external and internal factors including macroeconomic trends, management's assessment of the Company's loan growth prospects and evaluations of internal risk controls. This qualitative factor portion of the allowance for loan losses totaled \$5.3 million, resulting in a total allowance for loan losses of \$30.7 million at December 31, 2013. Our management believes, based upon historical performance, known factors, overall judgment, and regulatory methodologies, that the current methodology used to determine the adequacy of the allowance for loan losses is reasonable, including after considering the effect of the current residential housing market defaults and business failures (particularly of real estate developers) plaguing financial institutions in general.

Our allowance for loan losses is also subject to regulatory examinations and determinations as to adequacy, which may take into account such factors as the methodology used to calculate the allowance for loan losses and the size of the allowance for loan losses in comparison to a group of peer banks identified by the regulators. During their routine examinations of banks, regulatory agencies may require a bank to make additional provisions to its allowance for loan losses when, in the opinion of the regulators, credit evaluations and allowance for loan loss methodology differ materially from those of management.

While it is our policy to charge off in the current period loans for which a loss is considered probable, there are additional risks of future losses that cannot be quantified precisely or attributed to particular loans or classes of loans. Because these risks include the state of the economy, our management's judgment as to the adequacy of the allowance is necessarily approximate and imprecise.

### **Investments**

In addition to loans, we purchase investments in securities, primarily in mortgage-backed securities and state and municipal securities. No investment in any of those instruments will exceed any applicable limitation imposed by law or regulation. Our board of directors reviews the investment portfolio on an ongoing basis in order to ensure that the investments conform to the policy as set by the board of directors. Our investment policy provides that no more than 60% of our total investment portfolio may be composed of municipal securities. All securities held are traded in liquid markets, and we have no auction-rate securities. We had no investments in any one security, restricted or liquid, in excess of 10% of our stockholders' equity at December 31, 2013.

### **Deposit Services**

We seek to establish solid core deposits, including checking accounts, money market accounts, savings accounts and a variety of certificates of deposit and IRA accounts. We currently have no brokered deposits. To attract deposits, we employ an aggressive marketing plan throughout our service areas that features a broad product line and competitive services. The primary sources of core deposits are residents of, and businesses, and their employees located in, our market areas. We have obtained deposits primarily through personal solicitation by our officers and directors, through reinvestment in the community, and through our stockholders, who have been a substantial source of deposits and referrals. We make deposit services accessible to customers by offering direct deposit, wire transfer, night depository, banking-by-mail and remote capture for non-cash items. The Bank is a member of the FDIC, and thus our deposits are FDIC-insured.

### **Other Banking Services**

Given client demand for increased convenience and account access, we offer a range of products and services, including 24-hour telephone banking, direct deposit, Internet banking, mobile banking, traveler's checks, safe deposit boxes, attorney trust accounts and automatic account transfers. We also participate in a shared network of automated teller machines and a debit card system that our customers are able to use throughout Alabama and in other states and, in certain accounts subject to certain conditions, we rebate to the customer the ATM fees automatically after each business day. Additionally, we offer Visa® credit cards.

### **Asset, Liability and Risk Management**

We manage our assets and liabilities with the aim of providing an optimum and stable net interest margin, a profitable after-tax return on assets and return on equity, and adequate liquidity. These management functions are conducted within the framework of written loan and investment policies. To monitor and manage the interest rate margin and related interest rate risk, we have established policies and procedures to monitor and report on interest rate risk, devise strategies to manage interest rate risk, monitor loan originations and deposit activity and approve all pricing

strategies. We attempt to maintain a balanced position between rate-sensitive assets and rate-sensitive liabilities. Specifically, we chart assets and liabilities on a matrix by maturity, effective duration, and interest adjustment period, and endeavor to manage any gaps in maturity ranges.

## Seasonality and Cycles

We do not consider our commercial banking business to be seasonal.

## Employees

We had 262 full-time equivalent employees as of December 31, 2013. We consider our employee relations to be good, and we have no collective bargaining agreements with any employees.

## Supervision and Regulation

Both we and the Bank are subject to extensive state and federal banking laws and regulations that impose restrictions on and provide for general regulatory oversight of our operations. These laws and regulations require compliance with various consumer protection provisions applicable to lending, deposits, brokerage and fiduciary activities. They also impose capital adequacy requirements and restrict our ability to repurchase our stock and receive dividends from the Bank. These laws and regulations generally are intended to protect customers, rather than stockholders. The following discussion describes material elements of the regulatory framework that applies to us. However, the description below is not intended to summarize all laws and regulations applicable to us.

### *Bank Holding Company Regulation*

Since we own all of the capital stock of the Bank, we are a bank holding company under the federal Bank Holding Company Act of 1956, as amended (the "BHC Act"). As a result, we are primarily subject to the supervision, examination and reporting requirements of the BHC Act and the regulations of the Board of Governors of the Federal Reserve System (the "Federal Reserve").

### *Acquisition of Banks*

The BHC Act requires every bank holding company to obtain the Federal Reserve's prior approval before:

- acquiring direct or indirect ownership or control of any voting shares of any bank if, after the acquisition, the bank holding company will, directly or indirectly, own or control more than 5% of the bank's voting shares;
- acquiring all or substantially all of the assets of any bank; or
- merging or consolidating with any other bank holding company.

Additionally, the BHC Act provides that the Federal Reserve may not approve any of these transactions if such transaction would result in or tend to create a monopoly or substantially lessen competition or otherwise function as a restraint of trade, unless the anti-competitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the community to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the community to be served. The Federal Reserve's consideration of financial resources generally focuses on capital adequacy, which is discussed below.

Under the BHC Act, if adequately capitalized and adequately managed, we or any other bank holding company located in Alabama may purchase a bank located outside of Alabama. Conversely, an adequately capitalized and adequately managed bank holding company located outside of Alabama may purchase a bank located inside Alabama. In each case, however, restrictions may be placed on the acquisition of a bank that has only been in existence for a limited amount of time or will result in specified concentrations of deposits.

*Change in Bank Control.*

Subject to various exceptions, the BHC Act and the Change in Bank Control Act, together with related regulations, require Federal Reserve approval prior to any person's or company's acquiring "control" of a bank holding company. Under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of a class of voting stock of a bank holding company would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, any person or group of persons must obtain the approval of the Federal Reserve under the BHC Act before acquiring 25% (5% in the case of an acquirer that is already a bank holding company) or more of the outstanding common stock of a bank holding company, or otherwise obtaining control or a "controlling influence" over the bank holding company.

*Permitted Activities*

Under the BHC Act, a bank holding company is generally permitted to engage in or acquire direct or indirect control of more than 5% of the voting shares of any company engaged in the following activities:

- banking or managing or controlling banks; and

- any activity that the Federal Reserve determines to be so closely related to banking as to be a proper incident to the business of banking.

Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

- factoring accounts receivable;

- making, acquiring, brokering or servicing loans and usual related activities;

- leasing personal or real property;

- operating a non-bank depository institution, such as a savings association;

- trust company functions;

- financial and investment advisory activities;

- discount securities brokerage activities;

- underwriting and dealing in government obligations and money market instruments;

- providing specified management consulting and counseling activities;

- performing selected data processing services and support services;

- acting as an agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and

- performing selected insurance underwriting activities.

Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any of these activities or to terminate its ownership or control of any subsidiary when it has reasonable cause to believe that the bank holding company's continued ownership, activity or control constitutes a serious risk to the financial safety, soundness, or stability of it or any of its bank subsidiaries.

In addition to the permissible bank holding company activities listed above, a bank holding company may qualify and elect to become a financial holding company, permitting the bank holding company to engage in activities that are financial in nature or incidental or complementary to financial activity. The BHC Act expressly lists the following activities as financial in nature:

- lending, trust and other banking activities;

· insuring, guaranteeing, or indemnifying against loss or harm, or providing and issuing annuities, and acting as principal, agent, or broker for these purposes, in any state;

· providing financial, investment, or advisory services;

· issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;

underwriting, dealing in or making a market in securities;

other activities that the Federal Reserve may determine to be so closely related to banking or managing or controlling banks as to be a proper incident to managing or controlling banks;

foreign activities permitted outside of the United States if the Federal Reserve has determined them to be usual in connection with banking operations abroad;

merchant banking through securities or insurance affiliates; and

insurance company portfolio investments.

For us to qualify to become a financial holding company, the Bank and any other depository institution subsidiary of ours must be well-capitalized and well-managed and must have a Community Reinvestment Act rating of at least “satisfactory”. Additionally, we must file an election with the Federal Reserve to become a financial holding company and must provide the Federal Reserve with 30 days written notice prior to engaging in a permitted financial activity. We have not elected to become a financial holding company at this time.

#### *Support of Subsidiary Institutions*

The Federal Deposit Insurance Act and Federal Reserve policy require a bank holding company to act as a source of financial and managerial strength to its bank subsidiaries and to take measures to preserve and protect its bank subsidiaries in situations where additional investments in a troubled bank may not otherwise be warranted. In addition, where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company’s subsidiary depository institutions are responsible for any losses to the FDIC as a result of an affiliated depository institution’s failure. As a result, a bank holding company may be required to loan money to a bank subsidiary in the form of subordinate capital notes or other instruments which qualify as capital under bank regulatory rules. However, any loans from the holding company to such subsidiary banks likely will be unsecured and subordinated to such bank’s depositors and perhaps to other creditors of the bank.

#### *Repurchase or Redemption of Securities*

A bank holding company is generally required to give the Federal Reserve prior written notice of any purchase or redemption of its own then-outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company’s consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, Federal Reserve order or directive, or any condition imposed by, or written agreement with, the Federal Reserve. The Federal Reserve has adopted an exception to this approval requirement for well-capitalized bank holding companies that meet certain conditions.

#### ***Bank Regulation and Supervision***

The Bank is subject to extensive state and federal banking laws and regulations that impose restrictions on and provide for general regulatory oversight of our operations. These laws and regulations are generally intended to protect the Bank’s customers, rather than our stockholders. The following discussion describes the material elements of the regulatory framework that applies to the Bank.

Since the Bank is a commercial bank chartered under the laws of the State of Alabama and is not a member of the Federal Reserve System, it is primarily subject to the supervision, examination and reporting requirements of the

FDIC and the Alabama Department of Banking (the “Alabama Banking Department”). The FDIC and the Alabama Banking Department regularly examine the Bank’s operations and have the authority to approve or disapprove mergers, the establishment of branches and similar corporate actions. Both regulatory agencies have the power to prevent the development or continuance of unsafe or unsound banking practices or other violations of law. Additionally, the Bank’s deposits are insured by the FDIC to the maximum extent provided by law. The Bank is also subject to numerous state and federal statutes and regulations that affect its business, activities and operations.

&#1