

# Capstone Project

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STANDARDIZING THE BANK'S LIGHTLY MONITORED LENDING

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## Executive Summary

CenterState Bank Corporation, headquartered in Winter Haven, FL and trading under ticker symbol “CSFL”, will be a \$16 Billion regional bank when it closes its most recent acquisition on April 1, 2019. Since its incorporation in late 1999 the Bank has grown very rapidly, primarily by means of their intentional merger and acquisition strategy. CenterState was able to leverage its correspondent division to developed relationships with hundreds of community banks across the southeastern United States. With the onset of the Great Recession these correspondent relationships made it possible to acquire a number of banks at discount prices and rapidly expand CenterState’s footprint.

CenterState’s loan portfolio, similar to many Florida-based community banks, is heavily concentrated in commercial real estate. Executive management would like to increase loan portfolio diversification and sees increased commercial and industrial lending as one means of accomplishing this goal. In an effort to serve the Bank’s commercial and industrial customers and prospects CenterState has begun offering revolving lines of credit designed to support a company’s operating cycle through the acquisition and manufacturing of inventory, to the sale of products and services, until receivables can ultimately be collected.

CenterState has a low-to-moderate risk profile and true, asset-based-lending is outside the Bank’s risk appetite. CenterState *is* willing, however, to offer working capital lines of credit to well-qualified borrowers with earnings and cash flow that are relatively certain and more or less stable. Such companies are expected to be at a mature stage of development with well-capitalized balance sheets supported by adequately liquidity and limited leverage. These credit are “lightly-monitored” through the regular receipt and collection of borrowing base certificates.

This paper posits that the credit risk related to this loan portfolio is unacceptably high for several reasons. First, the Bank cannot currently quantify the size of this portfolio. Second, the policies and procedures around this portfolio are too vague and undefined. And, third, the Bank’s regionalized (i.e., decentralized) business strategy and local decision making results in a large degree of variability and inconsistency that is not well suited to this loan portfolio.

To address the unacceptable credit risk related to this portfolio this paper proposes that CenterState centralize the approval and servicing of all loans monitored through the use of a borrowing base certificate. While this would involve increased payroll expenses, and potentially increased software expense, centralizing this lending activity would: a) help return credit risk to an acceptable level, b) improve the consistency and delivery of this credit product and c) ultimately result in a larger, more profitable and stickier commercial and industrial portfolio.

## Introduction & Background

### CenterState Bank’s History

CenterState Bank Corporation is a financial holding company that was incorporated under the laws of the State of Florida on September 20, 1999. Over its 18 year history the bank has pursued an acquisitive strategy, through its national bank subsidiary, CenterState Bank, N.A., that has facilitated rapid growth. A timeline of CenterState’s acquisitions is presented immediately below:

### Timeline

Bank	State	Industry Type	Completed Date	Deal Value (\$M)	Total Assets (\$000)
National Commerce Corporation	AL	Bank	04/01/19	\$850.40	\$4,210,541
Charter Financial Corporation	GA	Thrift	09/01/18	\$399.77	\$1,643,673
HCBF Holding Company	FL	Bank	01/01/18	\$447.26	\$1,886,393
Sunshine Bancorp, Inc.	FL	Thrift	01/01/18	\$192.86	\$955,885

Gateway Financial Holdings of Florida, Inc.	FL	Bank	05/01/17	\$154.33	\$879,702
Platinum Bank Holding Company	FL	Bank	04/01/17	\$118.11	\$574,018
Hometown of Homestead Banking Company	FL	Bank	03/01/16	\$18.42	\$347,098
Community Bank of South Florida, Inc.	FL	Bank	03/01/16	\$64.99	\$486,392
First Southern Bancorp, Inc.	FL	Bank	06/01/14	\$195.98	\$1,093,256
Gulfstream Bancshares, Inc.	FL	Bank	01/17/14	\$82.00	\$572,324
Federal Trust Corporation/ <i>Hartford Financial Services Group, Inc.</i>	FL	Thrift	11/01/11	N/A	\$355,538
Valrico Bancorp, Inc.	FL	Bank	04/02/07	\$35.60	\$150,146
CenterState Bank Mid Florida	FL	Bank	03/31/06	\$14.94	\$59,906
CenterState Bank	FL	Bank	12/31/02	\$13.20	\$50,082
First National Bank of Polk County	FL	Bank	06/30/00	N/A	\$72,216
First National Bank of Osceola County	FL	Bank	06/30/00	N/A	\$107,476
Community National Bank of Pasco County	FL	Bank	06/30/00	N/A	\$95,634

As of the writing of this paper CenterState has completed six (6) FDIC Acquisitions and 15 non-FDIC acquisitions across Florida and Georgia. The Bank's 16 non-FDIC acquisition, a \$4 Billion Alabama-based bank, is scheduled for April 1, 2019. After the simultaneous purchases of Sunshine Bank and Harbor Community Bank on January 1, 2018 CenterState became one of the largest community banks in Florida based on market share and branch footprint.

The bank's most recent acquisition, Charter Financial Corp ("Charter"), closed on September 1, 2018. This is the bank's 15<sup>th</sup> non-FDIC acquisition and its first outside Florida. As a result of the transaction CenterState expanded its branch franchise into the Atlanta, Georgia market (where CenterState's correspondent banking, mortgage and SBA lending divisions are already headquartered) as well as into LaGrange/West Point, Georgia, Pensacola, Florida and Auburn, Alabama.

As of September 30, 2018 CenterState has grown to \$12.3B in assets, \$8.2B in loans and \$9.5B in deposits. As of October 5, 2018 CenterState had a total of 127 branches. When CenterState

acquires National Commerce Corporation on April 1, 2019 pro forma assets are expected to reach \$16.4B, pro forma deposits are expected to reach \$12.8B and pro forma loans are expected to reach \$11.5B.

## Market, Business Model, Strategy, Financial Condition, Market Share, Etc.

CenterState is guided by five (5) Core Values. They are:

*Local Market Driven* – “Our business structure is designed to value the unique character of the communities we serve and to encourage decision making by the banker that is closest to the action.

*A Long-Term Horizon* – “We approach business decision with an emphasis on long-term growth, sustainable profits and the career development of our officer and staff. We will not sacrifice credit quality for short term gain.”

*World Class Service* – “We will exceed our clients’ expectations by anticipating their needs and responding with a sense of urgency. Each of us has the freedom, authority and responsibility to do the right thing for our clients.”

*Relationship Banking* – “Our bank is built on life-long friendships. We communicate with candor and transparency. We believe that the relationship is more valuable than the transaction.”

*Faith and Family* – “Commitment to our faith and families is fundamental to the overall culture of our institution.”

The core values receive more than just lip service. The Board and executive management filter their objectives and strategies through these core values on a regular basis. The core values are also communicated and reinforced throughout the organization on a regular basis.

Examples of how CenterState lives these values are plentiful. Take the first value listed, *Local Market Driven*. A bank of CenterState's size would typically centralize most approval authorities. This would reduce risk and shave operating costs. CenterState's executive management team and board of directors, however, have intentionally structured the bank into geographic regions with Regional Presidents, Community Presidents, and Credit Administrators. These individuals are empowered to approve loans, within their authority limits, without requiring centralized concurrence or approval. Only very large loans, typically over \$15,000,000, require centralized approval. This approach ensures that the people closest to a given region are empowered to serve the unique needs within that region.

Another example can be seen in how the bank executes on its *Long-Term Horizon* value. Twice a year executive management gathers all the Regional Presidents and Credit Administrators to review national, state and regional economic statistics. At the same time the group reviews commercial real estate measures for the Bank's various regions to determine which regions and assets classes to avoid or prioritize. A commitment to the *Long-Term Horizon* has also kept the Bank from heavily entering the acquisition and development arena, has limited the Bank's homebuilder activity, and has kept the Bank from aggressively pursuing hospitality and multi-family lending opportunities. Finally, the Bank's commitment to the *Long-Term Horizon* has guided the bank to very carefully manage interest rate risk. The Bank has been disciplined not to go out far on the yield curve without implementing interest rate swaps. These swaps have provided customers with the fixed rates they desire while allowing CenterState to keep a portion of its loan portfolio floating.

## Market

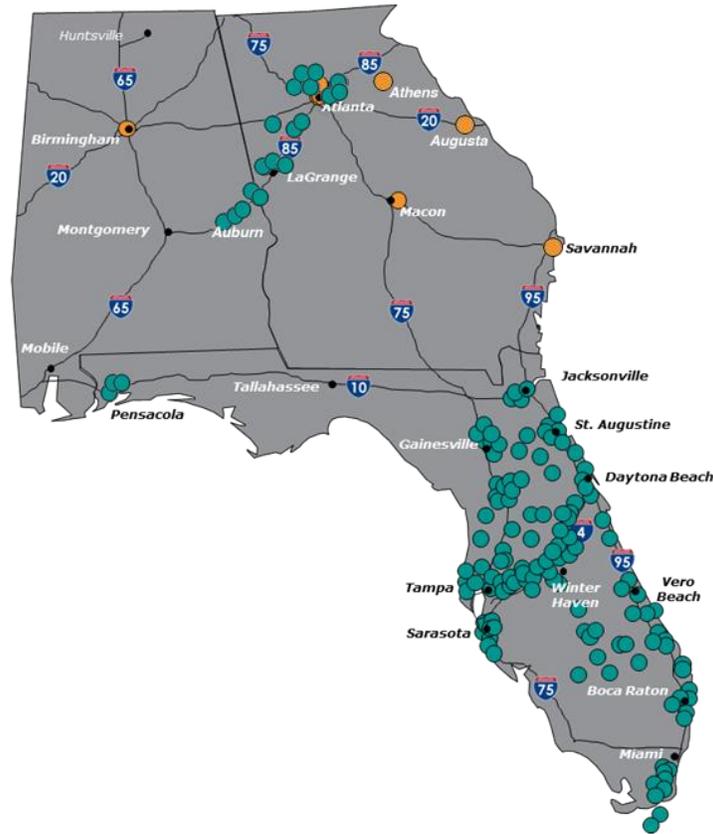
CenterState's headquarters are based in Winter Haven, Florida. Winter Haven is located in central Florida, near the highly trafficked I-4 corridor, and is roughly equidistant between Tampa and Orlando. Over the last 18 years the bank's footprint has expanded outward from central Florida, through its many acquisitions, to penetrate many of Florida's most important counties and cities.

As mentioned previously, CenterState had a total of 127 branches in Florida, Georgia and Alabama as of October 5, 2018. Reviewing the map below reveals that the Bank's footprint follows the I-95 corridor on the state's east coast, the I-75 corridor on the state's west coast and up into north central Florida, and through the center of the state along the I-4 corridor. This footprint provides access to some of the state's most significant metropolitan statistical areas (MSA's) including:

- Miami-Fort Lauderdale-West Palm Beach;
- Tampa-St. Petersburg-Clearwater;
- Orlando-Kissimmee-Sanford;
- Jacksonville; and
- North Port-Sarasota-Bradenton.

As mentioned previously, the Charter acquisition expands the bank's branch franchise to Atlanta, Georgia, LaGrange/West Point, Georgia, Pensacola, Florida and Auburn, Alabama. This expansion into Georgia and Alabama will continue with CenterState's upcoming acquisition of National Commercial Corporation, which is scheduled for legal close on April 1, 2019. The National Commerce Corporation acquisition will provide CenterState a deeper foothold in Atlanta, Georgia and will also establish a presence in the key Alabama cities of Huntsville and Birmingham. The net result of the CenterState's acquisition activity is the creation of a new regional bank serving the southeastern United States.

## CenterState Bank Footprint



Florida presents a very desirable banking opportunity. Population growth has been and continues to be very strong. Florida ranks first in the nation for net domestic migration.<sup>1</sup> Florida also has a \$967 billion economy – this is 75% larger than any other state in the southeastern United States – and maintains an attractive tax policy.<sup>2</sup> To put this in perspective, if Florida was a country its economy would be the 18<sup>th</sup> largest in the world – ahead of countries such as Saudi Arabia, Poland and Argentina.<sup>3</sup>

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<sup>1</sup> Source: US Census Bureau

<sup>2</sup> Source: Bureau of Economic Analysis

<sup>3</sup> Source: International Monetary Fund, World Economic Outlook

## Business Model

CenterState is a community bank that seeks to meet its markets' consumer, residential and commercial lending needs. The Bank has a low-to-moderate risk profile and is unwilling to sacrifice long-term safety and soundness for short-term gain. The Bank's acquisition activity has been and will continue to be a critical element in the organization's business model. As the bank exceeds the \$10 billion in assets threshold it faces increased regulatory and compliance burdens. In order to absorb these burdens the CenterState will need to rapidly grow with the goal of gaining the scale necessary to maintain desired profitability targets.

Along with conventional deposit and lending products the bank also offers:

- SBA Lending
- Correspondent Banking

CenterState operates in many high-growth markets. Therefore, the Bank's investors expect the bank to exhibit high-growth performance. Executive management aims to meet these expectations through a combination of organic and acquisitive growth. The ultimate goal is to grow all the good things about the Bank at a compound annual growth rate of 10% and for all acquisitions to be 5% accretive to earnings per share. This combination should result in minimum growth of 15%. The emphasis on the compound annual growth rate is important because executive management will strategically seek to grow faster than 10% early in economic recoveries, but will back off to a pace slower than 10% during the back half.

## Strategy

CenterState's executive management team is determined to maintain the distinctives that make community banks so beneficial to the local communities they serve. This is largely accomplished in two ways:

*Regionalization* – CenterState is divided into seven (7) regions. Each region operates as if it were a standalone bank, with a regional president responsible for managing their region and one or more community presidents responsible for the sub communities within that region. Each regional president is encouraged to run their region in the manner that best suits the nature and character particular to their specific market. This provides the regional president with the autonomy and empowerment to determine for themselves which business development strategies, loan types and industries they and their teams should focus on.

*Individual Authorities* – CenterState has granted loan authority to individuals within each region. Smaller loan amounts may be approved directly by the relationship manager, their community president or their regional president. Credit Administrators in each region have the authority to approve loans and total exposures that cannot be approved by line staff. Only the largest loans and total exposures require committee approval.

These two (2) strategies are critical to the objective of operating like a community bank, regardless of CenterState's growth. It is a higher-cost strategy but one that executive management believes is critical to the Bank's long-term success.

With regard to day-to-day lending and financial management the Bank employs the following strategies:

*Interest Rate Risk* – The Bank is very careful not to expose itself to undue interest rate risk. Fixed rates are generally not offered for more than 10 years. The Bank also make frequent use of a simple SWAP agreement to meet the borrower’s desire for a long-term fixed rate and the Bank’s desire for a variable rate.

*Pricing* – Loans are priced to accomplish minimum return-on-equity targets. Low-risk, high-quality borrower are subject to lower thresholds and higher-risk, lower-quality borrowers are required to meet higher thresholds.

*Concentrations* – Executive management has been through more than one economic correction and the Great Recession is still fresh in everyone’s collective memory. Concentrations are closely monitored and single-loan thresholds and maximum loans to one borrower are kept well below the Bank’s legal lending limit.

*Non-Interest Income* – Executive management has used its correspondent bank to forge relationships with over 600 banks across the nation. This serves two purposes. First, it provides CenterState with a database of potential acquisition targets. Second, it provides the Bank with an additional source of non-interest income. CenterState has also increased efforts to expand its Small Business Administration (SBA) lending. SBA loans provide the Bank with a credit enhancement that reduces risk but also provides the opportunity for significant premium income on the sale of guaranteed loans.

## Financial Condition

The following tables highlight CenterState’s financial condition for the two most recent completed years as well as for the three quarters through September 30, 2018.

Period Ended	2018 FQ3 YTD 9/30/2018	2017 FY 12/31/2017	2016 FY 12/31/2016
<b>Balance Sheet (\$000)</b>			
Total Assets	12,274,365	7,123,975	5,078,559
Total Net Loans	8,223,835	4,760,043	3,404,991
Total Deposits	9,474,526	5,560,523	4,152,544
Equity Attributable to Parent Company	1,913,159	904,750	552,457
Total Equity	1,913,159	904,750	552,457

CenterState’s Balance Sheet displays rapid growth across all categories. At 12/31/17 total assets were up 40.3%. For the same period total net loans were up by an almost identical amount (i.e., 39.8%). This rapid pace of growth continued into 2018. At 9/30/2018 total assets had grown by another 72.3% and total net loans by 72.8%. As CenterState has grown its merger and acquisition targets have also grown. This accounts for the bank’s dramatically expanding balance sheet.

Period Ended	2018 FQ3 YTD 9/30/2018	2017 FY 12/31/2017	2016 FY 12/31/2016
<b>Profitability (%)</b>			
Net Income (\$000)	105,784	55,795	42,341
Net Income Attributable to Parent (\$000)	105,784	55,795	42,341
ROAA	1.34	0.88	0.87
Core ROAA	1.77	1.34	1.31
ROAE	8.98	6.81	7.96
ROATCE	15.81	9.78	10.70
CORE ROAE	11.88	10.38	11.99
Net Interest Margin	4.38	4.28	4.20
Reported: Net Interest Margin	4.39	4.28	4.20
Efficiency Ratio	50.56	54.65	56.52
Noninterest Inc./Operating Revenue	19.52	21.35	26.32

Looking at CenterState’s profitability for 2016, 2017 and the three quarters ending 9/30/18 reveals a similar growth trend and improving profitability. As CenterState reached the \$10 Billion in assets threshold it was critical to continue the Bank’s rapid merger and acquisition strategy to gain

the size and scale necessary to absorb heightened regulatory and compliance costs. The chart above demonstrates the Bank's efforts have been successful. Net income through 9/30/18 is roughly two and a half times what was reported in the full year of 2016. Return on average assets displays a positive trend and very rapid improvement between the full year 2017 and the three quarters ending 9/30/18. Net interest margin is strong and improving and the Bank's efficiency ratio displays a steadily improving trend.

Period Ended	2018 FQ3 YTD 9/30/2018	2017 FY 12/31/2017	2016 FY 12/31/2016
<b>Balance Sheet Ratios (%)</b>			
Loans/Deposits	86.79	85.84	82.59
Securities/Assets	14.88	18.74	20.13
Total Equity/Total Assets	15.59	12.70	10.88
Tangible Equity/Tangible Assets	9.13	9.10	8.68
Tang Comment Equity/Tang Assets	9.13	9.10	8.68

From 12/31/16 to 9/30/18 CenterState's loan-to-deposit ratio increased from 82.59% to 86.79% as strong loan growth outpaced deposit growth. Despite aggressively growing the Bank's loan portfolio capital ratios remain strong and exhibit a positive trend through the entire review period.

Period Ended	2018 FQ3 YTD 9/30/2018	2017 FY 12/31/2017	2016 FY 12/31/2016
<b>Asset Quality (%)</b>			
NPAs/Assets	0.31	0.47	0.73
NPA Excl Restructured/Assets	0.23	0.30	0.52
NPAs & 90+ PD/Assets	0.31	0.47	0.73
NPAs/Loans & REO	0.46	0.70	1.08
Nonaccrual & 90+ & OREO/Assets	0.23	0.30	0.52
NPAs & 90+ PD/Loans & REO	0.46	0.70	1.08
NPAs & Loans 90+/Tang Common Equity + LLR	3.50	5.11	8.15
NCOs/Avg Loans	0	(0.02)	0.01
Loan Loss Reserves/Gross Loans	0.47	0.68	0.79
Reserves/NPAs	102.61	97.98	72.62
Loan Loss Provision/NCO	NM	NM	NM

CenterState attempts to follow a moderate risk profile. Additionally, this historically long economic recovery has resulted in very low losses across all the Bank’s peers. For these two reasons the table above displays a very high quality loan portfolio. Non-performing assets are very low and exhibit a positive trend. While the Bank’s reserve ratio is shrinking over the review period its relevant to note that many of the acquired portfolios contain “marks” to effectively discount acquired loans that might display troubling characteristics. While these discounts only apply to the specific loans to which they relate, they do function as a type of reserve that isn’t accounted for in the reserve ratios above.

Period Ended	2018 FQ3 YTD 9/30/2018	2017 FY 12/31/2017	2016 FY 12/31/2016
<b>Capital Adequacy</b>			
Tier 1 Common Capital (CET1) (\$000)	1,058,346	621,956	431,546
Tier 1 Capital (\$000)	1,105,846	649,350	452,925
Tier 2 Capital (\$000)	38,811	32,825	27,041
Total Capital (\$000)	1,144,657	682,175	479,966
Total Risk-weighted Assets (\$000)	9,203,009	5,431,060	3,828,518
Tier 1 Common Capital (CET1) Ratio (%)	11.50	11.46	11.27
Tier 1 Ratio (%)	12.00	11.96	11.83
Total Capital Ratio (%)	12.50	12.57	12.54
Liquidity Coverage Ratio (%)	NA	NA	NA
Leverage Ratio (%)	11.00	9.82	9.11
Basel III Leverage Ratio (%)	NA	NA	NA

The table above addresses capital adequacy and highlights that CenterState is well capitalized. Despite a high volume of merger and acquisition activity the Bank’s Tier 1 Ratio has increased from 11.83% at 12/31/16 to 12.00% as 9/30/18.

## Market Share

CenterState does not have an ultimate goal in terms of size. But, because of the increased costs associated with crossing the \$10 billion threshold, the Board and executive management are intensely focused on growing to \$20 billion as quickly as possible. At this size the Bank will have

the scale to absorb increased regulatory and compliance costs and still provide a return that is attractive to shareholders.

Organic growth will be important in reaching the \$20 billion mark. But, even more important is CenterState's ability to continue executing on its acquisition-oriented strategy. Without future acquisitions it will be difficult for CenterState to reach its target size in a time frame that the Bank's shareholders will accept.

When it comes to market share CenterState's goal is to be the largest bank by deposit market share in each of the markets it serves.

CenterState needs to grow by another \$8 Billion to reach its immediate size goal (\$4 Billion after the National Commerce Bank transaction is complete). Even as the Bank strives to close this gap it is currently among the largest banking companies headquartered in Florida by assets, market capitalization, deposit market share, and branch footprint.

## Strategy/Implementation

### Investment Description

Roughly eighty percent of CenterState's loan portfolio is real estate secured. Executive management would like to increase its commercial and industrial lending activity, helping diversify CenterState's heavily real estate centric portfolio. Isolated markets have attempted to grow their commercial and industrial portfolio by offering lightly monitored revolving lines of credit. The lines are primarily secured by the borrower's accounts receivable and, to a lesser extent, their eligible inventory. To monitor CenterState's collateral position relationship managers are expected to collect, review and approve regular borrowing-base certificates.

While the Bank's current approach to providing these lines may have been adequate in the past, its rapid growth and large footprint call for greater standardization, especially in light of the desire to increase commercial and industrial lending activity. This paper proposes, and seeks executive management's approval, to:

1. Define CenterState's appetite for borrowing-base certificate supported lines of credit;
2. Establish standardized processes;
3. Centralize underwriting and approval; and
4. Centralize servicing and administration.

A point of clarification may be appropriate. This paper is *not* suggesting the Bank expand into Asset-Based-Lending in the traditional sense. CenterState lacks the expertise for Asset Based Lending and the related credit risk exceeds the Bank's risk appetite.

The product referred to here is considered "lightly" monitored. It is provided only to businesses displaying successful track records, stable or improving revenue and profitability trends, and liquid, lightly margined and well-capitalized balance sheets. CenterState already has a portfolio of loans fitting this description. The Bank has an appetite to increase this portfolio but should not do so without enhancing the processes, procedures and policies governing the origination and monitoring of these credits. With adequate staffing these variables could be addressed, risk could be adequately managed and CenterState could offer a desirable product to its customers and prospects.

## Project Justification and Expected Results

CenterState already has a small portfolio of lightly-monitored commercial lines of credit. And, executive management has voiced a desire to increase commercial and industrial lending activity.

This project is justified for the following reasons:

1. CenterState's current approach (decentralized, limited standardization, etc.) unnecessarily increases the risk surrounding this lending activity;
2. Commercial and industrial underwriting is not the same as commercial real estate underwriting and warrants a dedicated underwriter and credit administrator (i.e., approver) with appropriate training and experience;
3. Accounts receivable and inventory are a higher-risk collateral types. Their values can be overstated. Or, they may rapidly decrease in value. This too justifies the need for standardization, training and experience.
4. Standardization around desired borrowers and industries and credit quality will help ensure that credit quality stays within pre-determined tolerances; and
5. Lightly-monitored lines of credit can be managed in a manner that allows CenterState to exit relationships exceeding its credit risk appetite by handing loans off to lenders with higher risk appetites (e.g., traditional asset based lenders and factoring companies).

Expected results include:

1. Reduced and better managed risk;
2. Better penetration into the commercial and industrial markets throughout CenterState's footprint;
3. Customer's utilizing lightly-monitored lines of credit are more likely to maintain full deposit and treasury management services with CenterState;

4. Improved interest and fee income; and
5. “Stickier” relationships in which borrowers are more likely to consider CenterState their primary financial institution.

### **Existing Lightly Monitored Credit Facilities**

While CenterState has not specifically targeted this type of commercial and industrial lending it has developed a small portfolio of credits that are lightly monitored using borrowing base certificates. Three (3) of these credit facilities are outlined below:

#### **EAC Corporation of Delaware**

*Industry:* EAC is a metal trading business. The company supplies raw materials to the specialty steel and foundry markets across the globe. EAC is a leading supplier of primary metals, ferro alloys and high temperature scrap primarily for steel and iron smelting purposes.

*Line Amount:* \$10,000,000

*Borrowing Base:* A monthly borrowing base is required. The advance rate against eligible receivables is set at 75%. The advance rate against eligible inventory is set at 25% of the inventory located at their Kokomo, IN warehouse, not to exceed \$1,200,000 in inventory-related exposure.

#### **Cold Air Distributors**

*Industry:* Cold Air Distributors is an automotive parts distributor that was founded in 1962. The business has a 180,000 square foot main warehouse and corporate office located in Ft. Pierce, FL and 19 total locations.

Line Amount: \$2,500,000

Borrowing Base: The line is secured by a blanket lien on all business assets and is monitored through a monthly borrowing base certificate. Advances are limited to 70% of eligible accounts receivable and 25% of inventory. Both accounts receivable and inventory are discounted by 25% before applying their respective advance ratios. This nets out the approximate percentage of inventory and accounts receivable related to Ford and GM inventory, each of whom have a priority lien on the inventory they supply.

### **Southern Sewer Equipment Sales**

Industry: Southern Sewer was started in 1986 and was purchased by the current owners in 1991. They are a leading Florida supplier of sewer cleaning machinery and equipment.

Line Amount: \$1,000,000

Borrowing Base: The line is secured by a blanket lien on all business assets and is monitored through a monthly borrowing base certificate. Advances are limited to 70% of accounts receivable and 50% of finished inventory.

### **Project Leader's Role**

The project leader's role is as follows:

- Develop guidelines for the type of clients and industries eligible for lightly-monitored lines of credit;
- Develop standards and policies to govern CenterState's lightly-monitored lending activity;

- Set forth the administrative model used to monitor CenterState’s asset-based-lending activity;
- Develop projections and a budget; and
- Present findings and recommendations to CenterState’s executive committee.

### Congruence with Bank’s Overall Strategy

CenterState’s acquisitive business model has allowed what started as a small, central Florida community bank, to become one of the largest and most dominant community banks in the state. Yet, the management team remains committed to the same five (5) core values established when the bank was much smaller.

This proposal and the associated investment align with CenterState’s overall strategy and credit appetite. Centralizing underwriting, approval and servicing of our lightly-monitored commercial lines of credits will:

1. *Allow CenterState to better service our local markets, particularly those with commercial and industrial business.* Having dedicated, trained and experienced staff to underwrite and decision these credits should increase relationship manager confidence in developing commercial and industrial relationships. Furthermore, having dedicated support to monitor and review borrowing-base certificates will reduce relationship managers’ work load and any liability for inaccurate reporting.
2. *Ensure that this lending activity is conducted in a manner consistent with CenterState’s long-term horizon.* By establishing standards and guidelines and employing a dedicated staff CenterState will be able manage the risk associated with these accounts receivable and inventory secured facilities. Without this structure and discipline a small number of defaults could threaten the portfolio’s long-term success and profitability.

3. *Facilitate comprehensive relationships with our clients.* Offering these lightly-monitored lines of credit allows the Bank to execute on its relationship banking strategy. These lines of credit are important to the successful day-to-day operations of many commercial and industrial customers. If CenterState hopes to compete effectively in this arena it needs to better define this product offering and ensure that it is delivered in a consistent manner across its footprint.

### Future Opportunities

By adopting this proposal CenterState may be able to leverage one or more future opportunities. First, as the Bank develops greater expertise it may be able to expand into true asset based lending and factoring. This could be developed in-house or through acquisition of a commercial finance company or a community bank possessing this expertise.

A second opportunity arising from this proposal relates to the Small Business Administration's CAP loan program. As CenterState becomes more proficient with this type of lending it may be able to leverage governmental guaranty programs to serve customers that do not quite fit the Bank's conventional lending requirements.

A third opportunity stemming from this initiative is that CenterState may have the opportunity to train its correspondent bank clients on how to implement a similar program. Alternatively, if CenterState moves upstream to handle larger and riskier, true ABL facilities, the Bank may be able to provide ABL lending services to the correspondent bank client base.

Finally, a fourth opportunity that may arise from this initiative is the ability to originate a small number of "club deals". CenterState may occasionally encounter strong and growing borrowers in need of line amounts exceeding the Bank's comfort level for these loan types. In these situations

the Bank may elect to act as an arranger, pulling in other lenders interested in participating on the loan request. These club deals would enable CenterState to serve the needs of larger borrowers, that might otherwise go to a competitor, while at the same time augmenting the Bank's fee revenue through arranger fees (estimated at roughly 20 basis points on the facility commitment) and other up-front fees (estimated at roughly 50 basis points on the Bank's portion of the total facility).

### Process Change or Improvement

CenterState already has a small portfolio of lightly-monitored facilities and the Bank's policy provides high-level standards on how these credits are to be managed. Under the current process customers are provided with a standardized borrowing base certificate that they provide to CenterState monthly, quarterly or with each draw request. Monitoring is handled directly by the relationship managers and their loan officer assistants. Due to the Bank's decentralized structure, the process is variable from region to region. An audit of this lending activity would likely reveal inaccuracies, errors, missing certificates and lines that are out of trust. As has been established in this paper – the current structure introduces unnecessary, unacceptable risk.

Bringing control and standardization to this lending activity would include a number of changes. First, the Bank's loan policy will be updated. Policy updates would address: a) the types of borrowers eligible for the program, b) minimum and maximum line amount thresholds, c) collateral margins, d) standard covenants, and e) minimum underwriting criteria.

Next, underwriting and approval for these credits would be delegated to commercial and industrial specialists. This team would consist of a credit administrator and commercial loan underwriter who are well-versed in commercial and industrial lending and who have been tasked with underwriting all lightly-monitored requests. Approvals would be addressed by the dedicated credit

administrator, an individual with the experience and education to properly decision these requests in light of CenterState's credit appetite.

Finally, servicing and monitoring would be centralized. Borrowers would provide their borrowing base certificates directly to the lightly-monitored administration department. This newly formed department would handle tasks such as:

- Tracking receipt of updated borrowing bases;
- Reconciling borrowing bases back to supporting documentation;
- Adjusting line availability in CenterState's core; and
- Addressing and reconciling any out-of-trust issues with the relationship manager and borrower.

### Implementation Schedule & Responsible Individuals

Given the timing of this project the lightly-monitored program would be considered a 2020 budgetary item. In order to implement by 2020 there are six (6) key tasks that must be accomplished:

1. The lightly-monitored policy need to be written and approved by the Board of Directors;
2. Processes and procedures need to be drafted;
3. The lightly-monitored budget addressing projected volume, income, and staffing expense needs to be prepared;
4. The proposal needs to be presented to and approved by CenterState's executive management team;
5. The policy needs to be approved by the Board; and
6. The budget needs to be approved by the Bank's chief financial officer.

The following individuals would be the primary responsible parties:

**Joshua Harris** – Joshua Harris would be primarily responsible for items one through three.

**Tanya Isaman** – Tanya Isaman would be primarily responsible for assisting with item two and for managing the administrative team that would handle the centralized ABL-lite monitoring.

**Dan Bockhorst** – Dan Bockhorst would primarily be responsible for items four (4) through six (6).

## Financial Impact

### Size and Type of Investment

To expand into more traditional commercial and industrial lending by refining and centralizing the Bank’s monitored lines of credits will require a moderate investment. The table below identifies the personnel that will need to be hired and provides an estimated budget for their fully burdened annual salary cost.

	<b>Annual Investment</b>
Credit Administrator	\$ 155,000
Commercial Loan Underwriter	105,000
Monitored Line Manager	55,000
Software	50,000
<b>Total</b>	<b>\$ 365,000</b>

Additional investments would be nominal. Office space, furniture and computers are already in place. It is likely that growing this portfolio would introduce increased regulatory scrutiny and a corresponding increase in regulatory costs. When this cost might be incurred, and the magnitude, are difficult to forecast and budget.

In general, the Bank does not have an appetite for monitored lines that require on-site field exams and audits to verify financial system integrity, reporting quality, and inventory accuracy. It is

anticipated that in the one-off situations requiring these measures the cost would be passed along to the borrower.

## Revenue and Expense Estimates

The table below sets forth a three-year budget of revenues and expenses for the Bank's centralized monitored lines of credit department.

Estimating expenses is a fairly easy exercise. However, estimating and forecasting future income is more difficult. Because CenterState has grown very rapidly, and because this growth was accomplished through a large number of acquisitions, the Bank's loan system lacks the accuracy and detail to identify the current number of monitored lines of credit. The Bank's loan system *is* capable of generating a report of all non-real estate secured revolving lines of credit. This report can be sorted on numerous fields including collateral type and loan amount.

To establish baseline, year 1, revenue estimates the aforementioned loan report was used to isolate all revolving lines secured with accounts receivable or inventory with loan amounts over \$500,000. This resulted in a total of 113 lines of credit with total commitments of \$204 Million and an average commitment of \$1.8 Million. If the largest facility is removed from the sample (a \$22 Million facility) the total commitments drop to \$182 Million and the average commitment falls to \$1.6 Million.

CenterState requires all revolving lines of credit over \$500,000 to be monitored through a borrowing base certificate arrangement. Thus, the majority of the facilities identified should likely be monitored through this centralized department. The forecast below assumes the following to estimate revenue:

1. The entire \$204 Million portfolio is monitored by the newly created and centralized monitoring group;
2. Average Utilization Rate of 50%;
3. Average Net Interest Margin of 4.00%
4. Average Annual Fee of .50%;
5. Portfolio growth of 10% annually; and
6. Salaries and related payroll burdens increase by 3.0% annually.

	<b>2020</b>	<b>2021</b>	<b>2022</b>
Interest Income	\$ 4,080,000	\$ 4,488,000	\$ 4,936,800
Fee Income	510,000	561,000	617,000
Total Income	4,590,000	5,049,000	5,553,900
Expenses			
Personnel	365,000	324,450	334,184
Software	50,000	50,000	50,000
Total Expenses	365,000	374,450	384,184
Net Income	\$ 4,225,000	\$ 4,674,550	\$ 5,169,716

### Subjective Evaluation of the Risks of the Investment

The risks related to this investment are minimal. Consider the following points:

- The loan portfolio already exists and
- The loan portfolio's interest and fee income are more than adequate to offset the incremental costs of a dedicated credit administrator, underwriter and servicing specialist.

### Statement or Argument of Why the Investment is or is not Worthwhile

The cost of this investment need to be weighed against the myriad of risk associated with the Bank's current structure and process. Without trying to bolster the Bank's commercial and industrial portfolio it has amassed \$204 Million in revolving commitments secured solely by

accounts receivable and/or inventory. These facilities have been originated by lenders with limited commercial and industrial lending experience. They have been priced according the Bank's standard pricing guidelines to achieve a minimum return on equity of 18-20%. But, this pricing model likely doesn't account for the additional administrative and servicing burden associated with lightly monitored lines of credit.

The Bank also needs to account for the risk associated with its decentralized approach to underwriting, approving and servicing this portfolio. Variability in the lending process bears a direct relationship to credit risk. This decentralized approach has increased variability and, by extension, credit risk. If this process is not centralized, and a dedicated group is not given responsibility for maintaining appropriate lending discipline, this portfolio is likely carrying excess risk that will only be uncovered in an economic downturn. Monitoring must be regular and consistent across the Bank in order to ensure each of these commitments is adequately supported by quality accounts receivable and inventory. Because these facilities are secured by working assets, that can quickly lose value in the event of distress, it is important to closely monitor these lines for compliance.

The Bank's loan portfolio is currently highly concentrated in commercial real estate. This investment will help the CenterState diversify into commercial and industrial lending.

Beyond portfolio diversification this investment also presents an opportunity to create profitable and "sticky" banking relationships. Relationships including a monitored line of credit tend to garner a larger share of the customer's wallet. Most of the borrowers will also maintain their operating accounts with CenterState as well as a variety of treasury management services.

## Non-Financial Impact

### Logistical and Organizational Hurdles

There are a number of logistical and organizational hurdles that must be addressed to successfully implement this paper's recommendations.

First, the Bank must determine which department is best suited to house the lightly-monitored team and to whom the team leader will report. The Bank must also identify an internal candidate to fill the role or, if a satisfactory internal candidate is unavailable, begin the search for an external candidate.

Second, the Bank needs to refine its lightly-monitored line of credit policies and procedures. Current guidance is limited and procedures are lacking. Before the department can fulfill its designated role the Bank will need to develop at least a first iteration of policies and procedures.

Third, the infrastructure for managing these lightly monitored lines of credit is very limited. At a minimum the Bank will need to develop standardized forms and templates. Beyond forms and templates the Bank may also need to investigate a software solution to streamline and automate portfolio tracking and reporting.

Lastly, the Bank will need to determine how to identify its current lightly monitored portfolio, capture new lightly-monitored applications, and ensure corporate-wide compliance with newly established policies and procedures. People tend to resist change. And, in a bank whose culture is deeply rooted around regionalized leadership and strategy, it may prove difficult to obtain voluntary buy-in.

## Plan to Overcome any Hurdles

To address the first identified hurdle it will be necessary to coordinate with the Chief Credit Officer and his direct reports. The Chief Credit Officer should be able to identify the department and or direct report that is best suited to manage the Bank's lightly-monitored portfolio. Once the department and executive are identified they will be charged with beginning the search for an individual to manage the portfolio.

To address the second hurdle it will be necessary to put together a small team to be responsible for creating the first iteration of lightly-monitored line of credit policies and procedures. This will start by identifying individuals with experience in commercial and industrial lending. Once assembled, this team will be provided with a list of items that must be addressed in policy and outlined in procedures. Assembling a good team and providing them with the requirements for a minimum viable policy and procedure document will ensure this hurdle is properly addressed.

The individual hired to manage the lightly-monitored portfolio will be responsible for developing standardized forms and templates. They will also be responsible for determining whether a software solution is necessary and, if so, for spearheading the search for the best vendor.

To address the last hurdle it will be necessary to create a new loan-type in the Bank's core software so that lightly-monitored credits can easily be identified, tracked and analyzed. For new originations it will be necessary to funnel all lightly-monitored revolving line of credit requests through a centralized approver – this would likely be one of the Bank's existing Credit Administrators who possesses a depth of commercial and industrial lending experience. These two steps would allow the Bank to quantify and track its lightly-monitored portfolio and ensure that new originations are approved in accordance with newly created policies. They would also ensure that the Bank has the capacity to track and monitor this portfolio.

## Non-Financial Evaluation Measures & Impacts

This project is expected to have a number of non-financial, yet equally important, impacts. These non-financial impacts fall into two rough categories. The first category has to do with non-financial impacts to the Bank's customers. The second category has to do with non-financial impacts to the Bank's internal Processes.

### **Bank Customers**

In order to evaluate the impact of this paper's recommendations it will be important to measure their impact on the Bank's customers.

#### *Customer Acquisition*

One of the most basic measures to monitor will be customer acquisition, retention, and attrition. A poorly devised lightly-monitored line of credit program will result in a lack of market awareness. If Bank relationship managers don't understand or believe in the program they will lack the motivation to actively prospect for commercial and industrial customers, or to intentionally sell the lightly-monitored product.

#### *Customer Satisfaction*

The recommendations in the paper will have a direct impact on customer satisfaction. If no changes are made to the current program future losses could ensue. Such losses could cause the board of directors, executive management or both to lose an appetite for the product type. This would hurt the Bank's reputation with existing borrowers and negatively impact customer satisfaction.

Even without losses customer satisfaction could suffer if the Bank delivers its lightly-monitored facilities in a haphazard, inconsistent fashion. Variability in structure, terms and conditions as

well as underwriting, approval and monitoring could result in two different customers having dramatically different experiences. Consistency is vital to customer satisfaction.

### Customer Retention

The bank's handling of the lightly-monitored portfolio has a direct impact on customer retention. CenterState needs to be able to offer the lightly-monitored line of credit to its commercial and industrial customers and prospects. Failure to do so could result in losing relationships to banks or other financial institutions who can service the entire customer relationship.

CenterState must also be able to clearly communicate its lightly-monitored line of credit solution and deliver a consistent borrower experience. If customers can't rely on CenterState to deliver on these expectations they will be more likely to look for a bank that can.

### Depth of Relationship & Share of Wallet

One of the primary premises of this paper is that a well-developed lightly-monitored line of credit product will have a direct and positive impact on relationship depth and wallet share. Customers using CenterState for their working capital line of credit tend to perceive CenterState as their "primary" bank. These relationships tend to include primary operating accounts as well as treasury management services.

### Customer Profitability

All of the above measures are expected to, individually and in the aggregate, have a direct impact on customer profitability.

### Internal Processes

This paper's proposals will also have a number of non-financial impacts on CenterState's internal processes. These are discussed below:

### Product Usage

As alluded to above, CenterState relationship managers are less likely to sell a product they do not understand. Conversely, they are more likely to aggressively sell a product that they understand and believe their bank can successfully and consistently deliver.

### Cross Sale Ratio

Implementing the recommendations in this paper should have a direct relationship on cross sale ratios. The lightly-monitored line of credit is in high demand with commercial and industrial borrowers. Furthermore, their financial operations tend to work more smoothly when the same bank handles their line of credit, operating accounts and treasury management needs.

### Loss Ratio

At present CenterState is unable to track the loss ratio related to its lightly-monitored portfolio. The recommendations in this paper would put the Bank on track to clearly identify and measure this portfolio, track portfolio performance, and institute appropriate underwriting, approval and monitoring so as to effectively manage the portfolio's credit risk.

### Underwriting Quality Audit

Once this portfolio is properly identified and underwriting is centralized CenterState will be able to measure underwriting quality. This will provide an important portfolio monitoring tool and provide an early warning system for potential future portfolio deterioration.

## Impact on Long-Term Profitability

Implementing this paper's recommendations will require additional personnel. The cost of this personnel, however, will be more than offset by reduced credit risk, appropriate risk-based pricing and fees, a larger portfolio and deeper relationships with greater wallet share. In short, this proposal will have a positive impact on the Bank's long-term profitability.

## Conclusion

Lightly-monitored working capital lines of credit are in high demand and afford CenterState an opportunity develop comprehensive and long-term banking relationships with the manufacturers, wholesalers, distributors and other operating entities throughout its footprint. When originated, monitored and serviced in accordance with a well thought out and properly executed plan they also present the Bank with an acceptable credit risk, despite lacking the collateral support provided by real estate or equipment.

The challenge is that, at present, CenterState's policies and procedures are inadequate to offset the elevated risk associated with this lending activity. This risk-reward equation for this type of lending only makes sense when the risk is managed through: 1) a well thought out and comprehensive policy, 2) standardized procedures and 3) centralized underwriting and approval. These elements must be in place to ensure the long-term profitability of this portfolio.

The two primary obstacles to this proposal are financial and cultural. In order to centralize the underwriting, approval and monitoring it will be necessary to assign this work to existing personnel or to hire a team specifically for this role. These salaries would comprise the majority of the financial burden. Just as important is the need to overcome people's general aversion to change and the appearance that power or control is being taken out of their respective regions.

This proposal also presents the Bank with a number of benefits. First, centralizing the Bank's lightly-monitored line of credit activity will help the Bank accurately quantify the size and quality of the portfolio. Second, it will ensure the Bank's new lightly-monitored originations meet clearly defined credit policy standards. Third, it will reduce credit risk by instituting a disciplined approach to monitoring and servicing the lightly-monitored portfolio. Fourth, it will increase CenterState's proficiency at working with commercial and industrial borrowers. And, finally, it will increase long-term profitability by properly managing and monitoring portfolio risk and by forging deeper, comprehensive banking relationships with the commercial and industrial borrowers throughout the Bank's footprint.

### National Commerce Bank Update

National Commerce Bank, the Alabama-based bank that CenterState is acquiring effective April 1, 2019, has its own, stand-alone commercial finance group. Upon integration CenterState will require all lightly-monitored lines of credit to be centrally managed and monitored by this commercial finance team. This group will be responsible for the timely collection and review of current borrowing base certificates, for adjusting system holds and line availability to match borrowing bases, and for addressing any facilities that are out of trust. The team will ultimately report up to the Director of Credit Services who reports directly to the Chief Credit Officer.