Merion Capital Group

Earnings Review

July 25, 2017

Freedom Bank of Virginia (FDVA - OTCQX - Recent Price: $13.00)

Rating: Outperform / **Buy Price:** $13.00 / **Target (Sell) Price:** $14.50

FDVA: Favorable Credit Quality, Mortgage Banking Lead to 2Q17 Earnings Beat; Raising EPS Estimates and Target Price; Upgrading Rating to Outperform.

2Q17 Results:

Freedom Bank of Virginia reported 2Q17 net income of $1.1 million, up $427k or 65.8% compared to the $649k posted in a 1Q17. On a per share basis, the company reported 2Q17 EPS of approximately $0.17 compared to $0.10 in the prior quarter. The posted results easily surpassed our $0.12 estimate. Higher-than-expected mortgage banking income and a net recovery of prior charge-offs that precluded the need for a loan loss provision, partially offset by NIM compression and higher growth in noninterest expenses, were the primary drivers behind the outperformance during the quarter.

- Gross loans held-for-investment were essentially flat with the prior quarter at $396.6 million. A 10.0% decline in construction loans offset growth of 12.5% in residential mortgages, 4.7% in consumer loans, and 2.8% in C&I. CRE loans, the largest segment of the portfolio, declined slightly, falling 0.6% from the prior quarter. Some of the slowdown in loan growth has been a deliberate effort to stay within regulatory CRE concentration guidelines, but management now feels comfortable with taking the foot off the brakes in this segment. Management also notes some very aggressive pricing in certain loan segments that they have been unable to meet, preferring to maintain margins. Still, they believe they are well-positioned to post solid loan growth in 2H17. While loan balances were flat, securities balances grew $10.7 million or 27.4% sequentially as the bank rebuilds its liquidity position after drawing down securities balances in 2016 to help fund the bank's rapid loan growth.
- Total deposits grew $15.5 million or 3.5% sequentially. Noninterest bearing accounts slipped $946k or 1.4% sequentially, while interest bearing demand deposits spiked $20.3 million or 16.2%. Time deposits fell $3.6 million or 1.5%.
- Net interest income increased $168k or 3.4% linked-quarter, as average earning assets rose approximately 4.8%, but the NIM contracted 7 bps to 3.71%. The shift in asset mix from loans to securities likely played a part in a sequential decline of roughly 1 bps in average yields on earning asset. Meanwhile, the average cost of interest bearing liabilities climbed 8 bps. Management still reports little pricing pressure on deposits so far resulting from the recent Fed

Market Data			Earnings Per Share Data				
				Our Forecast		Consensus	
			2016A	2017E	2018E	2017	2018
Market Value (M)	$70	1Q (Mar.)	$ 0.07	$ 0.10	$ 0.17	NA	NA
ADTV (Shs)	1,719	2Q (Jun.)	$ 0.11	$ 0.17	$ 0.24	NA	NA
ADTV (000')	$21.5	3Q (Sep.)	$ 0.12	$ 0.19	$ 0.28	NA	NA
52 Week Range	$8.12-$13.99	4Q (Dec.)	$ 0.15	$ 0.19	$ 0.29	NA	NA
Dividend Yield	0.00%	Year	$ 0.44	$ 0.66	$ 0.99	NA	NA
		P / E	28.4	19.1	12.6	NA	NA

Source: SNL Financial, MCG estimates

Fundamental Metrics (MRQ)	
Balance Sheet	
Total Assets (M)	$519
Gross Loans HFI (M)	$397
Total Deposits (M)	$453
Loans / Deposits	88%
Securities / Assets	13%
Debt / Assets	2%
Profitability	
FTE NIM	3.71%
Nonint. Income / Revenue	24%
Efficiency Ratio	73.39%
Core ROAA	0.85%
Core ROACE	8.07%
Credit Quality	
NPAs / Assets	0.10%
NPLs / Loans	0.17%
NCO Ratio	-0.28%
Reserves / Loans	0.12%
Provision / Avg Loans	0.00%
Capital Adequacy	
TCE / TA Ratio	10.4%
Total Capital Ratio	14.04%
Tier 1 Ratio	12.95%
Tier 1 CE Ratio	12.95%
Leverage Ratio	10.64%
Performance	
Core Value	$9.25
3 Yr. Success Ratio	6%
Failure Ratio	1.4%

Source: SNL Financial, Company data

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rate hikes. Freedom maintains an asset sensitive balance sheet, and while we expect additional growth in the securities portfolio, we still believe the repricing, renewal, and origination of loans at higher yields will lead to increases in average earning asset yields.

- Noninterest income advanced $669k or 81.6% sequentially, driven by a $688k jump in mortgage banking revenues. Mortgage rates moderated in 2Q17 after rising in the prior period. FDVA's mortgage operation specializes in first time homebuyers and purchase money transactions. We still expect this segment to hold up in the coming quarters. Meanwhile, service charges on deposit accounts, declined $18k or 23.6% sequentially.
- Noninterest expenses increased $221k or 5.2%. Employee compensation rose $145k or 5.3% linked-quarter. The increase reflects the increased volumes in mortgage production and the associated commission compensation. A $78k rise in data processing fees also contributed to the sequential increase in noninterest expenses. The bank's efficiency ratio improved to approximately 72.57% from 79.73% in 1Q17.
- Freedom enjoyed a net recovery on previous charge-offs of $286k in 2Q17, due to a significant recovery on real estate loan that had been in workout since the recession. The bank sold the note at a price above the loan's carrying value. As a result, no loan loss provision was necessary during the quarter, after a $30k provision was recorded in 1Q17.
- Asset quality improved noticeably in 2Q17, as nonaccrual loans declined 34.4% sequentially and performing TDRs dropped 14.0%. As a result, NPAs/Assets declined from 0.20% at March 31, 2017 to just 0.13% at June 30, 2017. The loan loss reserve improved to roughly 1.11% of total loans at June 30, 2017 from 1.06% at March 31, 2017.
- The tangible common equity ratio slipped to 10.38% at June 30, 2017 from 10.47% at March 31, 2017. Meanwhile, tangible book value per share grew to $8.69 from $8.49.

Earnings Estimates: We have only made a few significant changes to our earnings model following 2Q17 results. We still assume that loan growth will resume in 2H17, as constraints on CRE lending are relaxed and construction lending regains its footing. However, we have slightly reduced the pace of the renewed growth in the back half of the year after growth fell below our expectations over the last two quarters. We are still projecting annualized growth of over 12.0% in the second half of the year. Along with the reduced loan growth rate, however, we have boosted the projected growth in securities as management continues to rebuild liquidity. As a result, earning asset growth has not changed substantially. Despite this change in earning asset mix, we still expect the bank's asset sensitivity to manifest in NIM expansion in 2H17. We have reduced our projections for the loan loss provision going forward. Even with these reductions, the improvement in asset quality from already strong levels means our projections result in very high reserve coverage levels. Finally, we have increased our estimates of mortgage banking activity following the 2Q17 performance. This results in higher mortgage banking revenues, as well as an increase in compensation expenses to reflect the associated commissions. We are still assuming a reduced corporate tax rate of 30.0% starting in 2018, down from the 34.0% rate we are using for 2017. After including all of the preceding adjustments to our model, we are raising our 2017, 2018, and 2019 EPS estimates for FDVA from $0.57, $0.92, and $1.24, respectively, to $0.66, $0.99, and $1.37.

Stock Price Implications: While loan growth was lighter than expected and there was some NIM compression in 2Q17, FDVA's results easily surpassed our projections, as asset quality improvements and strong mortgage banking revenues propelled a significant sequential rise in earnings. We believe that loan growth is poised to resume in the second half of 2017 and that NIM expansion will result. Meanwhile, excellent asset quality and a solid mortgage environment should keep these elements of the earnings story intact. Progress has been choppy, as it often is with a bank of this size, but FDVA has exhibited a clear trend toward improved ROAA and ROAE while maintaining strong capital levels and excellent asset quality. Publicly traded banks in Virginia with assets between $300 million and $800 million are currently trading at median multiples of roughly 128.4% of TBV and 14.4x trailing twelve-months EPS. FDVA is trading at 143.9% of TBV and 22.7x TTM EPS.

We continue to base our target price on our 2018 EPS estimate to capture the expected corporate tax rate cut. We start with a 16.1 P/E multiple (a 12% premium to the current peer valuation) and discount it back to a 14.8x multiple to reflect the forward EPS estimate we are using. We had been using a 14.1x multiple, but as 2018 approaches, we have reduced the discount applied to the forward estimate. Applied to the $0.99 EPS estimate for 2018, this generates a $14.50 twelve-month price target, up $1.50 from our prior target. Our target suggests a potential gain of roughly 11.5% over the next twelve months. Consequently, we are raising our rating for shares of FDVA from Neutral to Outperform.

Exhibit 1

Freedom Bank of Virginia: 2Q17 Highlights

	Actual Results			Change	
	2Q16	1Q17	2Q17	LQ[1]	YOY
Loans Held for Investment ($000)[2]	366,760	396,659	396,554	-0.1%	8.1%
Total Deposits ($000)[2]	394,823	437,729	453,204	14.1%	14.8%
Average Earning Assets ($000)	434,138	478,297	501,083	19.1%	15.4%
Total Revenue ($000)	5,232	5,283	6,121	63.4%	17.0%
Net Interest Income ($000)	3,986	4,463	4,631	15.1%	16.2%
NIM (FTE)	0.00%	0.00%	0.00%	0.00%	0.00%
Average Securities Yield	2.20%	2.77%	2.82%	0.05%	0.62%
Average Loan HFI Yield	5.08%	5.11%	5.33%	0.22%	0.25%
Average Cost of Int.-bearing Deposits	1.09%	1.15%	1.22%	0.07%	0.13%
Efficiency Ratio	74.3%	79.7%	72.6%	-7.16%	-1.73%
NCO Ratio	0.00%	-0.10%	-0.28%	-0.19%	-0.29%

1. Linked quarter changes for the balances are annualized.

2. Loans Held for Investment and Total Deposits balances are end of period balances.

Source: company filings, SNL Financial

Exhibit 2

Freedom Bank of Virginia

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(Figures in thousanSs except for per share data)

2013A	2014A	2015A	2016A	2017E	2018E	2019E	*Fiscal years ending December 31*	1Q16A	2Q16A	3Q16A	4Q16A	1Q17A	2Q17A	3Q17E	4Q17E
9,274	11,389	13,895	16,770	19,060	21,632	24,578	Net interest income	3,767	3,986	4,442	4,575	4,463	4,631	4,917	5,049
298	486	673	1,091	273	682	893	Provision for loan and lease losses	143	267	516	165	30	-	125	119
8,977	10,903	13,222	15,679	18,787	20,950	23,685	**Net interest income after provision**	3,624	3,719	3,926	4,410	4,433	4,631	4,793	4,930
							Non-interest income:								
375	241	222	224	261	272	307	Service charges on deposit accounts	65	57	35	66	77	59	62	63
446	260	2,542	4,242	4,516	5,624	6,854	Gain on sale of mortgage loans	570	1,174	1,334	1,163	728	1,417	1,317	1,054
58	59	61	60	57	64	65	BOLI Income	15	15	15	15	15	14	14	14
-	-	-	-	-	-	-	Other noninterest income	-	-	-	-	-	-	-	-
880	561	2,825	4,525	4,834	5,959	7,226	**Total non-interest income**	651	1,246	1,384	1,245	820	1,490	1,393	1,131
							Total Non-interest expense								
5,225	5,974	8,583	10,726	11,162	11,547	12,135	Salaries wages & employee benefits	2,454	2,734	2,969	2,569	2,746	2,891	2,833	2,692
534	623	840	983	968	974	998	Occupancy expense	242	238	250	252	254	237	238	240
240	371	451	537	579	593	605	Occupancy expense	127	126	150	133	142	145	146	146
733	817	922	908	910	1,029	1,087	Data processing	237	232	221	218	168	246	246	249
637	845	886	1,046	1,284	1,281	1,307	Professional fees	226	240	228	352	354	304	310	316
163	186	189	204	208	202	205	Business Development	43	72	36	53	58	50	50	50
213	237	291	322	425	417	417	Insurance agency commissions expense	79	79	79	86	112	104	104	104
248	260	310	386	476	502	512	Franchise taxes	75	96	107	107	107	123	123	123
-	-	-	-	-	-	-	OREO writedowns	-	-	-	-	-	-	-	-
		424	250	638	738	899	Mortgage fees and settlement	-	-	-	250	141	186	173	138
490	470	547	689	812	847	864	Other noninterest expenses	182	141	181	184	188	206	208	210
8,484	9,783	13,444	16,051	17,462	18,130	19,030	**Total non-interest expense**	3,665	3,959	4,222	4,205	4,271	4,492	4,431	4,269
1,372	1,600	1,719	2,742	4,065	6,146	8,554	**Net Income**	402	663	719	957	649	1,076	1,158	1,183
							Per Share Data:								
0.36	0.40	0.39	0.44	0.66	0.99	1.37	Diluted Earnings Per Share	0.07	0.11	0.12	0.15	0.10	0.17	0.19	0.19
-	-	-	-	-	-	-	Dividend	-	-	-	-	-	-	-	-
0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	Dividend Payout Ratio	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
6.85	7.40	7.80	8.36	8.41	9.38	10.74	Book Value Per Share	8.02	8.17	8.30	8.36	8.49	8.69	8.23	8.41
6.85	7.40	7.80	8.36	8.41	9.38	10.74	Tangible Book Value Per Share	8.02	8.17	8.30	8.36	8.49	8.69	8.23	8.41
3,793	3,979	4,393	6,236	6,206	6,220	6,233	Average Diluted Shares OutstanSing (MM)*	5,956	6,166	6,166	6,173	6,194	6,208	6,209	6,212
							Profitability Measures:								
83.56%	82.54%	80.41%	74.41%	72.21%	64.98%	59.19%	Efficiency Ratio	81.98%	74.30%	71.85%	71.34%	79.73%	72.57%	69.43%	68.27%
0.54%	0.54%	0.46%	0.61%	0.78%	1.06%	1.31%	Return on average assets	0.40%	0.60%	0.60%	0.78%	0.54%	0.85%	0.87%	0.87%
5.32%	5.88%	5.37%	5.82%	7.82%	11.10%	13.64%	Return on average equity	3.52%	5.35%	5.63%	7.40%	5.04%	8.17%	8.75%	9.08%
3.88%	3.99%	3.90%	3.76%	3.75%	3.80%	3.85%	Net Interest Margin	3.77%	3.69%	3.77%	3.80%	3.78%	3.71%	3.74%	3.75%
0.35%	0.19%	0.76%	1.01%	0.93%	1.03%	1.11%	Fee Income % Average Assets	0.16%	0.28%	0.29%	0.26%	0.17%	0.29%	0.26%	0.21%
							Average Balances:								
217,578	276,304	315,936	402,942	415,925	475,525	543,082	Net Loans	331,476	363,176	392,718	402,942	392,383	391,992	405,746	415,925
39,085	51,431	51,849	62,941	72,749	84,207	98,394	Interest Bearing Deposits	56,152	66,629	66,057	62,941	69,545	68,599	72,029	72,749
208,068	260,257	297,715	336,451	407,989	456,858	511,569	Non-interest Bearing Deposits	309,101	328,195	348,243	336,451	368,184	384,605	399,989	407,989
239,183	285,300	356,681	446,053	508,697	569,898	639,063	Average Earning Assets	402,217	434,138	469,169	478,686	478,297	501,083	521,636	533,771
192,846	120,957	290,273	342,645	391,857	444,453	497,583	Average Interest Bearing Liabilities	310,236	329,054	360,977	370,312	364,688	384,616	403,075	415,050
							Asset Quality Ratios:								
-0.03%	0.16%	0.07%	0.02%	-0.08%	0.04%	0.05%	Net Charge-offs / Average Loans	-0.05%	0.00%	0.00%	0.11%	-0.10%	-0.28%	0.00%	0.04%
1.28%	0.26%	0.11%	0.28%	0.17%	0.17%	0.17%	Nonperforming Assets / Loans	0.34%	0.30%	0.31%	0.28%	0.25%	0.18%	0.17%	0.17%
1.17%	0.96%	0.96%	1.00%	1.10%	1.06%	1.04%	Reserves / Loans	0.97%	0.93%	1.00%	1.00%	1.06%	1.11%	1.10%	1.10%
0.14%	0.17%	0.21%	0.27%	0.06%	0.14%	0.16%	Provision /Loans	0.17%	0.29%	0.52%	0.16%	0.03%	0.00%	0.12%	0.11%
							Capital & Leverage Ratios:								
9.53%	8.69%	10.63%	10.40%	9.58%	9.52%	9.69%	Equity / Assets	11.63%	10.59%	10.36%	10.40%	10.47%	10.38%	9.54%	9.58%
9.53%	8.69%	10.63%	10.40%	9.58%	9.52%	9.69%	Tangible Equity / Tangible Assets	11.63%	10.59%	10.36%	10.40%	10.47%	10.38%	9.54%	9.58%

Disclosure Appendix

Analyst Certification:

I, Joseph Gladue, the primary analyst covering this issuer, certify that: 1) all of the views expressed in this report accurately reflect my personal views about the subject security or issuer, and 2) no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Risk Factors:

The realization of any or all of the following risk factors, among others, may adversely affect the company's stock price and prevent it from reaching our target price, if one is established:

- a weakening of the United States economy and the regional and local economies in which the company conducts operations
- unanticipated loan losses or securities-related losses
- a weakening of local real estate markets or the soundness and liquidity of the securities market for real-estate backed assets
- failure to maintain sufficient excess capital or liquidity to conduct operations
- the effects of trade, monetary, and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System
- the effects of increased inflation, a flatter yield curve, or increased volatility in financial markets
- inability to attract core deposits or continue to obtain third party financing on favorable terms
- adverse legal action against the company or litigation initiated by the company
- inability to successfully integrate acquired operations or to maintain sufficient excess capital post the close of a transaction

Investment Rating Definitions:

Investment ratings reflect the analyst's assessment of the subject stock's return potential relative to the NASDAQ Bank Index. There are three investment rating tiers:

- **Outperform/Buy:** The subject stock's total return is expected to exceed the return of the NASDAQ Bank Index by 10% or more over the next 12-month period.
- **Neutral/Hold:** The subject stock's total return is expected to be comparable with the return of the NASDAQ Bank Index over the next 12-month period.
- **Underperform/Sell:** The subject stock's total return is expected to be less than the return of the NASDAQ Bank Index by 10% or more over the next 12-month period.

Investment Rating Distributions (as of June 30, 2017)

	All Covered Companies		Investment Banking Services Provided in the Last 12 Months	
Rating Categories	**Count**	**% of Total**	**Count**	**% of Category**
Outperform/Buy	10	56%	0	0%
Neutral/Hold	8	44%	0	0%
Underperform/Sell	NA	0%	0	0%
Total	18	100%		

Other Important Disclosures:

Merion Capital Group is the trade name used by MCG Securities LLC. MCG Securities LLC is a FINRA-registered broker-dealer.

MCG Securities expects to receive compensation for investment banking services from the subject company in the next three months and/or seeks to receive such compensation.

Analyst compensation is based, in part, on MCG Securities' profitability, which includes revenues from investment banking.

Target prices, if applicable, are derived from our 12 Month Valuation Assessment. Our 12 Month Valuation Assessment is based on a blend of several relative value methodologies.

MCG Securities shares in the commissions for trades that are executed through Tourmaline Partners, LLC.