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## Paragon Commercial Corporation (No Formal Market)

**John A. (Buddy) Howard, CFA**  
**May 9, 2014**

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<b>Price: *</b>	\$1,081	<b>EPS **</b>	<b>2012A:</b>	\$ 90	<b>P/E</b>	<b>2012A:</b>	12.0x
<b>52 Wk. Range:</b>	\$ 900 - \$ 1,181	(FY: DEC)	<b>2013A:</b>	\$ 139		<b>2013A:</b>	7.8x
<b>Div/Div Yld:</b>	\$0.00 / 0.0%		<b>2014E:</b>	\$ 188		<b>2014E:</b>	5.8x
<b>Shrs/Mkt Cap:</b>	35.5 K / \$38 mm	<b>Book Value:</b>		\$ 2,246	<b>Price/Book Value:</b>		0.48x

\* Limited trading. Price is most recent of which Company is aware. \*\* EPS is diluted.

### Background

Paragon Commercial Corporation (the "Company") is a Raleigh, North Carolina-based commercial bank holding company for Paragon Bank (the "Bank"), a bank that began operations on May 10, 1999. With approximately \$1.1 billion in assets as of March 31, 2014, the Bank focuses on business banking and private banking. The Bank conducts operations through locations in Raleigh, NC and Charlotte, NC. Paragon Commercial Corporation offers a broad array of products to commercial clients, business owners and other targeted private banking customers, either through its own products or through affiliated companies that have partnered with the Bank. Commercial and private banking products and services offered include check and statement imaging, business checking, money market investment accounts, certificates of deposit, letters of credit, online banking and business loans. Paragon also offers commercial insurance, retirement plans, leasing, and investment services, commercial real estate financing, residential mortgages and accounts receivable funding through the third party providers. The Bank also provides a variety of financial products and services exclusively to individuals who desire a comprehensive banking relationship, from premium checking, money market and certificate of deposit accounts to customized financing solutions for personal and business needs.

### First Quarter Earnings Increased 89%

Although reported earnings in the first quarter of 2014 were actually below what we had projected, the quarter was a strong one for Paragon Commercial Corporation, as earnings nearly doubled, margins increased substantially, the balance sheet expanded (both from the year-ago date and on a linked quarter basis), and asset quality improved. Moreover, many of the leading indicators of problem assets, such as loans that are 30 to 89 days past due, were quite low, giving us further confidence that the outlook for asset quality remains good. The Company's profitability and efficiency ratios also remain strong and are better than most other banks operating in North Carolina.

Net income for the first quarter of 2014 was \$1.6 million, or \$43.63 per diluted share, which was up 89% from \$0.8 million, or \$23.19 per diluted share, in the year-ago quarter and up from \$1.4 million in 2013's fourth quarter. (We had projected the Company would earn \$1.9 million, or \$55 per share.) The excellent earnings growth was mainly due to 15% growth in net interest income, which totaled \$8.0 million in 2014's first quarter, versus \$7.0 million in the year-ago quarter. The net interest income growth was a function of improvement in margins (up 30 basis points to 3.49% in the first quarter of 2014 from 3.19% in the year-ago quarter) as well as 5% growth in average earning assets. Significant progress was also made in noninterest income, reflecting a large (nearly \$1 million) drop in losses on the sale of OREO. In total, noninterest income was \$374,000 in 2014's first quarter, versus a loss of \$631,000 in the year-ago quarter. Excluding gains and losses on securities and the losses on the sale of real estate, noninterest income dropped, though the magnitude of that drop was quite insignificant (about \$75,000) in

**ASSETS: \$1.1 B**

**HQ: RALEIGH, NC**

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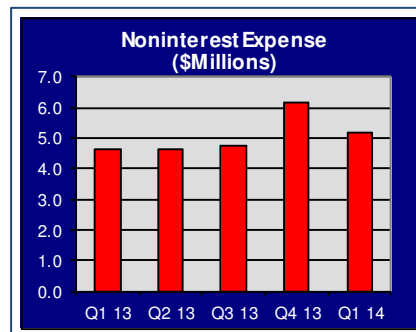
**1<sup>ST</sup> QUARTER HIGHLIGHTS:**

**EPS: \$44 VS. \$23**

**NET INTEREST INCOME WAS UP 15%**

**THE MARGIN IMPROVED 30 BASIS POINTS AND AVERAGE EARNING ASSETS WERE UP ABOUT 5%**

**NONINTEREST INCOME INCREASED ON A LINKED QUARTER BASIS**



**NONINTEREST EXPENSE  
DECREASED 16% FROM THE  
FOURTH QUARTER OF 2013**

**DEPOSITS INCREASED 11%, AND  
CDs DECLINED FROM THE YEAR-  
AGO DATE**

**THE ROAA, ROAE, MARGIN,  
EFFICIENCY RATIO AND  
NPAs/ASSETS RATIO ALL  
IMPROVED FROM THE YEAR-AGO  
QUARTER**

**NEARLY ALL THE RATIOS WERE  
SUPERIOR TO THE MEDIAN FOR  
NC BANKS**

**THE STOCK TRADES AT A  
DISCOUNT TO THE NC BANKS ON  
BOTH A P/E AND PRICE/BOOK  
VALUE RATIO**

**NPAs/ASSETS: 1.86%**

**LOANS 30-89 DAYS PAST DUE  
DECREASED SIGNIFICANTLY**

**RESERVES/LOANS: 0.97%**

**EPS:  
2012A: \$ 90  
2013A: \$ 139  
2014E: \$ 188**

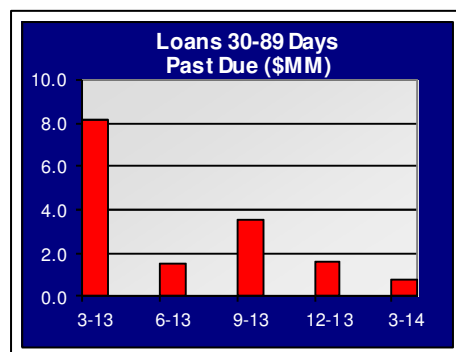
comparison to the improvement in net interest income, which rose more than \$1 million. Additionally, several of the year-ago noninterest items were nonrecurring, such as rental income on OREO that has since been sold. Finally, noninterest expense was up 13% to \$5.2 million in the first quarter of 2014 from \$4.6 million in the year-ago quarter, though on a linked quarter basis it declined 16%, part of which was due to the absence of one-time items in 2013's fourth quarter.

Balance sheet growth was strong, and was led by deposits. Gross loans increased 7%, deposits grew 11% and total assets were up 9%. We would also note that the mix of deposits improved at March 31, 2014, as higher cost CDs declined 11% from the year-ago date, and were reduced to 51% of total deposits from 64% over this period. The Company remains well capitalized with shareholders' equity of \$80 million, or 7.48% of total assets, at March 31, 2014, and all of its regulatory capital ratios exceeded the minimums for it to be considered "well capitalized."

### **Profitability is Superior to NC Banks, Shares Reflect a Compelling Value**

As can be seen from the adjacent table, Paragon has had significant improvement in its profitability, efficiency and asset quality ratios over the past year. Both ROAA and ROAE nearly doubled, the margin was up 30 basis points and the efficiency ratio dropped (improved), as did the NPAs/assets ratio. Moreover, most of these ratios were superior to the medians for the NC banks with assets between \$250 million and \$3 billion. Despite the superior fundamentals, the stock is currently trading at a discount to the majority of NC banks on both a multiple of earnings and book value. Specifically, the multiples of both earnings and book value were about half the NC bank medians. While some of this disparity can be attributed to differences in marketability, we nevertheless believe the current valuation presents good upside opportunities, particularly given the Board's recent decision to split the stock 125-for-1 and to apply for listing with DTC, which would enable the shares to be traded electronically and ultimately to be listed on an exchange.

SELECTED PERFORMANCE RATIOS VS. NC BANKS (%)			
	Paragon Q1 13	Q1 14	NC Peer Group Median
<b>ROAA</b>	0.30	0.60	0.43
<b>ROAE</b>	4.31	7.96	4.53
<b>Net Int. Margin</b>	3.19	3.49	3.90
<b>Efficiency Ratio</b>	69.4	60.8	84.2
<b>NPAs/Assets</b>	3.24	1.86	2.09
<b>P/E (x)</b>		6.8	12.4
<b>Price/Book Value (x)</b>		0.48	1.01



### **NPA Declined 37% from the Year-Ago Date**

Paragon's level of NPAs continued to decline, and at March 31, 2014, totaled \$19.8 million, or 1.86% of total assets, down from \$20.2 million, or 1.95% of total assets, at December 31, 2013, and down 37% from \$31.5 million, or 3.24% of total assets, at the year-ago date. The majority of the improvement came from a significant drop in nonaccrual loans. We would also note that loans 30 to 89 days past due, which are generally a leading indicator in NPA levels, have significantly decreased from the year-ago date and decreased on a sequential basis as well. The

allowance for loan losses was \$7.6 million, or 0.97% of gross loans, at March 31, 2014, compared to \$9.3 million (1.27% of gross loans) at the year-ago date.

### **Projections**

Based on the first quarter coming in below our estimates, we are revising our projections to \$6.7 million, or \$188 per diluted share, for 2014, versus our prior estimate of \$223 per share. These projections could vary widely (positive or negative) depending on variations in the provision and other credit-related charges.

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