

PINNACLE FINANCIAL PARTNERS INC
Form 10-Q
November 01, 2013
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(mark one)

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

For the quarterly period ended September 30, 2013

or

TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d)
OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the transition period from ____ to ____

Commission File Number: 000-31225

, Inc.

(Exact name of registrant as specified in its charter)

Tennessee

(State or other jurisdiction of incorporation or organization)

62-1812853

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

150 Third Avenue South, Suite 900, Nashville, Tennessee

(Address of principal executive offices)

37201

(Zip Code)

(615) 744-3700

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changes since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller reporting company

(do not check if you are a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 29, 2013 there were 35,149,392 shares of common stock, \$1.00 par value per share, issued and outstanding.

Pinnacle Financial Partners, Inc.
Report on Form 10-Q
September 30, 2013

| TABLE OF CONTENTS | Page No. |
|--|----------|
| <u>PART I – Financial Information:</u> | |
| <u>Item 1. Consolidated Financial Statements (Unaudited)</u> | 4 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 23 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | 32 |
| <u>Item 4. Controls and Procedures</u> | 32 |
| <u>PART II – Other Information:</u> | |
| <u>Item 1. Legal Proceedings</u> | 33 |
| <u>Item 1A. Risk Factors</u> | 33 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 34 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 35 |
| <u>Item 4. Mine Safety Disclosures</u> | 35 |
| <u>Item 5. Other Information</u> | 35 |
| <u>Item 6. Exhibits</u> | 36 |
| <u>Signatures</u> | 37 |

FORWARD-LOOKING STATEMENTS

Certain of the statements in this quarterly report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words "expect," "anticipate," "goal," "objective," "intend," "plan," "believe," "should," "seek," "estimate" 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 the actual results, performance or achievements of Pinnacle Financial Partners, Inc. ("Pinnacle Financial") to differ materially from any results expressed or implied by such forward-looking statements. Such risks include, without limitation, (i) deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses; (ii) continuation of the historically low short-term interest rate environment; (iii) the inability of Pinnacle Financial to grow its loan portfolio; (iv) changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments; (v) effectiveness of Pinnacle Financial's asset management activities in improving, resolving or liquidating lower-quality assets; (vi) increased competition with other financial institutions; (vii) greater than anticipated adverse conditions in the national or local economies including the Nashville-Davidson-Murfreesboro-Franklin MSA and the Knoxville MSA, particularly in commercial and residential real estate markets; (viii) rapid fluctuations or unanticipated changes in interest rates on loans or deposits; (ix) the results of regulatory examinations; (x) the ability to retain large, uninsured deposits; (xi) the development of any new market other than Nashville or Knoxville; (xii) a merger or acquisition; (xiii) any matter that would cause Pinnacle Financial to conclude that there was impairment of any asset, including intangible assets; (xiv) the ability to attract additional financial advisors or to attract customers from other financial institutions; (xv) further deterioration in the valuation of other real estate owned and increased expenses associated therewith; (xvi) inability to comply with regulatory capital requirements, including those resulting from recently adopted changes to capital calculation methodologies and required capital maintenance levels; (xvii) risks associated with litigation, including the applicability of insurance coverage; (xviii) changes in the value of Pinnacle Financial's investment securities and any resulting losses associated therewith resulting from changes in market rates of interest, with Pinnacle Financial's intent to hold these securities to maturity, or the underlying financial condition of the issuer thereof; (xix) a decision by Pinnacle Financial's board of directors to eliminate or reduce the amount of the quarterly cash dividend initiated on Pinnacle Financial's common stock and, (xx) 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. A more detailed description of these and other risks is contained in Pinnacle Financial's most recent annual report on Form 10-K filed with the Securities and Exchange Commission on February 22, 2013, Pinnacle Financial's most recent quarterly report on Form 10-Q filed with the Securities and Exchange Commission on July 31, 2013 and Part II, Item 1A "Risk Factors" below. Many of such factors are beyond Pinnacle Financial's ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. Pinnacle Financial disclaims any obligation to update or revise any forward-looking statements contained in this release, whether as a result of new information, future events or otherwise.

Item 1. Part I. Financial Information

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited)

| | September 30, 2013 | December 31, 2012 |
|--|-----------------------|----------------------|
| <u>ASSETS</u> | | |
| Cash and noninterest-bearing due from banks | \$92,150,263 | \$51,946,542 |
| Interest-bearing due from banks | 118,351,624 | 111,535,083 |
| Federal funds sold and other | 639,572 | 1,807,044 |
| Cash and cash equivalents | 211,141,459 | 165,288,669 |
| Securities available-for-sale, at fair value | 704,291,206 | 706,577,806 |
| Securities held-to-maturity (fair value of \$38,717,744 and \$583,212 at September 30, 2013 and December 31, 2012, respectively) | 39,593,672 | 574,863 |
| Mortgage loans held-for-sale | 16,961,925 | 41,194,639 |
| Loans | 3,969,302,182 | 3,712,162,430 |
| Less allowance for loan losses | (67,279,672) | (69,417,437) |
| Loans, net | 3,902,022,510 | 3,642,744,993 |
| Premises and equipment, net | 74,117,834 | 75,804,895 |
| Other investments | 30,537,063 | 26,962,890 |
| Accrued interest receivable | 16,167,556 | 14,856,615 |
| Goodwill | 243,807,645 | 244,040,421 |
| Core deposits and other intangible assets | 4,087,425 | 5,103,273 |
| Other real estate owned | 15,522,233 | 18,580,097 |
| Other assets | 132,950,060 | 98,819,455 |
| Total assets | \$5,391,200,588 | \$5,040,548,616 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Deposits: | | |
| Noninterest-bearing | \$1,138,420,589 | \$985,689,460 |
| Interest-bearing | 784,995,026 | 760,786,247 |
| Savings and money market accounts | 1,860,598,743 | 1,662,256,403 |
| Time | 549,528,625 | 606,455,873 |
| Total deposits | 4,333,542,983 | 4,015,187,983 |
| Securities sold under agreements to repurchase | 84,031,927 | 114,667,475 |
| Federal Home Loan Bank advances | 115,670,655 | 75,850,390 |
| Subordinated debt and other borrowings | 99,283,292 | 106,158,292 |
| Accrued interest payable | 925,097 | 1,360,598 |
| Other liabilities | 45,530,772 | 48,252,519 |
| Total liabilities | 4,678,984,726 | 4,361,477,257 |
| Stockholders' equity: | | |
| Preferred stock, no par value, 10,000,000 shares authorized; no shares issued and outstanding | - | - |
| Common stock, par value \$1.00; 90,000,000 shares authorized; 35,133,733 and 34,696,597 shares issued and outstanding | | |

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| | | |
|---|-----------------|-----------------|
| at September 30, 2013 and December 31, 2012, respectively | 35,133,733 | 34,696,597 |
| Additional paid-in capital | 547,641,227 | 543,760,439 |
| Retained earnings | 129,792,296 | 87,386,689 |
| Accumulated other comprehensive (loss) income, net of taxes | (351,394) | 13,227,634 |
| Total stockholders' equity | 712,215,862 | 679,071,359 |
| Total liabilities and stockholders' equity | \$5,391,200,588 | \$5,040,548,616 |

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------------|------------------------------------|---------------|
| | 2013 | 2012 | 2013 | 2012 |
| Interest income: | | | | |
| Loans, including fees | \$42,778,193 | \$40,405,396 | \$126,441,555 | \$118,331,163 |
| Securities: | | | | |
| Taxable | 3,538,446 | 3,973,717 | 10,860,146 | 13,356,957 |
| Tax-exempt | 1,601,067 | 1,621,541 | 4,741,440 | 4,972,539 |
| Federal funds sold and other | 259,536 | 440,254 | 834,748 | 1,557,831 |
| Total interest income | 48,177,242 | 46,440,908 | 142,877,889 | 138,218,490 |
| Interest expense: | | | | |
| Deposits | 2,708,376 | 3,986,328 | 9,076,757 | 13,112,653 |
| Securities sold under agreements to repurchase | 55,601 | 99,379 | 204,240 | 370,405 |
| Federal Home Loan Bank advances and other borrowings | 840,318 | 1,422,845 | 2,666,721 | 4,114,008 |
| Total interest expense | 3,604,295 | 5,508,552 | 11,947,718 | 17,597,066 |
| Net interest income | 44,572,947 | 40,932,356 | 130,930,171 | 120,621,424 |
| Provision for loan losses | 684,956 | 1,412,575 | 5,631,408 | 3,080,892 |
| Net interest income after provision for loan losses | 43,887,991 | 39,519,781 | 125,298,763 | 117,540,532 |
| Noninterest income: | | | | |
| Service charges on deposit accounts | 2,797,342 | 2,531,707 | 7,818,452 | 7,295,045 |
| Investment services | 1,955,652 | 1,676,601 | 5,643,690 | 4,934,262 |
| Insurance sales commissions | 1,021,430 | 987,222 | 3,522,430 | 3,415,945 |
| Gain on mortgage loans sold, net | 1,326,469 | 1,978,935 | 5,130,411 | 4,930,190 |
| (Loss) gain on sale of investment securities, net of OTTI | (1,441,234) | (49,784) | (1,466,475) | 162,733 |
| Trust fees | 931,543 | 767,042 | 2,756,079 | 2,332,716 |
| Other noninterest income | 4,796,079 | 2,537,863 | 11,210,770 | 7,217,879 |
| Total noninterest income | 11,387,281 | 10,429,586 | 34,615,357 | 30,288,770 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 21,009,680 | 19,470,535 | 61,152,789 | 58,500,279 |
| Equipment and occupancy | 5,412,865 | 5,156,131 | 15,730,074 | 15,217,897 |
| Other real estate expense | 699,211 | 2,399,232 | 2,810,779 | 10,179,572 |
| Marketing and other business development | 720,866 | 834,661 | 2,498,708 | 2,359,760 |
| Postage and supplies | 581,433 | 637,906 | 1,690,588 | 1,816,925 |
| Amortization of intangibles | 246,675 | 683,430 | 1,015,848 | 2,055,564 |
| Other noninterest expense | 4,652,161 | 4,396,465 | 11,725,844 | 13,183,603 |
| Total noninterest expense | 33,322,891 | 33,578,360 | 96,624,630 | 103,313,600 |
| Income before income taxes | 21,952,381 | 16,371,007 | 63,289,490 | 44,515,702 |
| Income tax expense | 7,305,431 | 5,021,882 | 20,883,883 | 14,361,979 |
| Net income | 14,646,950 | 11,349,125 | 42,405,607 | 30,153,723 |
| Preferred stock dividends | - | - | - | 1,660,868 |
| Accretion on preferred stock discount | - | - | - | 2,153,172 |
| Net income available to common stockholders | \$14,646,950 | \$11,349,125 | \$42,405,607 | \$26,339,683 |

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Per share information:

| | | | | |
|--|------------|------------|------------|------------|
| Basic net income per common share available to common stockholders | \$0.43 | \$0.33 | \$1.24 | \$0.78 |
| Diluted net income per common share available to common stockholders | \$0.42 | \$0.33 | \$1.23 | \$0.76 |
| Weighted average shares outstanding: | | | | |
| Basic | 34,282,899 | 33,939,248 | 34,148,562 | 33,879,186 |
| Diluted | 34,606,567 | 34,523,076 | 34,415,776 | 34,473,895 |

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------|-------------------|--------------|
| | September 30, | | September 30, | |
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$14,646,950 | \$11,349,125 | \$42,405,607 | \$30,153,723 |
| Other comprehensive income, net of tax: | | | | |
| Change in fair value on available-for-sale securities, net of tax | (1,191,495) | 1,911,296 | (17,396,100) | 2,199,651 |
| Change in fair value of cash flow hedges, net of income tax | (421,473) | - | 2,925,895 | - |
| Net loss (gain) on sale of investment securities reclassified from other comprehensive income into net income, net of tax | 875,838 | 30,254 | 891,177 | (98,893) |
| Total comprehensive income | \$13,909,820 | \$13,290,675 | \$28,826,579 | \$32,254,481 |

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)

| | Common Stock | | | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comp. Income (Loss), net | Total Stock Equity |
|---|------------------------------|------------|--------------|-----------------------------|----------------------------------|----------------------|---|--------------------------|
| | Preferred Stock Amount | Shares | Amount | Common Stock Warrants | | | | |
| Balances, December 31, 2011 | \$69,096,828 | 34,354,960 | \$34,354,960 | \$3,348,402 | \$536,227,537 | \$49,783,584 | \$17,333,257 | \$7 |
| Exercise of employee common stock options and related tax benefits | - | 230,718 | 230,718 | - | 1,297,396 | - | - | 1, |
| Repurchase of preferred stock | (71,250,000) | - | - | - | - | - | - | (7 |
| Issuance of restricted common shares, net of forfeitures | - | 95,890 | 95,890 | - | (95,890) | - | - | - |
| Issuance of salary stock units | - | 57,508 | 57,508 | - | 942,565 | - | - | 1, |
| Restricted shares withheld for taxes | - | (47,417) | (47,417) | - | (741,427) | - | - | (7 |
| Compensation expense for restricted shares | - | - | - | - | 2,489,334 | - | - | 2, |
| Compensation expense for stock options | - | - | - | - | 329,350 | - | - | 3, |
| Cancellation of outstanding warrants | - | - | - | (3,348,402) | 2,593,402 | - | - | (7 |
| Accretion on preferred stock discount | 2,153,172 | - | - | - | - | (2,153,172) | - | - |
| Preferred dividends paid | - | - | - | - | - | (2,127,605) | - | (2 |
| Net income | - | - | - | - | - | 30,153,723 | - | 30 |
| Other comprehensive | - | - | - | - | - | - | 2,100,758 | 2, |

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| | | | | | | | | |
|---|-----|------------|--------------|-----|---------------|---------------|--------------|-----|
| income | | | | | | | | |
| Balances, September 30, 2012 | \$- | 34,691,659 | \$34,691,659 | \$- | \$543,042,267 | \$75,656,530 | \$19,434,015 | \$6 |
| Balances, December 31, 2012 | \$- | 34,696,597 | \$34,696,597 | \$- | \$543,760,439 | \$87,386,689 | \$13,227,634 | \$6 |
| Exercise of employee common stock options and related tax benefits | - | 191,928 | 191,928 | - | 2,372,601 | - | - | 2 |
| Issuance of restricted common shares, net of forfeitures | - | 300,718 | 300,718 | - | (300,718) | - | - | - |
| Restricted shares withheld for taxes | - | (55,510) | (55,510) | - | (1,218,326) | - | - | (1 |
| Compensation expense for restricted shares | - | - | - | - | 3,014,761 | - | - | 3 |
| Compensation expense for stock options | - | - | - | - | 12,470 | - | - | 12 |
| Net income | - | - | - | - | - | 42,405,607 | - | 42 |
| Other comprehensive loss | - | - | - | - | - | - | (13,579,028) | (13 |
| Balances, September 30, 2013 | \$- | 35,133,733 | \$35,133,733 | \$- | \$547,641,227 | \$129,792,296 | \$(351,394) | \$7 |

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Nine Months Ended September 30 | |
|---|-----------------------------------|---------------|
| | 2013 | 2012 |
| Operating activities: | | |
| Net income | \$42,405,607 | \$30,153,723 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization/accretion of premium/discount on securities | 3,444,484 | 5,697,121 |
| Depreciation and amortization | 6,918,189 | 7,548,657 |
| Provision for loan losses | 5,631,408 | 3,080,892 |
| Gain on mortgage loans sold, net | (5,130,411) | (4,930,190) |
| Loss (gain) on sale of investment securities, net | 1,466,475 | (162,733) |
| Stock-based compensation expense | 3,027,231 | 3,818,757 |
| Deferred tax (expense) benefit | (51,547) | 2,128,122 |
| Losses on dispositions of other real estate and other investments | 2,889,742 | 9,313,372 |
| Excess tax benefit from stock compensation | (232,776) | (31,524) |
| Mortgage loans held for sale: | | |
| Loans originated | (320,203,874) | (354,271,377) |
| Loans sold | 349,567,000 | 355,189,000 |
| Decrease in other assets | 12,875,979 | 25,959,161 |
| (Decrease) increase in other liabilities | (3,105,860) | 2,486,701 |
| Net cash provided by operating activities | 99,501,647 | 85,979,682 |
| Investing activities: | | |
| Activities in securities available-for-sale: | | |
| Purchases | (182,289,872) | (43,610,007) |
| Sales | 1,414,628 | 35,420,503 |
| Maturities, prepayments and calls | 111,542,890 | 162,369,154 |
| Activities in securities held-to-maturity: | | |
| Purchases | (2,452,919) | - |
| Maturities, prepayments and calls | 2,982,450 | 1,755,000 |
| Increase in loans, net | (269,103,013) | (250,553,288) |
| Purchases of software, premises and equipment | (4,371,613) | (2,852,918) |
| Purchase of bank owned life insurance | (30,000,000) | - |
| (Decrease) increase in other investments | (3,611,128) | 18,503,170 |
| Net cash used in investing activities | (375,888,577) | (78,968,386) |
| Financing activities: | | |
| Net increase in deposits | 318,355,000 | 64,947,672 |
| Net increase (decrease) in securities sold under agreements to repurchase | (30,635,547) | 3,195,562 |
| Advances from Federal Home Loan Bank: | | |
| Issuances | 624,000,000 | 495,000,000 |
| Payments/maturities | (584,128,201) | (530,124,164) |
| (Decrease) increase in other borrowings | (6,875,000) | 9,307,292 |
| Exercise of common stock options and stock appreciation rights | 1,290,692 | 739,270 |
| Excess tax benefit from stock compensation | 232,776 | 31,524 |

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| | | |
|--|---------------|---------------|
| Preferred dividends paid | - | (2,127,605) |
| Repurchase of preferred shares outstanding | - | (71,250,000) |
| Repurchase of outstanding warrants | - | (755,000) |
| Net cash provided by financing activities | 322,239,720 | (31,035,449) |
| Net increase in cash and cash equivalents | 45,852,790 | (24,024,153) |
| Cash and cash equivalents, beginning of period | 165,288,669 | 172,163,040 |
| Cash and cash equivalents, end of period | \$211,141,459 | \$148,138,887 |

See accompanying notes to consolidated financial statements (unaudited).

PINNACLE FINANCIAL PARTNERS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Nature of Business — Pinnacle Financial Partners, Inc. (Pinnacle Financial) is a bank holding company whose primary business is conducted by its wholly-owned subsidiary, Pinnacle Bank. Pinnacle Bank is a commercial bank headquartered in Nashville, Tennessee. Pinnacle Bank provides a full range of banking services in its primary market areas of the Nashville-Davidson-Murfreesboro-Franklin, Tennessee and Knoxville, Tennessee Metropolitan Statistical Areas.

Basis of Presentation — The accompanying unaudited consolidated financial statements have been prepared in accordance with instructions to Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial position, results of operations, and cash flows in conformity with U.S. generally accepted accounting principles (U.S. GAAP). All adjustments consisting of normally recurring accruals that, in the opinion of management, are necessary for a fair presentation of the financial position and results of operations for the periods covered by the report have been included. The accompanying unaudited consolidated financial statements should be read in conjunction with the Pinnacle Financial consolidated financial statements and related notes appearing in the 2012 Annual Report previously filed on Form 10-K.

These consolidated financial statements include the accounts of Pinnacle Financial and its wholly-owned subsidiaries. PNFP Statutory Trust I, PNFP Statutory Trust II, PNFP Statutory Trust III and PNFP Statutory Trust IV are affiliates of Pinnacle Financial and are included in these consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

Use of Estimates — The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include the determination of the allowance for loan losses, any potential impairment of intangible assets, including goodwill and the valuation of deferred tax assets, other real estate owned, and our investment portfolio, including other-than-temporary impairment. These financial statements should be read in conjunction with Pinnacle Financial's Annual Report on Form 10-K for the year ended December 31, 2012. There have been no significant changes to Pinnacle Financial's significant accounting policies as disclosed in Pinnacle Financial's Annual Report on Form 10-K for the year ended December 31, 2012.

Recently Adopted Accounting Pronouncements — In February 2013, the FASB issued Accounting Standards Update 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" which provides disclosure guidance on amounts reclassified out of AOCI by component.

The adoption did not have any impact on our financial position or results of operations but has impacted our financial statement disclosure. As shown on the statement of comprehensive income for the three and nine months ended September 30, 2013, Pinnacle Financial reclassified approximately \$876,000 and \$891,000 of net losses out of other comprehensive income into loss on the sale of investment securities, net of tax, compared to reclassifications of net losses for the three months ended September 30, 2012, of approximately \$30,000, net of tax and net gains for the nine months ended September 30, 2012, of \$99,000, net of tax.

Goodwill — ASU No. 2011-8 provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity

determines that this is the case, it is required to perform the quantitative two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). Based on the qualitative assessment, if an entity determines that the fair value of a reporting unit is more than its carrying amount, the quantitative two-step goodwill impairment test is not required. Pinnacle Financial performed our annual assessment as of September 30, 2013. The results of our qualitative assessment indicated that the fair value of our reporting units was more than its carrying value, and accordingly, the two-step goodwill impairment test was not performed.

Cash Flow Information — Supplemental cash flow information addressing certain cash and noncash transactions for each of the nine months ended September 30, 2013 and 2012 was as follows:

| | For the nine months ended September 30, | |
|---|--|--------------|
| | 2013 | 2012 |
| Cash Transactions: | | |
| Interest paid | \$12,434,753 | \$18,317,526 |
| Income taxes paid, net | 20,850,009 | 5,699,106 |
| Noncash Transactions: | | |
| Loans charged-off to the allowance for loan losses | 14,088,656 | 11,265,378 |
| Loans foreclosed upon and transferred to other real estate owned | 3,491,421 | 8,489,792 |
| Available-for-sale securities transferred to held-to-maturity portfolio | 39,959,647 | - |

Income Per Common Share — Basic net income per common share available to common stockholders (EPS) is computed by dividing net income available to common stockholders by the weighted average common shares outstanding for the period. For the three and nine months ended September 30, 2012, weighted average common shares outstanding also include salary stock units issued to the named executive officers. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted. The difference between basic and diluted weighted average shares outstanding is attributable to common stock options, common stock appreciation rights, warrants and dilutive restricted shares. The dilutive effect of outstanding options, common stock appreciation rights, warrants and restricted shares is reflected in diluted EPS by application of the treasury stock method.

For the three and nine months ended September 30, 2013, there were 323,668 and 267,214 shares, respectively, associated with dilutive stock options, stock appreciation rights and dilutive restricted shares that were included in the net income per share calculation. For the three and nine months ended September 30, 2012, there were 583,828 and 594,709 shares, respectively, associated with dilutive stock options, stock appreciation rights, warrants and restricted shares outstanding to purchase common shares that were included in the net income per share calculation.

The following is a summary of the basic and diluted net income per share calculations for the three and nine months ended September 30, 2013 and 2012:

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|---------------|--|---------------|
| | 2013 | 2012 | 2013 | 2012 |
| Basic net income per share calculation: | | | | |
| Numerator - Net income available to common stockholders | \$ 14,646,950 | \$ 11,349,125 | \$ 42,405,607 | \$ 26,339,683 |
| Denominator - Average common shares outstanding | 34,282,899 | 33,939,248 | 34,148,562 | 33,879,186 |
| Basic net income per share available to common stockholders | \$0.43 | \$0.33 | \$1.24 | \$0.78 |
| Diluted net income per share calculation: | | | | |
| Numerator – Net income available to common stockholders | \$ 14,646,950 | \$ 11,349,125 | \$ 42,405,607 | \$ 26,339,683 |
| Denominator - Average common shares outstanding | 34,282,899 | 33,939,248 | 34,148,562 | 33,879,186 |
| Dilutive shares contingently issuable | 323,668 | 583,828 | 267,214 | 594,709 |
| Average diluted common shares outstanding | 34,606,567 | 34,523,076 | 34,415,776 | 34,473,895 |
| Diluted net income per share available to common stockholders | \$0.42 | \$0.33 | \$1.23 | \$0.76 |

Note 2. Participation in U.S. Treasury Capital Purchase Program (CPP)

On December 12, 2008, Pinnacle Financial issued 95,000 shares of preferred stock to the U.S. Treasury (the Treasury) for \$95 million pursuant to the CPP. For the time the CPP preferred stock was outstanding, the CPP preferred stock was non-voting, other than having class voting rights on certain matters, and paid cumulative dividends quarterly at a rate of 5% per annum. Pinnacle Financial redeemed the preferred shares issued to the Treasury under the CPP in two transactions. During the fourth quarter of 2011, Pinnacle Financial redeemed 23,750 of the preferred shares in a transaction totaling approximately \$23.9 million, including accrued but unpaid dividends of \$142,000. During the second quarter of 2012, Pinnacle Financial completed the redemption of the remaining 71,250 preferred shares outstanding in a transaction totaling \$71.6 million which included accrued but unpaid dividends of \$346,000.

Concurrently, Pinnacle Financial accelerated the accretion of the remaining preferred stock discount of approximately \$1.7 million during the second quarter of 2012.

Additionally, Pinnacle Financial issued warrants to purchase 534,910 shares of common stock to the Treasury as a condition to its participation in the CPP. The warrants had an exercise price of \$26.64 each, were immediately exercisable and expired 10 years from the date of issuance. On June 16, 2009, Pinnacle Financial completed the sale of 8,855,000 shares of its common stock in a public offering, resulting in net proceeds to Pinnacle Financial of approximately \$109 million. As a result, and pursuant to the terms of the warrants, the number of shares issuable upon exercise of the warrants was reduced by 50%, or 267,455 shares. During the third quarter of 2012, Pinnacle Financial repurchased all of the remaining outstanding warrants held by the Treasury for \$755,000.

Note 3. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at September 30, 2013 and December 31, 2012 are summarized as follows (in thousands):

| | September 30, 2013 | | | |
|-----------------------------------|--------------------|-------------|-------------------------|------------|
| | Amortized Cost | Gross Gains | Gross Unrealized Losses | Fair Value |
| Securities available-for-sale: | | | | |
| U.S. Treasury securities | \$4,999 | \$ 1 | \$ - | \$5,000 |
| U.S. government agency securities | 137,908 | 225 | 10,642 | 127,491 |
| Mortgage-backed securities | 390,179 | 10,142 | 5,991 | 394,330 |
| State and municipal securities | 142,943 | 6,581 | 734 | 148,790 |
| Asset-backed securities | 17,461 | - | 147 | 17,314 |
| Corporate notes and other | 10,224 | 1,153 | 10 | 11,367 |
| | \$703,714 | \$ 18,102 | \$ 17,524 | \$704,292 |
| Securities held-to-maturity: | | | | |
| State and municipal securities | \$39,594 | \$ 72 | \$ 948 | \$38,718 |
| | \$39,594 | \$ 72 | \$ 948 | \$38,718 |
| | December 31, 2012 | | | |
| | Amortized Cost | Gross Gains | Gross Unrealized Losses | Fair Value |
| Securities available-for-sale: | | | | |
| U.S. Treasury securities | \$- | \$ - | \$ - | \$- |
| U.S. government agency securities | 110,817 | 49 | 414 | 110,452 |
| Mortgage-backed securities | 360,504 | 15,770 | 623 | 375,651 |
| State and municipal securities | 177,364 | 14,489 | 126 | 191,727 |
| Asset-backed securities | 17,361 | - | 9 | 17,352 |
| Corporate notes and other | 9,881 | 1,519 | 4 | 11,396 |
| | \$675,927 | \$ 31,827 | 1,176 | \$707 |
| Securities held-to-maturity: | | | | |
| State and municipal securities | \$575 | \$ 8 | \$ - | \$ 1 |
| | \$575 | \$ 8 | \$ - | \$ 1 |

At September 30, 2013, approximately \$596.0 million of securities within Pinnacle Financial's investment portfolio were either pledged to secure public funds and other deposits or securities sold under agreements to repurchase.

During the first quarter of 2013, approximately \$40.0 million of available-for-sale securities were transferred to the held-to-maturity portfolio. The transfers of debt securities into the held-to-maturity category from the available-for-sale category were made at fair value at the date of transfer. The unrealized holding gain or loss at the date of transfer was retained in other comprehensive income and in the carrying value of the held-to-maturity securities. Such amounts will be amortized to interest income over the remaining life of the securities.

The amortized cost and fair value of debt securities as of September 30, 2013 by contractual maturity are shown below. Actual maturities may differ from contractual maturities of mortgage- and asset-backed securities since the mortgages and assets underlying the securities may be called or prepaid with or without penalty. Therefore, these securities are not included in the maturity categories in the following summary (in thousands):

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September 30, 2013

| | Available-for-sale | | Held-to-maturity | |
|--------------------------------|--------------------|------------|------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$8,458 | \$8,486 | \$320 | \$320 |
| Due in one year to five years | 26,415 | 27,000 | 12,476 | 12,465 |
| Due in five years to ten years | 143,804 | 144,830 | 15,529 | 15,127 |
| Due after ten years | 117,187 | 112,331 | 11,269 | 10,806 |
| Mortgage-backed securities | 390,179 | 394,330 | - | - |
| Asset-backed securities | 17,461 | 17,314 | - | - |
| | \$703,504 | \$704,291 | \$39,594 | \$38,718 |

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At September 30, 2013 and December 31, 2012, the following investments had unrealized losses. The table below classifies these investments according to the term of the unrealized losses of less than twelve months or twelve months or longer (in thousands):

| | Investments with an Unrealized Loss of less than 12 months | | Investments with an Unrealized Loss of 12 months or longer | | Total Investments with an Unrealized Loss | |
|---------------------------------------|--|-------------------|--|-------------------|---|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| At September 30, 2013: | | | | | | |
| U.S. Treasury securities | \$- | \$ - | \$ - | \$ - | \$- | \$ - |
| U.S. government agency securities | 102,206 | 10,642 | - | - | 102,206 | 10,642 |
| Mortgage-backed securities | 159,504 | 5,991 | - | - | 159,504 | 5,991 |
| State and municipal securities | 41,453 | 1,682 | - | - | 41,453 | 1,682 |
| Asset-backed securities | 17,314 | 147 | - | - | 17,314 | 147 |
| Corporate notes | 1,569 | 9 | 160 | 1 | 1,729 | 10 |
| Total temporarily-impaired securities | \$322,046 | \$ 18,471 | \$ 160 | \$ 1 | \$322,206 | \$ 18,472 |

At December 31, 2012:

| | | | | | | |
|---------------------------------------|-----------|----------|------|------|-----------|----------|
| U.S. Treasury securities | \$- | \$ - | \$ - | \$ - | \$- | \$ - |
| U.S. government agency securities | 78,899 | 414 | - | - | 78,899 | 414 |
| Mortgage-backed securities | 40,988 | 623 | - | - | 40,988 | 623 |
| State and municipal securities | 5,179 | 126 | - | - | 5,179 | 126 |
| Asset-backed securities | 17,353 | 9 | - | - | 17,353 | 9 |
| Corporate notes | 162 | 4 | - | - | 162 | 4 |
| Total temporarily-impaired securities | \$142,581 | \$ 1,176 | \$ - | \$ - | \$142,581 | \$ 1,176 |

The applicable dates for determining when securities are in an unrealized loss position are September 30, 2013 and December 31, 2012. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month periods ended September 30, 2013 and December 31, 2012, but is in the "Investments with an Unrealized Loss of less than 12 months" category above.

As shown in the tables above, at September 30, 2013, Pinnacle Financial had approximately \$18.5 million in unrealized losses on \$322.2 million of securities. The unrealized losses associated with these investment securities are driven by changes in interest rates and the unrealized loss is recorded as a component of equity. These securities will continue to be monitored as a part of our ongoing impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond issuers. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If a shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a charge to earnings and a new cost basis for the security will be established.

Because Pinnacle Financial currently does not intend to sell those securities that have an unrealized loss at September 30, 2013, and it is not more-likely-than-not that Pinnacle Financial will be required to sell the securities before recovery of their amortized cost bases, which may be maturity, Pinnacle Financial does not consider these securities to be other-than-temporarily impaired at September 30, 2013. Subsequent to September 30, 2013, Pinnacle Financial sold available-for-sale securities with a fair market value of \$22.1 million and realized a loss of \$1.4 million. Pinnacle Financial recorded an other-than-temporary-impairment charge in the third quarter of 2013 as a result of management's intention at September 30, 2013 to sell these specific securities at a loss pursuant to our current asset/liability strategy.

Periodically, available-for-sale securities may be sold or the composition of the portfolio realigned to improve yields, quality or marketability, or to implement changes in investment or asset/liability strategy, including maintaining collateral requirements and raising funds for liquidity purposes. Additionally, if an available-for-sale security loses its investment grade, tax-exempt status, the underlying credit support is terminated or collection otherwise becomes uncertain based on factors known to management, Pinnacle Financial will consider selling the security, but will review each security on a case-by-case basis as these factors become known. Consistent with the investment policy, available-for-sale securities of \$1.4 million were sold and a loss of \$25,000 realized during the nine months ended September 30, 2013.

The carrying values of Pinnacle Financial's investment securities could decline in the future if the financial condition of issuers deteriorates and management determines it is probable that Pinnacle Financial will not recover the entire amortized cost bases of the securities. As a result, there is a risk that other-than-temporary impairment charges may occur in the future. There is a risk that other-than-temporary impairment charges may occur in the future if management's intention to hold these securities to maturity and or recovery changes.

Note 4. Loans and Allowance for Loan Losses

For financial reporting purposes, Pinnacle Financial classifies its loan portfolio based on the underlying collateral utilized to secure each loan. This classification is consistent with those utilized in the Quarterly Report of Condition and Income filed with the Federal Deposit Insurance Corporation (FDIC).

Commercial loans receive risk ratings by the assigned financial advisor subject to validation by Pinnacle Financial's independent loan review department. Risk ratings are categorized as pass, special mention, substandard, substandard-nonaccrual or doubtful-nonaccrual. Pinnacle Financial believes that its categories follow those used by Pinnacle Bank's primary regulators. At September 30, 2013, approximately 76% of our loan portfolio was analyzed as a commercial loan type with a specifically assigned risk rating in the allowance for loan loss assessment. Consumer loans and small business loans are generally not assigned an individual risk rating but are evaluated as either accrual or nonaccrual based on the performance of the individual loans. However, certain consumer real estate-mortgage loans and certain consumer and other loans receive a specific risk rating due to the loan proceeds being used for commercial purposes even though the collateral may be of a consumer loan nature.

Risk ratings are subject to continual review by the loan officer. At least annually, our credit policy requires that every risk rated loan of \$500,000 or more be subject to a formal credit risk review process. Each loan grade is also subject to review by our independent loan review department, which reviews the majority of our risk rated portfolio annually.

Included in the coverage are independent loan reviews of loans in targeted higher-risk portfolio segments.

The following table presents our loan balances by primary loan classification and the amount within each risk rating category. Pass rated loans include all credits other than those included in special mention, substandard, substandard-nonaccrual and doubtful-nonaccrual which are defined as follows:

Special mention loans have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in Pinnacle Financial's credit position at some future date.

Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize collection of the debt. Substandard loans are characterized by the distinct possibility that Pinnacle Financial will sustain some loss if the deficiencies are not corrected.

Substandard-nonaccrual loans are substandard loans that have been placed on nonaccrual status.

Doubtful-nonaccrual loans have all the characteristics of substandard-nonaccrual loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

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The following table outlines the amount of each loan classification categorized into each risk rating category as of September 30, 2013 and December 31, 2012 (in thousands):

| | Commercial real estate - mortgage | Consumer real estate - mortgage | Construction and land development | Commercial and industrial | Consumer and other | Total |
|---|---|--|---|---------------------------------|-----------------------|--------------|
| <u>September 30, 2013</u> | | | | | | |
| Accruing loans | | | | | | |
| Pass | \$ 1,270,788 | \$ 664,152 | \$ 275,561 | \$ 1,460,479 | \$ 121,064 | \$ 3,792,044 |
| Special Mention | 10,298 | 1,095 | 33,292 | 21,844 | - | 66,529 |
| Substandard ⁽¹⁾ | 21,760 | 12,818 | 9,698 | 26,802 | - | 71,078 |
| Total | 1,302,846 | 678,065 | 318,551 | 1,509,125 | 121,064 | 3,929,651 |
| Impaired loans | | | | | | |
| Nonaccrual loans | | | | | | |
| Substandard-nonaccrual | 10,517 | 5,195 | 1,307 | 2,728 | 243 | 19,990 |
| Doubtful-nonaccrual | - | - | - | - | - | - |
| Total nonaccrual loans | 10,517 | 5,195 | 1,307 | 2,728 | 243 | 19,990 |
| Troubled debt restructurings ⁽²⁾ | | | | | | |
| Pass | 145 | 2,749 | 116 | 278 | 293 | 3,581 |
| Special Mention | 2,441 | - | - | - | - | 2,441 |
| Substandard | 10,890 | 1,249 | - | 1,500 | - | 13,639 |
| Total troubled debt restructurings | 13,476 | 3,998 | 116 | 1,778 | 293 | 19,661 |
| Total impaired loans | 23,993 | 9,193 | 1,423 | 4,506 | 536 | 39,651 |
| Total loans | \$ 1,326,839 | \$ 687,258 | \$ 319,974 | \$ 1,513,631 | \$ 121,600 | \$ 3,969,302 |

| <u>December 31, 2012</u> | Commercial | Consumer | Construction | Commercial | Consumer | Total |
|---|---------------------------|-------------------------|-------------------------|-------------------|-----------|--------------|
| | real estate - mortgage | real estate mortgage | and land development | and industrial | and other | |
| Accruing loans | | | | | | |
| Pass | \$ 1,093,628 | \$ 649,571 | \$ 259,878 | \$ 1,390,207 | \$ 93,712 | \$ 3,486,996 |
| Special Mention | 12,670 | 4,242 | 29,472 | 23,133 | - | 69,517 |
| Substandard ⁽¹⁾ | 42,343 | 13,896 | 19,622 | 29,513 | - | 105,374 |
| Total | 1,148,641 | 667,709 | 308,972 | 1,442,853 | 93,712 | 3,661,887 |
| Impaired loans | | | | | | |
| Nonaccrual loans | | | | | | |
| Substandard-nonaccrual | 9,290 | 5,877 | 4,509 | 3,035 | 79 | 22,790 |
| Doubtful-nonaccrual | 1 | 29 | - | 3 | - | 33 |
| Total nonaccrual loans | 9,291 | 5,906 | 4,509 | 3,038 | 79 | 22,823 |
| Troubled debt restructurings ⁽²⁾ | | | | | | |
| Pass | 4,705 | 3,623 | 71 | 502 | 119 | 9,020 |
| Special Mention | - | - | - | - | - | - |
| Substandard | 15,559 | 2,688 | - | 185 | - | 18,432 |
| Total troubled debt restructurings | 20,264 | 6,311 | 71 | 687 | 119 | 27,452 |
| Total impaired loans | 29,555 | 12,217 | 4,580 | 3,725 | 198 | 50,275 |
| Total loans | \$ 1,178,196 | \$ 679,926 | \$ 313,552 | \$ 1,446,578 | \$ 93,910 | \$ 3,712,162 |

- Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by (1) Pinnacle Bank's primary regulators for loans classified as substandard, excluding the impact of substandard nonaccrual loans and substandard troubled debt restructurings. Potential problem loans, which are not included in nonaccrual loans, amounted to approximately \$71.1 million at September 30, 2013, compared to \$105.4 million at December 31, 2012.
- (2) Troubled debt restructurings are presented as an impaired loan; however, they continue to accrue interest at contractual rates.

At September 30, 2013 and December 31, 2012, all loans classified as nonaccrual were deemed to be impaired. The principal balances of these nonaccrual loans amounted to \$20.0 million and \$22.8 million at September 30, 2013 and December 31, 2012, respectively, and are included in the table above. For the nine months ended September 30, 2013, the average balance of nonaccrual loans was \$21.0 million as compared to \$38.4 million for the twelve months ended December 31, 2012. At the date such loans were placed on nonaccrual status, Pinnacle Financial reversed all previously accrued interest income against current year earnings. Had these nonaccrual loans been on accruing status, interest income would have been higher by \$901,000 for the nine months ended September 30, 2013 and by \$1.5 million for the nine months ended September 30, 2012.

The following table details the recorded investment, unpaid principal balance and related allowance and average recorded investment of our nonaccrual loans at September 30, 2013 and December 31, 2012 by loan classification and the amount of interest income recognized on a cash basis throughout the fiscal year-to-date period then ended, respectively, on these loans that remain on the balance sheets (in thousands):

| | |
|-----------------------|------------------------------|
| At September 30, 2013 | For the nine months ended |
|-----------------------|------------------------------|

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| | Unpaid | | | September 30, 2013 | |
|--|--------------------|--------------------|----------------------------------|-----------------------------|----------------------------|
| | Recorded principal | investment balance | Related allowance ⁽¹⁾ | Average recorded investment | Interest income recognized |
| Collateral dependent nonaccrual loans: | | | | | |
| Commercial real estate – mortgage | \$8,499 | \$ 8,872 | \$ - | \$6,874 | \$ - |
| Consumer real estate – mortgage | 2,235 | 2,234 | - | 2,242 | - |
| Construction and land development | 546 | 545 | - | 1,069 | - |
| Commercial and industrial | 1,763 | 1,818 | - | 1,957 | - |
| Consumer and other | - | - | - | - | - |
| Total | \$13,043 | \$13,469 | \$ - | \$12,142 | \$ - |
| Cash flow dependent nonaccrual loans: | | | | | |
| Commercial real estate – mortgage | \$2,018 | \$ 2,156 | \$ 94 | \$2,964 | \$ - |
| Consumer real estate – mortgage | 2,960 | 3,210 | 267 | 3,213 | - |
| Construction and land development | 761 | 837 | 40 | 803 | - |
| Commercial and industrial | 965 | 1,321 | 115 | 1,668 | - |
| Consumer and other | 243 | 246 | 29 | 245 | - |
| Total | \$6,947 | \$7,770 | \$ 545 | \$8,893 | \$ - |
| Total nonaccrual loans | \$19,990 | \$21,239 | \$ 545 | \$21,035 | \$ - |

| | At December 31, 2012 | | | For the year ended December 31, 2012 | |
|--|-----------------------------------|--------------------------------|-------------------------------------|---|----------------------------------|
| | Recorded investment balance | Unpaid principal balance | Related allowance ⁽¹⁾ | Average recorded investment | Interest income recognized |
| Collateral dependent nonaccrual loans: | | | | | |
| Commercial real estate – mortgage | \$8,740 | \$ 11,187 | \$ - | \$11,194 | \$ - |
| Consumer real estate – mortgage | 3,641 | 6,394 | - | 6,394 | - |
| Construction and land development | 1,546 | 2,062 | - | 2,063 | - |
| Commercial and industrial | 1,547 | 1,761 | - | 1,896 | - |
| Consumer and other | - | - | - | - | - |
| Total | \$15,474 | \$ 21,404 | \$ - | \$21,547 | \$ - |
| Cash flow dependent nonaccrual loans: | | | | | |
| Commercial real estate – mortgage | \$551 | \$ 1,841 | \$ 154 | \$3,228 | \$ - |
| Consumer real estate – mortgage | 2,265 | 4,473 | 573 | 5,828 | - |
| Construction and land development | 2,963 | 4,701 | 201 | 5,102 | - |
| Commercial and industrial | 1,491 | 2,459 | 814 | 2,528 | - |
| Consumer and other | 79 | 179 | 22 | 180 | - |
| Total | \$7,349 | \$ 13,653 | \$ 1,764 | \$16,866 | \$ - |
| Total nonaccrual loans | \$22,823 | \$ 35,057 | \$ 1,764 | \$38,413 | \$ - |

⁽¹⁾ Collateral dependent loans are typically charged-off to their net realizable value pursuant to requirements of our primary regulators and no specific allowance is carried related to those loans.

Pinnacle Financial's policy is that once a loan is placed on nonaccrual status each subsequent payment is reviewed on a case-by-case basis to determine if the payment should be applied to interest or principal pursuant to regulatory guidelines. Pinnacle Financial recognized no interest income from cash payments received on nonaccrual loans during the three and nine months ended September 30, 2013 or during the year ended December 31, 2012.

Impaired loans also include loans that Pinnacle Bank has elected to formally restructure when, due to the weakening credit status of a borrower, the restructuring may facilitate a repayment plan that seeks to minimize the potential losses that Pinnacle Bank may otherwise incur. If on nonaccrual status as of the date of restructuring, the loans are included in nonaccrual loans. Loans that have been restructured that were performing as of the restructure date and continue to perform in accordance with the restructured terms are reported separately as troubled debt restructurings.

At September 30, 2013 and December 31, 2012, there were \$19.7 million and \$27.5 million, respectively, of troubled debt restructurings that were performing as of their restructure date and which were accruing interest. These troubled debt restructurings are considered impaired loans pursuant to U.S. GAAP. Troubled commercial loans are restructured by specialists within our Special Assets Group, and all restructurings are approved by committees and credit officers separate and apart from the normal loan approval process. These specialists are charged with reducing Pinnacle Financial's overall risk and exposure to loss in the event of a restructuring by obtaining some or all of the following: improved documentation, additional guaranties, increase in curtailments, reduction in collateral release terms, additional collateral or other similar strategies.

The following table outlines the amount of each troubled debt restructuring categorized by loan classification made during the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

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| | Three months ended September 30, 2013 | | | Nine months ended September 30, 2013 | | |
|-----------------------------------|--|--|---|--|--|---|
| | Pre Modification Outstanding of Recorded contracts | Pre Modification Recorded Investment, net of related allowance | Post Modification Outstanding Recorded Investment, net of related allowance | Pre Modification Outstanding of Recorded contracts | Pre Modification Recorded Investment, net of related allowance | Post Modification Outstanding Recorded Investment, net of related allowance |
| Commercial real estate – mortgage | - | \$ - | \$ - | - | \$ - | \$ - |
| Consumer real estate – mortgage | - | - | - | 1 | 428 | 368 |
| Construction and land development | - | - | - | 1 | 50 | 43 |
| Commercial and industrial | 1 | 37 | 32 | 2 | 1,537 | 1,322 |
| Consumer and other | 1 | 58 | 51 | 2 | 258 | 223 |
| | 2 | \$ 95 | \$ 83 | 6 | \$ 2,273 | \$ 1,956 |

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| | Three months ended September 30, 2012 | | | Nine months ended September 30, 2012 | | |
|-----------------------------------|--|---|------|--|---|----------|
| | Pre Modification Outstanding Number of contracts | Post Modification Recorded Investment, net of related allowance | | Pre Modification Outstanding Number of contracts | Post Modification Recorded Investment, net of related allowance | |
| Commercial real estate – mortgage | - | \$ - | \$ - | 3 | \$ 1,387 | \$ 1,011 |
| Consumer real estate – mortgage | - | - | - | 2 | 348 | 295 |
| Construction and land development | - | - | - | - | - | - |
| Commercial and industrial | - | - | - | - | - | - |
| Consumer and other | - | - | - | - | - | - |
| | - | \$ - | \$ - | 5 | \$ 1,735 | \$ 1,306 |

During the three months ended September 30, 2013 and 2012, Pinnacle Financial did not have any troubled debt restructurings that subsequently defaulted during the previous twelve months. During the nine months ended September 30, 2013, one consumer real estate loan totaling \$480,000 which was previously classified as a troubled debt restructuring subsequently defaulted, within twelve months of the restructuring. During the nine months ended September 30, 2012, three consumer and industrial loans totaling \$175,000 and two consumer and other loans totaling \$153,000 which were previously classified as troubled debt restructurings subsequently defaulted, within twelve months of the restructuring. A default of a troubled debt restructuring is defined as an occurrence which violates the terms of the receivable's contract.

Pinnacle Financial analyzes its commercial loan portfolio to determine if a concentration of credit risk exists to any industry. Pinnacle Financial utilizes broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Pinnacle Financial has a credit exposure (loans outstanding plus unfunded lines of credit) exceeding 25 % of Pinnacle Bank's total risk-based capital to borrowers in the following industries at September 30, 2013 with the comparative exposures for December 31, 2012 (in thousands):

| | At September 30, 2013 | | | Total Exposure at December 31, 2012 |
|-------------------------------------|--------------------------------|----------------------|----------------|-------------------------------------|
| | Outstanding Principal Balances | Unfunded Commitments | Total exposure | |
| Lessors of nonresidential buildings | \$448,268 | \$ 29,354 | \$477,622 | \$ 440,237 |
| Lessors of residential buildings | 241,353 | 29,391 | 270,744 | 215,899 |
| Land subdividers | 72,240 | 13,008 | 85,248 | 108,283 |

The table below presents past due balances at September 30, 2013 and December 31, 2012, by loan classification and segment allocated between accruing and nonaccrual status (in thousands):

| <u>September 30, 2013</u> | 30-89 days past due and accruing | 90 days or more past due and | Total past due and accruing | Nonaccrual ⁽¹⁾ | Current and accruing | Total Loans |
|---------------------------|----------------------------------|------------------------------|-----------------------------|---------------------------|----------------------|-------------|
|---------------------------|----------------------------------|------------------------------|-----------------------------|---------------------------|----------------------|-------------|

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accruing

| | | | | | | |
|-----------------------------------|-----------|------|-----------|-----------|--------------|--------------|
| Commercial real estate: | | | | | | |
| Owner-occupied | \$ 1,659 | \$ - | \$ 1,659 | \$ 9,240 | \$ 627,351 | \$ 638,250 |
| All other | 2,235 | - | 2,235 | 1,277 | 685,077 | 688,589 |
| Consumer real estate – mortgage | 2,022 | - | 2,022 | 5,195 | 680,041 | 687,258 |
| Construction and land development | 41 | - | 41 | 1,307 | 318,626 | 319,974 |
| Commercial and industrial | 5,293 | - | 5,293 | 2,728 | 1,505,610 | 1,513,631 |
| Consumer and other | 1,782 | - | 1,782 | 243 | 119,575 | 121,600 |
| | \$ 13,032 | \$ - | \$ 13,032 | \$ 19,990 | \$ 3,936,280 | \$ 3,969,302 |

| | 30-89 days past due and accruing | 90 days or more past due and accruing | Total past due and accruing | Nonaccrual ⁽¹⁾ | Current and accruing | Total Loans |
|-----------------------------------|---|---|--------------------------------------|---------------------------|----------------------------|----------------|
| | | | | | | |
| Commercial real estate: | | | | | | |
| Owner-occupied | \$ 462 | \$ - | \$ 462 | \$ 8,091 | \$ 585,848 | \$ 594,401 |
| All other | 41 | - | 41 | 1,200 | 582,554 | 583,795 |
| Consumer real estate – mortgage | 3,870 | - | 3,870 | 5,906 | 670,150 | 679,926 |
| Construction and land development | 3,511 | - | 3,511 | 4,509 | 305,532 | 313,552 |
| Commercial and industrial | 2,549 | - | 2,549 | 3,038 | 1,440,991 | 1,446,578 |
| Consumer and other | 444 | - | 444 | 79 | 93,387 | 93,910 |
| | \$ 10,877 | \$ - | \$ 10,877 | \$ 22,823 | \$ 3,678,462 | \$ 3,712,162 |

(1) Approximately \$8.7 million and \$9.4 million of nonaccrual loans as of September 30, 2013 and December 31, 2012, respectively, are currently performing pursuant to their contractual terms.

The following table shows the allowance allocation by loan classification and accrual status at September 30, 2013 and December 31, 2012 (in thousands):

| | Accruing Loans | | Impaired Loans | | | | Total Allowance for Loan Losses | |
|-----------------------------------|----------------|-------------------|------------------|-------------------|---|-------------------|---------------------------------|-------------------|
| | September | | Nonaccrual Loans | | Troubled Debt Restructurings ⁽¹⁾ | | September | |
| | 30, 2013 | December 31, 2012 | 30, 2013 | December 31, 2012 | 30, 2013 | December 31, 2012 | 30, 2013 | December 31, 2012 |
| Commercial real estate – mortgage | \$ 18,820 | \$ 16,642 | \$ 94 | \$ 154 | \$ 1,936 | \$ 2,838 | \$ 20,850 | \$ 19,634 |
| Consumer real estate – mortgage | 7,128 | 7,336 | 267 | 573 | 514 | 853 | 7,909 | 8,762 |
| Construction and land development | 7,978 | 8,953 | 40 | 201 | 16 | 10 | 8,034 | 9,164 |
| Commercial and industrial | 24,035 | 23,829 | 115 | 814 | 249 | 95 | 24,399 | 24,738 |
| Consumer and other | 1,415 | 1,055 | 29 | 22 | 41 | 17 | 1,485 | 1,094 |
| Unallocated | - | - | - | - | - | - | 4,603 | 6,025 |
| | \$ 59,376 | \$ 57,815 | \$ 545 | \$ 1,764 | \$ 2,756 | \$ 3,813 | \$ 67,280 | \$ 69,417 |

(1) Troubled debt restructurings of \$19.7 million and \$27.5 million as of September 30, 2013 and December 31, 2012, respectively, are classified as impaired loans pursuant to U.S. GAAP; however, these loans continue to accrue interest at contractual rates.

The following table details the changes in the allowance for loan losses from December 31, 2011 to December 31, 2012 to September 30, 2013 by loan classification (in thousands):

| | Commercial real estate – mortgage | | Consumer real estate – mortgage | | Construction and land development | | Commercial and industrial | | Consumer and other | | Unallocated | Total |
|-----------------------------|-----------------------------------|-------------------|---------------------------------|-------------------|-----------------------------------|-------------------|---------------------------|-------------------|--------------------|-------------------|-------------|-------|
| | December 31, 2011 | December 31, 2012 | December 31, 2011 | December 31, 2012 | December 31, 2011 | December 31, 2012 | December 31, 2011 | December 31, 2012 | December 31, 2011 | December 31, 2012 | | |
| Balances, December 31, 2011 | \$ 23,397 | \$ 10,302 | \$ 12,040 | \$ 20,789 | \$ 1,125 | \$ 6,322 | \$ 73,975 | | | | | |

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| | | | | | | | |
|---|-----------|----------|----------|-----------|----------|----------|-----------|
| Charged-off loans | (4,667) | (6,731) | (2,530) | (4,612) | (1,117) | - | (19,657) |
| Recovery of previously charged-off loans | 285 | 818 | 1,155 | 7,175 | 97 | - | 9,530 |
| Provision for loan losses | 619 | 4,373 | (1,501) | 1,386 | 989 | (297) | 5,569 |
| Balances, December 31, 2012 | \$ 19,634 | \$ 8,762 | \$ 9,164 | \$ 24,738 | \$ 1,094 | \$ 6,025 | \$ 69,417 |
| Charged-off loans | (3,888) | (2,097) | (1,351) | (5,643) | (1,109) | - | (14,088) |
| Recovery of previously charged-off loans | 176 | 1,127 | 862 | 3,961 | 194 | - | 6,320 |
| Provision for loan losses | 4,928 | 117 | (641) | 1,343 | 1,306 | (1,422) | 5,631 |
| Balances, September 30, 2013 | \$ 20,850 | \$ 7,909 | \$ 8,034 | \$ 24,399 | \$ 1,485 | \$ 4,603 | \$ 67,280 |

The adequacy of the allowance for loan losses is assessed at the end of each calendar quarter. The level of the allowance is based upon evaluation of the loan portfolio, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, historical loss experience, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations.

At September 30, 2013, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$9.9 million to current directors, executive officers, and their related entities, of which \$7.7 million had been drawn upon. At December 31, 2012, Pinnacle Financial had granted loans and other extensions of credit amounting to approximately \$8.8 million to directors, executive officers, and their related entities, of which approximately \$8.1 million had been drawn upon. These loans and extensions of credit were made on substantially the same terms customary for other persons similarly situated for the type of loan involved. None of these loans to directors, executive officers, and their related entities were impaired at September 30, 2013 or December 31, 2012.

Residential Lending

At September 30, 2013, Pinnacle Financial had approximately \$17.0 million of mortgage loans held-for-sale compared to approximately \$41.2 million at December 31, 2012. Pinnacle Financial generally has an agreement for the subsequent sale of the mortgage loan prior to the loan being closed with the borrower. Pinnacle Financial sells loans to third-party investors on a loan-by-loan basis and has not entered into any forward commitments with investors for future bulk loan sales. All of these loan sales transfer servicing rights to the buyer. During the nine months ended September 30, 2013, Pinnacle Financial recognized \$5.1 million in gains on the sale of these loans, net of commissions paid, compared to \$4.9 million during the nine months ended September 30, 2012.

These mortgage loans held-for-sale are originated internally and are primarily to borrowers in Pinnacle Bank's geographic markets. These sales are typically on a best efforts basis to investors that follow conventional government sponsored entities (GSE) and the Department of Housing and Urban Development/U.S. Department of Veterans Affairs (HUD/VA) guidelines. Generally, loans sold to the HUD/VA are underwritten by Pinnacle Bank while the majority of the loans sold to other investors are underwritten by the purchasers of the loans.

Each purchaser has specific guidelines and criteria for sellers of loans, and the risk of credit loss with regard to the principal amount of the loans sold is generally transferred to the purchasers upon sale. While the loans are sold without recourse, the purchase agreements require Pinnacle Bank to make certain representations and warranties regarding the existence and sufficiency of file documentation and the absence of fraud by borrowers or other third parties such as appraisers in connection with obtaining the loan. If it is determined that the loans sold were in breach of these representations or warranties, Pinnacle Bank has obligations to either repurchase the loan for the unpaid principal balance and related investor fees or make the purchaser whole for the economic benefits of the loan.

From inception of Pinnacle Bank's mortgage department in January 2003 through September 30, 2013, Pinnacle Bank originated and sold approximately 14,600 mortgage loans totaling \$3.1 billion to third-party purchasers. Of the approximately 14,600 mortgage loans, Pinnacle Bank underwrote approximately 3,800 conventional loans at an 80% or less loan-to-value that were sold to other investors and underwrote 3,200 loans that were sold to the HUD/VA. The remaining mortgage loans were underwritten by the purchasers of those loans, but funded by Pinnacle Bank until settlement with the purchaser. To date, repurchase activity pursuant to the terms of these representations and warranties has been insignificant to Pinnacle Bank.

Based on information currently available, management believes that it does not have material exposure to losses that may arise relating to the representations and warranties that it has made in connection with its mortgage loan sales.

Due to the focus on foreclosure practices of financial institutions nationwide, Pinnacle Bank has evaluated its foreclosure process related to home equity and consumer mortgage loans within its loan portfolio. At September 30, 2013, Pinnacle Bank has \$825.4 million of home equity and consumer mortgage loans which are secured by first or second liens on residential properties. Foreclosure activity in this portfolio has been minimal. Any foreclosures on these loans are handled by designated Pinnacle Bank personnel and external legal counsel, as appropriate, following established policies regarding legal and regulatory requirements. Pinnacle Bank has not imposed any freezes on foreclosures. Based on information currently available, management believes that it does not have material exposure to faulty foreclosure practices.

Note 5. Income Taxes

ASC 740, Income Taxes, defines the threshold for recognizing the benefits of tax return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority. As of September 30, 2013, Pinnacle Financial had no unrecognized tax benefits related to Federal or State income tax matters and does not currently anticipate any material increase or decrease in unrecognized tax benefits relative to any tax positions taken prior to September 30, 2013. As of September 30, 2013, Pinnacle Financial has accrued no interest and no penalties related to uncertain tax positions.

Pinnacle Financial and its subsidiaries file consolidated U.S. Federal and state of Tennessee income tax returns. The IRS concluded its examination of the 2007, 2008, and 2009 federal tax returns during 2011. Pinnacle Financial remains open to audit under the statute of limitations by the IRS for the years ended December 31, 2010 through 2012 and by the State of Tennessee from December 31, 2009 through 2012.

Pinnacle Financial's effective tax rate for the three and nine months ended September 30, 2013 was 33.3% and 33.0%, respectively, compared to 30.7% and 32.3%, respectively, for the three and nine months ended September 30, 2012.

The effective tax rate differs from the Federal income tax statutory rate of 35% and state income tax rate of 6.50% primarily due to our investments in bank qualified municipal securities, our real estate investment trust and bank-owned life insurance offset in part by meals and entertainment expense and executive compensation expense, portions of which are non-deductible.

Note 6. Commitments and Contingent Liabilities

In the normal course of business, Pinnacle Financial has entered into off-balance sheet financial instruments which include commitments to extend credit (i.e., including unfunded lines of credit) and standby letters of credit. Commitments to extend credit are usually the result of lines of credit granted to existing borrowers under agreements that the total outstanding indebtedness will not exceed a specific amount during the term of the indebtedness. Typical borrowers are commercial concerns that use lines of credit to supplement their treasury management functions, thus their total outstanding indebtedness may fluctuate during any time period based on the seasonality of their business and the resultant timing of their cash flows. Other typical lines of credit are related to home equity loans granted to consumers. Commitments to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At September 30, 2013, these commitments amounted to \$1.2 billion.

Standby letters of credit are generally issued on behalf of an applicant (our customer) to a specifically named beneficiary and are the result of a particular business arrangement that exists between the applicant and the beneficiary. Standby letters of credit have fixed expiration dates and are usually for terms of two years or less unless terminated beforehand due to criteria specified in the standby letter of credit. A typical arrangement involves the applicant routinely being indebted to the beneficiary for such items as inventory purchases, insurance, utilities, lease guarantees or other third party commercial transactions. The standby letter of credit would permit the beneficiary to obtain payment from Pinnacle Financial under certain prescribed circumstances. Subsequently, Pinnacle Financial would then seek reimbursement from the applicant pursuant to the terms of the standby letter of credit. At September 30, 2013, these commitments amounted to \$62.4 million.

Pinnacle Financial follows the same credit policies and underwriting practices when making these commitments as it does for on-balance sheet instruments. Each customer's creditworthiness is evaluated on a case-by-case basis, and the amount of collateral obtained, if any, is based on management's credit evaluation of the customer. Collateral held varies but may include cash, real estate and improvements, marketable securities, accounts receivable, inventory, equipment and personal property.

The contractual amounts of these commitments are not reflected in the consolidated financial statements and only amounts drawn upon would be reflected in the future. Since many of the commitments are expected to expire without being drawn upon, the contractual amounts do not necessarily represent future cash requirements. However, should the commitments be drawn upon and should our customers default on their resulting obligation to us, Pinnacle Financial's maximum exposure to credit loss, without consideration of collateral, is represented by the contractual amount of those commitments. At September 30, 2013, and December 31, 2012, Pinnacle Financial had accrued \$1.4 million and \$1.9 million, respectively, for the inherent risks associated with these off balance sheet commitments.

During the fourth quarter of 2011, a customer of Pinnacle Bank filed a putative class action lawsuit (styled John Higgins, et al, v. Pinnacle Financial Partners, Inc., d/b/a Pinnacle National Bank) in Davidson County, Tennessee Circuit Court against Pinnacle Bank and Pinnacle Financial, on his own behalf, as well as on behalf of a purported class of Pinnacle Bank's customers within the State of Tennessee alleging that Pinnacle Bank's method of ordering debit card transactions had caused customers of Pinnacle Bank to incur higher overdraft charges than had a different method been used. Pinnacle Financial and Pinnacle Bank reached a tentative settlement agreement with the plaintiff during the second quarter of 2013. Although the settlement has not yet been finalized, Pinnacle Financial does not believe that any liability arising from this legal matter will have a material adverse effect on Pinnacle Financial's consolidated financial condition, operating results or cash flows.

Various legal claims also arise from time to time in the normal course of business. In the opinion of management, the resolution of these claims outstanding at September 30, 2013 will not have a material impact on Pinnacle Financial's financial statements.

Note 7. Stock Options, Stock Appreciation Rights and Restricted Shares

As described more fully in the Annual Report on Form 10-K, Pinnacle Financial has two equity incentive plans. Additionally, Pinnacle Financial has assumed equity plans in connection with acquisitions of Cavalry Bancorp, Inc. (Cavalry) and Mid-America Bancshares, Inc. (Mid-America) under which it has granted stock options and stock appreciation rights to its employees to purchase common stock at or above the fair market value on the date of grant and granted restricted share awards to employees and directors. At September 30, 2013, there were approximately 556,000 shares available for future issuances under the assumed plans that have not expired.

Common Stock Options and Stock Appreciation Rights

As of September 30, 2013, there were 1,087,023 stock options and 6,195 stock appreciation rights outstanding to purchase common shares. A summary of the stock option and stock appreciation rights activity within the equity incentive plans during the nine months ended September 30, 2013 and information regarding expected vesting, contractual terms remaining, intrinsic values and other matters is as follows:

| | Weighted- Average Exercise Price | Weighted- Average Contractual Term (in years) | Aggregate Intrinsic Value (000's) |
|--------|---|---|--|
| Number | | | |

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| | | | | | |
|---|------------|----------|------|----------|-----|
| Outstanding at December 31, 2012 | 1,318,701 | \$ 23.36 | 3.14 | \$ 2,203 | (1) |
| Granted | - | | | | |
| Exercised | (191,689) | | | | |
| Stock appreciation rights exercised | (1,066) | | | | |
| Forfeited | (32,728) | | | | |
| Outstanding at September 30, 2013 | 1,093,218 | \$ 25.20 | 2.59 | \$ 5,528 | (2) |
| Outstanding and expected to vest as of September 30, 2013 | 1,093,218 | \$ 25.20 | 2.59 | \$ 5,528 | (2) |
| Options exercisable at September 30, 2013 | 1,093,218 | \$ 25.20 | 2.59 | \$ 5,528 | (2) |

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of \$18.84 per common share at December 31, 2012 for the approximately 331,571 options and stock appreciation rights that were in-the-money at December 31, 2012.

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted closing price of Pinnacle Financial common stock of \$29.56 per common share at September 30, 2013 for the approximately 758,719 options and stock appreciation rights that were in-the-money at September 30, 2013.

During the nine months ended September 30, 2013, approximately 33,000 option awards vested at an average exercise price of \$21.51 with an intrinsic value of \$263,000 at the time of vesting.

During the three and nine months ended September 30, 2013, Pinnacle Financial recorded stock option compensation expense of \$12,000, based on Black-Scholes valuation at the date of grant compared to \$79,000 and \$329,000 for the three and nine months ended September 30, 2012. For these awards, Pinnacle Financial recognized compensation expense using a straight-line amortization method. As of September 30, 2013, there was no unrecognized compensation cost related to unvested stock options granted under our equity incentive plans.

Restricted Share Awards

Additionally, Pinnacle Financial's 2004 Equity Incentive Plan and certain of the plans assumed in connection with the acquisition of Mid-America provide for the granting of restricted share awards and other performance or market-based awards. There were no market-based awards outstanding as of September 30, 2013 under any of these plans. During the nine months ended September 30, 2013, Pinnacle Financial awarded 160,595 shares of restricted common stock to certain associates and outside directors and 193,189 restricted stock units converted to restricted share awards for certain associates.

A summary of activity for unvested restricted share awards for the nine months ended September 30, 2013 is as follows:

| | Number | Grant Date Weighted-Average Cost |
|---|-----------|--|
| Unvested at December 31, 2012 | 739,909 | \$ 15.45 |
| Shares awarded | 160,595 | 21.42 |
| Conversion of restricted share units to restricted share awards | 193,189 | 21.51 |
| Restrictions lapsed and shares released to associates/directors | (212,795) | 15.94 |
| Shares forfeited ⁽¹⁾ | (53,070) | 15.27 |
| Unvested at September 30, 2013 | 827,828 | \$ 19.09 |

(1) Represents 26,152 shares forfeited due to failure to meet performance targets and 26,918 shares forfeited due to employee termination and/or retirement.

Pinnacle Financial grants restricted share awards to associates, executive management and outside directors with a combination of time and, in the case of associates, performance vesting criteria. The following table outlines restricted stock grants that were made, grouped by similar vesting criteria, during the nine months ended September 30, 2013:

| Grant Year | Group ⁽¹⁾ | Vesting Period in years | Shares awarded | Restrictions Lapsed and shares released to participants | Shares Forfeited by participants ⁽⁵⁾ | Shares Unvested |
|---|----------------------|-------------------------|----------------|---|---|-----------------|
| Time Based Awards ⁽²⁾ | | | | | | |
| 2013 | Associates | 5 | 146,425 | - | 3,225 | 143,200 |
| Performance Based Awards ⁽³⁾ | | | | | | |
| 2013 | Leadership team | 5 | 193,189 | - | - | 193,189 |
| Outside Director Awards ⁽⁴⁾ | | | | | | |
| 2013 | Outside directors | 1 | 14,170 | 1,129 | - | 13,041 |

- Groups include our employees (referred to as associates above) and our outside directors. When the restricted shares are awarded, a participant receives voting rights with respect to the shares, but is not able to transfer the shares until the restrictions have lapsed. Once the restrictions lapse, the participant is taxed on the value of the award and may elect to sell some shares to pay the applicable income taxes associated with the award.
- (1) These shares vest in equal annual installments on the anniversary date of the grant.
The forfeiture restrictions on these restricted share awards lapse in separate equal installments should Pinnacle Financial achieve certain earnings and soundness targets over each year of the subsequent vesting period (or alternatively, the cumulative vesting period).
 - (2) Restricted share awards are issued to the outside members of the board of directors in accordance with their board compensation plan. Restrictions lapse on the one year anniversary date of the award based on each individual board member meeting their attendance goals for the various board and board committee meetings to which each member was scheduled to attend.
 - (3) These shares represent forfeitures resulting from associate terminations during the year-to-date period ended September 30, 2013.
 - (4)
 - (5)

Compensation expense associated with performance-based restricted share awards, which are issued from time-to-time, is recognized over the performance period that the restrictions associated with the awards are anticipated to lapse based on a graded vesting schedule such that each performance tranche is amortized separately.

Compensation expense associated with the time-based restricted share awards is recognized on a straight-line basis over the time period that the restrictions associated with the awards lapse based on the total cost of the award at the grant date. For the three and nine months ended September 30, 2013, Pinnacle Financial recognized approximately \$1.0 million and \$3.0 million, respectively, in compensation costs attributable to all restricted share awards, compared to \$818,000 and \$2.5 million, respectively, for the three and nine months ended September 30, 2012.

Restricted Share Units

Pinnacle Financial granted 128,018 restricted share units to the senior executive officers and the Leadership Team in the first quarter of 2013. These restricted share units will be converted to restricted shares in 2014 on a tiered scale if earned based on actual 2013 results. The number of units that ultimately convert to unvested restricted shares will be determined after the 2013 earnings are finalized based upon the achievement of certain predetermined profitability goals for 2013 that were established on January 11, 2013 by the Human Resources and Compensation Committee of Pinnacle Financial's board of directors (HRCC). The number of restricted shares issuable in settlement of these restricted share units could range between 0% to 100% based on the level of 2013 profitability. Once these restricted share units are converted to restricted share awards, with a grant date in 2014, the forfeiture restrictions on the number of restricted shares issued in settlement of these restricted share units will lapse in 20% increments over the following five years based on the achievement of soundness thresholds to be set by the HRCC in January of each respective fiscal year. As the specific value of the award that will ultimately be granted to the recipients of these restricted share units and the associated performance targets cannot yet be determined, no grant was deemed to have been made, and therefore, no expense has been recognized related to these awards.

Note 8. Regulatory Matters

Pursuant to Tennessee banking law, Pinnacle Bank may not, without the prior consent of the Commissioner of the TDFI, pay any dividends to Pinnacle Financial in a calendar year in excess of the total of Pinnacle Bank's net income for that year plus the retained net income for the preceding 2 years. During the nine months ended September 30, 2013, Pinnacle Bank paid \$8.9 million in dividends to Pinnacle Financial. As of September 30, 2013, Pinnacle Bank could pay approximately \$95.8 million of additional dividends to Pinnacle Financial without prior approval of the Commissioner of the TDFI.

Pinnacle Financial has not paid any cash dividends on its common stock since inception; however, on October 15, 2013, its board of directors approved the initiation of a quarterly cash dividend. The initial dividend of \$0.08 per share will be paid on December 20, 2013 to shareholders of record at the close of business on November 26, 2013.

The amount and timing of all future dividend payments is subject to the discretion of Pinnacle Financial's board of directors and will depend on Pinnacle Financial's earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to us.

Pinnacle Financial and Pinnacle Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions, by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Pinnacle Financial and Pinnacle Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices.

Quantitative measures established by regulation to ensure capital adequacy require Pinnacle Financial and Pinnacle Bank to maintain minimum amounts and ratios of Total and Tier I capital to risk-weighted assets and for Pinnacle Bank of Tier I capital to average assets. Management believes, as of September 30, 2013, that Pinnacle Financial and Pinnacle Bank met all capital adequacy requirements to which they are subject. To be categorized as well-capitalized under applicable banking regulations, Pinnacle Financial and Pinnacle Bank must maintain minimum Total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table and not be subject to a written agreement, order or directive to maintain a higher capital level. Pinnacle Financial's and Pinnacle Bank's actual capital amounts and ratios are presented in the following table (in thousands):

| | Actual Amount | Ratio | Minimum Capital Requirement Amount | Minimum Ratio | Minimum To Be Well-Capitalized Amount | Ratio |
|---|------------------|--------|---|------------------|--|--------|
| <u>At September 30, 2013</u> | | | | | | |
| Total capital to risk weighted assets: | | | | | | |
| Pinnacle Financial | \$603,484 | 13.2 % | \$364,570 | 8.0 % | \$456,867 | 10.0 % |
| Pinnacle Bank | \$586,156 | 12.9 % | \$363,804 | 8.0 % | \$455,921 | 10.0 % |
| Tier I capital to risk weighted assets: | | | | | | |
| Pinnacle Financial | \$546,376 | 12.0 % | \$182,285 | 4.0 % | \$274,120 | 6.0 % |
| Pinnacle Bank | \$529,166 | 11.6 % | \$181,902 | 4.0 % | \$273,553 | 6.0 % |
| Tier I capital to average assets (*): | | | | | | |
| Pinnacle Financial | \$546,376 | 10.8 % | \$202,668 | 4.0 % | \$N/ | A N/ A |
| Pinnacle Bank | \$529,166 | 10.5 % | \$201,975 | 4.0 % | \$252,468 | 5.0 % |

(*) Average assets for the above calculations were based on the most recent quarter.

Note 9. Derivative Instruments

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. Pinnacle Financial enters into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, Pinnacle Financial enters into offsetting positions with a large U.S. financial institution in order to minimize the risk to Pinnacle Financial. These swaps are derivatives, but are not designated as hedging instruments.

Interest rate swap contracts involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counter party or customer owes Pinnacle Financial, and results in credit risk to Pinnacle Financial. When the fair value of a derivative instrument contract is negative, Pinnacle Financial owes the customer or counterparty and therefore, has no credit risk.

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A summary of Pinnacle Financial's interest rate swaps related to customers as of September 30, 2013 and December 31, 2012 is included in the following table (in thousands):

| | September 30, 2013 | | December 31, 2012 | |
|------------------------------------|--------------------|----------------------|-------------------|----------------------|
| | Notional Amount | Estimated Fair Value | Notional Amount | Estimated Fair Value |
| Interest rate swap agreements: | | | | |
| Pay fixed / receive variable swaps | \$260,242 | \$11,435 | \$236,377 | \$16,132 |
| Pay variable / receive fixed swaps | 260,242 | (11,749) | 236,377 | (16,366) |
| Total | \$520,484 | \$(314) | \$472,754 | \$(234) |

During the second quarter of 2013, Pinnacle Financial entered into a forward cash flow hedge relationship to manage our future interest rate exposure. The hedging strategy converts the LIBOR based variable interest rate on forecasted borrowings to a fixed interest rate and protects Pinnacle Financial from floating interest rate variability. The terms of the individual contracts within the relationship are as follows (in thousands):

| | Forecasted Variable Notional Amount | Variable Interest Rate | Fixed Interest Rate | Term | Asset/ (Liabilities) | Unrealized Gain in Accumulated Other Comprehensive Income |
|--------------------|-------------------------------------|------------------------|---------------------|-------------------------|----------------------|---|
| Interest Rate Swap | \$33,000 | 3 month LIBOR | 1.428 | % April 2015-April 2018 | \$390 | \$237 |
| Interest Rate Swap | 33,000 | 3 month LIBOR | 1.857 | % Oct. 2015-April 2019 | 638 | 388 |
| Interest Rate Swap | 33,000 | 3 month LIBOR | 1.996 | % Oct. 2015-Oct. 2019 | 1,278 | 776 |
| Interest Rate Swap | 33,000 | 3 month LIBOR | 2.265 | % April 2016-April 2020 | 915 | 556 |
| Interest Rate Swap | 33,000 | 3 month LIBOR | 2.646 | % April 2016-April 2022 | 844 | 513 |
| Interest Rate Swap | 33,000 | 3 month LIBOR | 2.523 | % Oct. 2016-Oct. 2020 | 750 | 456 |
| | 198,000 | | | | 4,815 | 2,926 |

(1) Pinnacle Financial will pay the fixed interest rate and the counterparties pay Pinnacle Financial the variable rate.

(2) No cash will be exchanged prior to the term.

The cash flow hedges were determined to be fully effective during the period presented. And therefore, no amount of ineffectiveness has been included in net income. The aggregate fair value of the swaps is recorded in other assets with changes in fair value recorded in accumulated other comprehensive (loss) income, net of tax. If a hedge was deemed to be ineffective, the amount included in accumulated other comprehensive (loss) income would be reclassified to current earnings. The hedge would no longer be considered effective if a portion of the hedge becomes ineffective, the item hedged is no longer in existence or Pinnacle Financial discontinues hedge accounting. Pinnacle Financial expects the hedges to remain fully effective during the remaining terms of the swaps. Pinnacle Financial does not expect any amounts to be reclassified from accumulated other comprehensive (loss) income related to these swaps over the next twelve months.

Note 10. Fair Value of Financial Instruments

FASB ASC 820, Fair Value Measurements and Disclosures, which defines fair value, establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. The definition of fair value focuses on the exit price, i.e., the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not the entry price, i.e., the price that would

be paid to acquire the asset or received to assume the liability at the measurement date. The statement emphasizes that fair value is a market-based measurement; not an entity-specific measurement. Therefore, the fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability.

Valuation Hierarchy

FASB ASC 820 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 – inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. Following is a description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Assets

Securities available-for-sale – Where quoted prices are available for identical securities in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and certain other financial products. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics and are classified within Level 2 of the valuation hierarchy. In certain cases where there is limited activity or less transparency around inputs to the valuation and more complex pricing models or discounted cash flows are used, securities are classified within Level 3 of the valuation hierarchy.

Nonaccrual loans – A loan is classified as nonaccrual when it is probable Pinnacle Financial will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Nonaccrual loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. If the recorded investment in the nonaccrual loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses or the difference may be recognized as a charge-off. Nonaccrual loans are classified within Level 3 of the hierarchy due to the unobservable inputs used in determining their fair value such as collateral values and the borrower's underlying financial condition.

Alternative investments – Included in other investments are alternative investments in certain nonpublic private equity funds. The valuation of nonpublic private equity investments requires significant management judgment due to the absence of observable quoted market prices, inherent lack of liquidity and the long-term nature of such assets. These investments are valued initially based upon transaction price. The carrying values of other investments are adjusted either upwards or downwards from the transaction price to reflect expected exit values as evidenced by financing and sale transactions with third parties, or when determination of a valuation adjustment is confirmed through ongoing reviews by senior investment managers. A variety of factors are reviewed and monitored to assess positive and negative changes in valuation including, but not limited to, current operating performance and future expectations of the particular investment, industry valuations of comparable public companies and changes in market outlook and the third-party financing environment over time. In determining valuation adjustments resulting from the investment

review process, emphasis is placed on current company performance and market conditions. These investments are included in Level 3 of the valuation hierarchy as these funds are not widely traded and the underlying investments of such funds are often privately-held and/or start-up companies for which market values are not readily available.

Other real estate owned – Other real estate owned (OREO) represents real estate foreclosed upon by Pinnacle Bank through loan defaults by customers or acquired by deed in lieu of foreclosure. Substantially all of these amounts relate to lots, homes and development projects that are either completed or are in various stages of construction for which Pinnacle Financial believes it has adequate collateral. Upon foreclosure, the property is recorded at the lower of cost or fair value, based on appraised value, less selling costs estimated as of the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation downward adjustments are determined on a specific property basis and are included as a component of noninterest expense along with holding costs. Any gains or losses realized at the time of disposal are also reflected in noninterest expense, as applicable. OREO is included in Level 3 of the valuation hierarchy due to the lack of observable market inputs into the determination of fair value. Appraisal values are property-specific and sensitive to the changes in the overall economic environment.

Other assets – Included in other assets are certain assets carried at fair value, including interest rate swap agreements to facilitate customer transactions and the cash flow hedge relationship. The carrying amount of interest rate swap agreements is based on Pinnacle Financial's pricing models that utilize observable market inputs. The fair value of the cash flow hedge is determined using the income approach by comparing the discounted fixed rate cash flows with the discounted variable rate cash flows. The difference between these discounted cash flows represents the fair value of the hedge. Pinnacle Financial reflects these assets within Level 2 of the valuation hierarchy as these assets are valued using similar transactions that occur in the market.

Liabilities

Other liabilities – Pinnacle Financial has certain liabilities carried at fair value including certain interest rate swap agreements to facilitate customer transactions. The fair value of these liabilities is based on Pinnacle Financial's pricing models that utilize observable market inputs and is reflected within Level 2 of the valuation hierarchy.

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The following tables present financial instruments measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, by caption on the consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above) (in thousands):

| | Total carrying value in the consolidated balance sheet | Quoted market prices in an active market (Level 1) | Models with significant observable market parameters (Level 2) | Models with significant unobservable market parameters (Level 3) |
|--|--|---|--|---|
| <u>September 30, 2013</u> | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. Treasury securities | \$ 5,000 | \$ 5,000 | \$ - | \$ - |
| U.S. government agency securities | 127,490 | - | 127,490 | - |
| Mortgage-backed securities | 394,330 | - | 394,330 | - |
| State and municipal securities | 148,790 | - | 148,790 | - |
| Agency-backed securities | 17,314 | - | 17,314 | - |
| Corporate notes and other | 11,367 | - | 11,367 | - |
| Total investment securities available-for-sale | \$ 704,291 | \$ 5,000 | \$ 699,291 | \$ - |
| Alternative investments | 5,965 | - | - | 5,965 |
| Other assets | 16,250 | - | 16,250 | - |
| Total assets at fair value | \$ 726,506 | \$ 5,000 | \$ 715,541 | \$ 5,965 |
| Other liabilities | \$ 11,749 | \$ - | \$ 11,749 | \$ - |
| Total liabilities at fair value | \$ 11,749 | \$ - | \$ 11,749 | \$ - |
| <u>December 31, 2012</u> | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. government agency securities | \$ 110,452 | \$ - | \$ 110,452 | \$ - |
| Mortgage-backed securities | 375,651 | - | 375,651 | - |
| State and municipal securities | 191,727 | - | 191,727 | - |
| Agency-backed securities | 17,352 | - | 17,352 | - |
| Corporate notes and other | 11,396 | - | 11,396 | - |
| Total investment securities available-for-sale | 706,578 | - | 706,578 | - |
| Alternative investments | 4,214 | - | - | 4,214 |
| Other assets | 16,599 | - | 16,132 | 467 |
| Total assets at fair value | \$ 727,391 | \$ - | \$ 722,710 | \$ 4,681 |
| Other liabilities | \$ 16,366 | \$ - | \$ 16,366 | \$ - |
| Total liabilities at fair value | \$ 16,366 | \$ - | \$ 16,366 | \$ - |

| | Total carrying value in the consolidated balance sheet | Quoted market prices in an active market (Level 1) | Models with significant observable market parameters (Level 2) | Models with significant unobservable market parameters (Level 3) | Total losses for the year-to-date period then ended |
|---------------------------|--|---|--|---|--|
| <u>September 30, 2013</u> | | | | | |
| Other real estate owned | \$ 15,522 | \$ - | \$ - | \$ 15,522 | \$ (1,708) |

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| | | | | | | |
|--------------------------------------|-----------|------|------|-----------|------------|---|
| Nonaccrual loans, net ⁽¹⁾ | 19,445 | - | - | 19,445 | (3,135) |) |
| Total | \$ 34,967 | \$ - | \$ - | \$ 34,967 | \$ (4,843) |) |

December 31, 2012

| | | | | | | |
|--------------------------------------|-----------|------|------|-----------|-------------|---|
| Other real estate owned | \$ 18,580 | \$ - | \$ - | \$ 18,580 | \$ (5,428) |) |
| Nonaccrual loans, net ⁽¹⁾ | 21,059 | - | - | 21,059 | (4,745) |) |
| Total | \$ 39,639 | \$ - | \$ - | \$ 39,639 | \$ (10,173) |) |

(1) Amount is net of a valuation allowance of \$545,000 at September 30, 2013 and \$1.8 million at December 31, 2012 as required by ASC 310-10, "Receivables."

In the case of the bond portfolio, Pinnacle Financial monitors the portfolio to ascertain when transfers between levels have been affected. The nature of the remaining assets and liabilities is such that transfers in and out of any level are expected to be rare. For the three and nine months ended September 30, 2013, there were no transfers between Levels 1, 2 or 3.

The table below includes a rollforward of the balance sheet amounts for the three and nine months ended September 30, 2013 (including the change in fair value) for financial instruments classified by Pinnacle Financial within Level 3 of the valuation hierarchy for assets and liabilities measured at fair value on a recurring basis. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, since Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources), the gains and losses in the table below include changes in fair value due in part to observable factors that are part of the valuation methodology (in thousands):

| | For the nine months ended September 30, | | | |
|--|---|-------------------|--------------|-------------------|
| | 2013 | | 2012 | |
| | Other assets | Other liabilities | Other assets | Other liabilities |
| Fair value, January 1 | \$4,681 | \$ - | \$3,400 | \$ - |
| Total realized gains included in income | (366) | - | 641 | - |
| Change in unrealized gains/losses included in other comprehensive income for assets and liabilities still held at September 30 | - | - | - | - |
| Purchases, issuances and settlements, net | 1,650 | - | 189 | - |
| Transfers out of Level 3 | - | - | - | - |
| Fair value, September 30 | \$5,965 | \$ - | \$4,230 | \$ - |
| Total realized gains (losses) included in income related to financial assets and liabilities still on the consolidated balance sheet at September 30 | \$(366) | \$ - | \$641 | \$ - |

The following methods and assumptions were used by Pinnacle Financial in estimating its fair value disclosures for financial instruments that are not measured at fair value. In cases where quoted market prices are not available, fair values are based on estimates using discounted cash flow models. Those models are significantly affected by the assumptions used, including the discount rates, estimates of future cash flows and borrower creditworthiness. The fair value estimates presented herein are based on pertinent information available to management as of September 30, 2013 and December 31, 2012. Such amounts have not been revalued for purposes of these consolidated financial statements since those dates and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Securities held-to-maturity- Estimated fair values for investment securities are based on quoted market prices where available. If quoted market prices are not available, then fair values are estimated by using pricing models that use observable inputs or quoted prices of securities with similar characteristics.

Loans, net - The fair value of our loan portfolio includes a credit risk factor in the determination of the fair value of our loans. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. Our loan portfolio is initially fair valued using a segmented approach. We divide our loan portfolio into the following categories: variable rate loans, impaired loans and all other loans. The results are then adjusted to account for credit risk.

For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values approximate carrying values. Fair values for impaired loans are estimated using discounted cash flow models or based on the fair value of the underlying collateral. For other loans, fair values are estimated using discounted cash flow models, using current market interest rates offered for loans with similar terms to borrowers of similar credit quality. The values derived from the discounted cash flow approach for each of the above portfolios are then further discounted to incorporate credit risk to determine the exit price.

Mortgage loans held-for-sale - Mortgage loans held-for-sale are carried at the lower of cost or fair value. The estimate of fair value is based on pricing models and other information.

Deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, subordinated debt and other borrowings - The carrying amounts of demand deposits, savings deposits, securities sold under agreements to repurchase, floating rate advances from the FHLB, floating rate subordinated debt and other borrowings, and floating rate loans approximate their fair values. Fair values for certificates of deposit, fixed rate advances from the FHLB and fixed rate subordinated debt are estimated using discounted cash flow models, using current market interest rates offered on certificates, advances and other borrowings with similar remaining maturities. For fixed rate subordinated debt, the maturity is assumed to be as of the earliest date that the indebtedness will be repriced.

Off-balance sheet instruments - The fair values of Pinnacle Financial's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to Pinnacle Financial until such commitments are funded.

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The following table presents the carrying amounts, estimated fair value and placement in the fair value hierarchy of Pinnacle Financial's financial instruments at September 30, 2013 and December 31, 2012. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as non-interest bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

| (dollars in thousands) | Carrying/ Notional Amount | Estimated Fair Value ⁽¹⁾ | Quoted market prices in an active market (Level 1) | Models with significant observable market parameters (Level 2) | Models with significant unobservable market parameters (Level 3) |
|---|---------------------------------|---|---|--|---|
| September 30, 2013 | | | | | |
| Financial assets: | | | | | |
| Securities held-to-maturity | \$39,594 | \$38,718 | \$ - | \$ 38,718 | \$ - |
| Loans, net | 3,969,302 | 3,587,031 | - | - | 3,587,031 |
| Mortgage loans held-for-sale | 16,962 | 17,290 | - | 17,290 | - |
| Financial liabilities: | | | | | |
| Deposits and securities sold under agreements to repurchase | 4,417,575 | 4,065,286 | - | - | 4,065,286 |
| Federal Home Loan Bank advances | 115,671 | 115,634 | - | - | 115,634 |
| Subordinated debt and other borrowings | 99,283 | 73,650 | - | - | 73,650 |
| Off-balance sheet instruments: | | | | | |
| Commitments to extend credit ⁽²⁾ | 1,161,846 | 1,097 | - | - | 1,097 |
| Standby letters of credit ⁽³⁾ | 62,363 | 274 | - | - | 274 |
| December 31, 2012 | | | | | |
| Financial assets: | | | | | |
| Securities held-to-maturity | \$575 | \$583 | \$ - | \$ 583 | \$ - |
| Loans, net | 3,642,744 | 3,358,435 | - | - | 3,358,435 |
| Mortgage loans held for sale | 41,195 | 42,425 | - | 42,425 | - |
| Financial liabilities: | | | | | |
| Deposits and securities sold under agreements to repurchase | 4,129,855 | 4,084,314 | - | - | 4,084,314 |
| Federal Home Loan Bank advances | 75,850 | 76,350 | - | - | 76,350 |
| Subordinated debt and other borrowings | 106,158 | 83,862 | - | - | 83,862 |
| Off-balance sheet instruments: | | | | | |
| Commitments to extend credit ⁽²⁾ | 1,030,723 | 1,594 | - | - | 1,594 |
| Standby letters of credit ⁽³⁾ | 74,679 | 304 | - | - | 304 |

- (1) Estimated fair values are consistent with an exit-price concept. The assumptions used to estimate the fair values are intended to approximate those that a market-participant would realize in a hypothetical orderly transaction. At the end of each quarter, Pinnacle Financial evaluates the inherent risks of the outstanding off-balance sheet commitments. In making this evaluation, Pinnacle Financial evaluates the credit worthiness of the borrower, the collateral supporting the commitments and any other factors similar to those used to evaluate the inherent risks of
- (2) our loan portfolio. Additionally, Pinnacle Financial evaluates the probability that the outstanding commitment will eventually become a funded loan. As a result, at September 30, 2013 and December 31, 2012, Pinnacle Financial included in other liabilities \$1.4 million and \$1.9 million, respectively, representing the inherent risks associated with these off-balance sheet commitments.
- At September 30, 2013 and December 31, 2012, the fair value of Pinnacle Financial's standby letters of credit was \$274,000 and \$304,000, respectively. This amount represents the unamortized fee associated with these standby
- (3) letters of credit and is included in the consolidated balance sheet of Pinnacle Financial and is believed to approximate fair value. This fair value will decrease over time as the existing standby letters of credit approach their expiration dates.

Note 11. Variable Interest Entities

Under ASC 810, Pinnacle Financial is deemed to be the primary beneficiary and required to consolidate a variable interest entity (VIE) if it has a variable interest in the VIE that provides it with a controlling financial interest. For such purposes, the determination of whether a controlling financial interest exists is based on whether a single party has both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. ASC 810 requires continual reconsideration of conclusions reached regarding which interest holder is a VIE's primary beneficiary and disclosures surrounding those VIE's which have not been consolidated. The consolidation methodology provided in this footnote for the quarter ended September 30, 2013, and the year ended December 31, 2012, has been prepared in accordance with ASC 810.

At September 30, 2013, Pinnacle Financial did not have any consolidated VIEs to disclose but did have several nonconsolidated VIEs. As discussed more fully in its Annual Report on Form 10-K for the fiscal year ended December 31, 2012, Pinnacle Financial has the following non-consolidated variable interest entities: low income housing partnerships, trust preferred issuances, accruing restructured commercial loans, and managed discretionary trusts.

The following table summarizes VIE's that are not consolidated by Pinnacle Financial as of September 30, 2013 and December 31, 2012 (in thousands):

| Type | September 30, 2013 | | | December 31, 2012 | | | Balance Sheet Classification | |
|---|----------------------------------|----------------------|--------|----------------------------------|----------------------|--------|-----------------------------------|---|
| | Assets Recognized (maximum loss) | Liability Recognized | | Assets Recognized (maximum loss) | Liability Recognized | | | |
| Low income housing partnerships | \$5,993 | \$ - | | \$6,096 | \$ - | | Other assets Subordinated debt | |
| Trust preferred issuances | N/ | A | 82,476 | N/ | A | 82,476 | debt | |
| Commercial troubled debt restructurings | 15,254 | - | | 20,951 | - | | Loans | |
| Managed discretionary trusts | N/ | A | N/ | A | N/ | A | N/ | A |

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at September 30, 2013 and December 31, 2012 and our results of operations for the three and nine months ended September 30, 2013 and 2012. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein.

Overview

General. Our diluted net income per common share available to common stockholders for the three and nine months ended September 30, 2013 was \$0.42 and \$1.23 compared to \$0.33 and \$0.76 for the same periods in 2012. At September 30, 2013, loans had increased to \$3.969 billion, as compared to \$3.712 billion at December 31, 2012, and total deposits increased to \$4.334 billion at September 30, 2013 from \$4.015 billion at December 31, 2012.

Results of Operations. Our net interest income increased \$3.6 million to \$44.6 million for the third quarter of 2013 compared to \$40.9 million for the third quarter of 2012. Our net interest income increased \$10.3 million to \$130.9 million for the nine months ended September 30, 2013 compared to \$120.6 million for the same period in the prior year. The net interest margin (the ratio of net interest income to average earning assets) for the three and nine months ended September 30, 2013 was 3.72% and 3.80%, respectively, compared to 3.78% and 3.76% for the same periods in 2012.

Our provision for loan losses was \$0.7 million and \$5.6 million for the three and nine months ended September 30, 2013 compared to \$1.4 million and \$3.1 million for the same periods in 2012. Our provisioning expense correlates with the growth in our net loans and the costs for continued resolution of our nonperforming assets. Net charge-offs were \$2.1 million and \$7.8 million for the three and nine months ended September 30, 2013, compared to \$1.9 million and \$8.0 million for the same periods in the prior year. Our allowance for loan losses as a percentage of total loans decreased from 1.87% at December 31, 2012 to 1.70% at September 30, 2013, as a result of improving credit metrics within our loan portfolio.

Noninterest income increased by \$1.0 million and \$4.3 million during the three and nine months ended September 30, 2013, compared to the same periods in the prior year. These increases are primarily attributable to continued growth in our fee businesses as well as increases in other noninterest income. Included in other noninterest income are miscellaneous consumer fees, such as ATM revenues, other consumer fees (primarily interchange), interest rate swap fee transactions for commercial borrowers and gains from the sale of loans that occur from time to time.

Noninterest expense decreased by \$0.3 million and \$6.7 million during the three and nine months ended September 30, 2013, as compared to the three and nine months ended September 30, 2012. Costs associated with the disposal and maintenance of other real estate owned decreased by \$1.7 million and \$7.4 million during the three and nine months ended September 30, 2013, when compared to the same periods in 2012.

During the three and nine months ended September 30, 2013, Pinnacle Financial recorded income tax expense of \$7.3 million and \$20.9 million, respectively. Pinnacle Financial's effective tax rate for the nine months ended September 30, 2013 and 2012 of 33.0% and 32.3%, respectively, differs from the combined federal and state income tax statutory rate primarily due to investments in bank qualified municipal securities, our real estate investment trust, and bank owned life insurance offset in part by meals and entertainment expense and executive compensation, portions of which are non-deductible.

Our efficiency ratio (the ratio of noninterest expense to the sum of net interest income and noninterest income) was 59.5% and 58.4% for the three and nine months ended September 30, 2013, compared to 65.4% and 68.5% for the same periods in 2012.

Net income available to common stockholders for the three and nine months ended September 30, 2013 was \$14.6 million and \$42.4 million compared to \$11.3 million and \$26.3 million for the same periods in 2012. Net income available to common stockholders for the nine months ended September 30, 2012 included charges related to preferred stock dividends and accretion of the preferred stock discount related to our participation in the TARP

Capital Purchase Program of \$3.8 million.

Financial Condition. Net loans increased \$259.3 million, or 6.9% during the nine months ended September 30, 2013. Total deposits were \$4.334 billion at September 30, 2013, compared to \$4.015 billion at December 31, 2012, an increase of \$318.4 million, or 7.9%.

Capital and Liquidity. At September 30, 2013, our capital ratios, including our bank's capital ratios, exceeded those levels necessary to be considered well-capitalized under applicable regulatory guidelines. From time to time we may be required to support the capital needs of our bank. At September 30, 2013, we had approximately \$16.8 million of cash at the holding company which could be used to support our bank. Although we do not anticipate our bank needing any additional capital from us currently, we believe we have various capital raising techniques available to us to provide for the capital needs of our bank, if necessary.

On October 15, 2013, our board of directors approved the initiation of a quarterly cash dividend. The initial dividend of \$0.08 per share will be paid on December 20, 2013 to shareholders of record at the close of business on November 26, 2013. The amount and timing of all future dividend payments is subject to the discretion of Pinnacle Financial's board of directors and will depend on Pinnacle Financial's earnings, capital position, financial condition and other factors, including new regulatory capital requirement, as they become known to us.

Critical Accounting Estimates

The accounting principles we follow and our methods of applying these principles conform with U.S. GAAP and with general practices within the banking industry. There have been no significant changes to our Critical Accounting Policies as described in our Annual Report on Form 10-K for the year ended December 31, 2012.

Results of Operations

The following is a summary of our results of operations (dollars in thousands, except per share data):

| | Three months ended | | 2013-2012 | | Nine months ended | | 2013-2012 | |
|--|--------------------|----------|-----------------------------|----|-------------------|-----------|-----------------------------|----|
| | September 30 | | Percent Increase (Decrease) | | September 30 | | Percent Increase (Decrease) | |
| | 2013 | 2012 | | | 2013 | 2012 | | |
| Interest income | \$48,177 | \$46,441 | 3.7 | % | \$142,878 | \$138,218 | 3.4 | % |
| Interest expense | 3,604 | 5,509 | (34.6) |)% | 11,948 | 17,597 | (32.1) |)% |
| Net interest income | 44,573 | 40,932 | 8.9 | % | 130,930 | 120,621 | 8.5 | % |
| Provision for loan losses | 685 | 1,413 | (51.5) |)% | 5,631 | 3,080 | 82.8 | % |
| Net interest income after provision for loan losses | 43,888 | 39,519 | 11.1 | % | 125,299 | 117,541 | 6.6 | % |
| Noninterest income | 11,387 | 10,430 | 9.2 | % | 34,615 | 30,289 | 14.3 | % |
| Noninterest expense | 33,323 | 33,579 | (0.8) |)% | 96,625 | 103,314 | (6.5) |)% |
| Net income before income taxes | 21,952 | 16,370 | 34.1 | % | 63,289 | 44,516 | 42.2 | % |
| Income tax expense | 7,305 | 5,022 | 45.5 | % | 20,884 | 14,362 | 45.4 | % |
| Net income | 14,647 | 11,348 | 29.1 | % | 42,405 | 30,154 | 40.6 | % |
| Preferred dividends and discount accretion | - | - | - | | - | 3,814 | (100.0) |)% |
| Net income available to common stockholders | \$14,647 | \$11,348 | 29.1 | % | \$42,405 | \$26,340 | 61.0 | % |
| Basic net income per common share available to common stockholders | \$0.43 | \$0.33 | 30.3 | % | \$1.24 | \$0.78 | 59.0 | % |
| Diluted net income per common share available | | | | | | | | |
| Diluted net income per common share available to common stockholders | \$0.42 | \$0.33 | 27.3 | % | \$1.23 | \$0.76 | 61.8 | % |

Net Interest Income. Net interest income represents the amount by which interest earned on various earning assets exceeds interest paid on deposits and other interest-bearing liabilities and is the most significant component of our revenues. Net interest income totaled \$44.6 million and \$130.9 million for the three and nine months ended September 30, 2013, an increase of \$3.6 million and \$10.3 million from the levels recorded in the same periods of 2012. We were able to increase net interest income during the nine months ended September 30, 2013 compared to the same period in 2012 due primarily to our focus on growing our loan portfolio and reducing our funding costs.

The following tables set forth the amount of our average balances, interest income or interest expense for each category of interest-earning assets and interest-bearing liabilities and the average interest rate for interest-earning assets and interest-bearing liabilities, net interest spread and net interest margin for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

| | Three months ended September 30, 2013 | | | Three months ended September 30, 2012 | | |
|---|--|----------|------------------|--|----------|------------------|
| | Average Balances | Interest | Rates/ Yields | Average Balances | Interest | Rates/ Yields |
| Interest-earning assets: | | | | | | |
| Loans ⁽¹⁾ | \$3,932,218 | \$42,778 | 4.33 % | \$3,488,736 | \$40,405 | 4.62 % |
| Securities: | | | | | | |
| Taxable | 571,985 | 3,538 | 2.45 % | 585,782 | 3,974 | 2.70 % |
| Tax-exempt ⁽²⁾ | 167,640 | 1,601 | 5.06 % | 180,765 | 1,622 | 4.77 % |
| Federal funds sold and other | 153,709 | 260 | 0.80 % | 124,459 | 440 | 1.55 % |
| Total interest-earning assets | 4,825,552 | \$48,177 | 4.02 % | 4,379,742 | \$46,441 | 4.28 % |
| Nonearning assets | | | | | | |
| Intangible assets | 248,095 | | | 250,274 | | |
| Other nonearning assets | 239,356 | | | 230,378 | | |
| Total assets | \$5,313,003 | | | \$4,860,394 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest bearing deposits: | | | | | | |
| Interest checking | \$783,623 | \$400 | 0.20 % | \$672,057 | \$637 | 0.38 % |
| Savings and money market | 1,755,037 | 1,370 | 0.31 % | 1,606,189 | 1,959 | 0.49 % |
| Time | 559,587 | 938 | 0.66 % | 627,918 | 1,390 | 0.88 % |
| Total interest-bearing deposits | 3,098,247 | 2,708 | 0.35 % | 2,906,164 | 3,986 | 0.55 % |
| Securities sold under agreements to repurchase | 110,123 | 56 | 0.20 % | 136,918 | 99 | 0.29 % |
| Federal Home Loan Bank advances | 181,392 | 173 | 0.38 % | 214,271 | 621 | 1.15 % |
| Subordinated debt and other borrowings | 100,995 | 667 | 2.62 % | 112,406 | 802 | 2.84 % |
| Total interest-bearing liabilities | 3,490,757 | 3,604 | 0.41 % | 3,369,759 | 5,508 | 0.65 % |
| Noninterest-bearing deposits | 1,100,532 | - | 0.00 % | 799,508 | - | 0.00 % |
| Total deposits and interest-bearing liabilities | 4,591,289 | \$3,604 | 0.31 % | 4,169,267 | \$5,508 | 0.53 % |
| Other liabilities | 16,439 | | | 21,454 | | |
| Stockholders' equity | 705,275 | | | 669,673 | | |
| Total liabilities and stockholders' equity | \$5,313,003 | | | \$4,860,394 | | |
| Net interest income | | \$44,573 | | | \$40,933 | |
| Net interest spread ⁽³⁾ | | | 3.61 % | | | 3.63 % |
| Net interest margin ⁽⁴⁾ | | | 3.72 % | | | 3.78 % |

1. Average balances of nonaccrual loans are included in the above amounts.

2. Yields based on the carrying value of those tax exempt instruments are shown on a fully tax equivalent basis.

3. Yields realized on interest-bearing assets less the rates paid on interest-bearing liabilities. The net interest spread calculation excludes the impact of demand deposits. Had the impact of demand deposits been included, the net interest spread for the three months ended September 30, 2013 would have been 3.71% compared to a net interest spread of 3.76% for the three months ended September 30, 2012.

4. Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.

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| | Nine months ended September 30, 2013 | | | Nine months ended September 30, 2012 | | |
|---|---|-----------|------------------|---|-----------|------------------|
| | Average Balances | Interest | Rates/ Yields | Average Balances | Interest | Rates/ Yields |
| Interest-earning assets: | | | | | | |
| Loans ⁽¹⁾ | \$3,820,711 | \$126,442 | 4.44 % | \$3,390,838 | \$118,330 | 4.67 % |
| Securities: | | | | | | |
| Taxable | 561,974 | 10,860 | 2.58 % | 636,516 | 13,357 | 2.80 % |
| Tax-exempt ⁽²⁾ | 171,352 | 4,741 | 4.94 % | 183,572 | 4,973 | 4.83 % |
| Federal funds sold and other | 130,226 | 835 | 1.01 % | 143,311 | 1,558 | 1.58 % |
| Total interest-earning assets | 4,684,263 | \$142,878 | 4.14 % | 4,354,237 | \$138,218 | 4.30 % |
| Nonearning assets | | | | | | |
| Intangible assets | 248,488 | | | 250,969 | | |
| Other nonearning assets | 240,305 | | | 237,805 | | |
| Total assets | \$5,173,056 | | | \$4,843,011 | | |
| Interest-bearing liabilities: | | | | | | |
| Interest bearing deposits: | | | | | | |
| Interest checking | \$782,965 | \$1,537 | 0.26 % | \$674,086 | \$2,243 | 0.44 % |
| Savings and money market | 1,656,988 | 4,381 | 0.35 % | 1,562,930 | 6,068 | 0.52 % |
| Time | 575,689 | 3,159 | 0.73 % | 657,073 | 4,802 | 0.98 % |
| Total interest-bearing deposits | 3,015,642 | 9,077 | 0.40 % | 2,894,089 | 13,113 | 0.61 % |
| Securities sold under agreements to repurchase | 123,395 | 204 | 0.22 % | 132,523 | 370 | 0.37 % |
| Federal Home Loan Bank advances | 191,622 | 587 | 0.41 % | 228,378 | 1,847 | 1.08 % |
| Subordinated debt and other borrowings | 103,427 | 2,079 | 2.69 % | 104,003 | 2,267 | 2.91 % |
| Total interest-bearing liabilities | 3,434,086 | 11,948 | 0.46 % | 3,358,993 | 17,597 | 0.70 % |
| Noninterest-bearing deposits | 1,022,576 | - | 0.00 % | 752,491 | - | 0.00 % |
| Total deposits and interest-bearing liabilities | 4,456,662 | \$11,948 | 0.36 % | 4,111,484 | \$17,597 | 0.57 % |
| Other liabilities | 18,639 | | | 28,881 | | |
| Stockholders' equity | 697,755 | | | 702,646 | | |
| Total liabilities and stockholders' equity | \$5,173,056 | | | \$4,843,011 | | |
| Net interest income | | \$130,930 | | | \$120,621 | |
| Net interest spread ⁽³⁾ | | | 3.67 % | | | 3.60 % |
| Net interest margin ⁽⁴⁾ | | | 3.80 % | | | 3.76 % |

1. Average balances of nonaccrual loans are included in the above amounts.

2. Yields based on the carrying value of those tax exempt instruments are shown on a fully tax equivalent basis.

Yields realized on interest-bearing assets less the rates paid on interest-bearing liabilities. The net interest spread calculation excludes the impact of demand deposits. Had the impact of demand deposits been included, the net interest spread for the nine months ended September 30, 2013 would have been 3.78% compared to a net interest spread of 3.73% for the nine months ended September 30, 2012.

3. Net interest margin is the result of annualized net interest income calculated on a tax-equivalent basis divided by average interest-earning assets for the period.

For the three months ended September 30, 2013 and 2012, our net interest spread was 3.61% and 3.63%, respectively, while the net interest margin was 3.72% and 3.78%, respectively. A reduction in loan yields between the third quarter of 2013 and the third quarter of 2012 was the primary reason for the decline in the margin and spread. For the nine months ended September 30, 2013 and 2012 our net interest spread was 3.67% and 3.60%, respectively, while the net interest margin was 3.80% and 3.76%, respectively. The improving net interest margin when comparing the nine months ended September 30, 2013 to the comparable period in 2012 reflected management's efforts to maximize earnings by focusing on loan growth and reduced deposit pricing. During the three and nine months ended September 30, 2013, total funding rates were less than those rates for the same periods in the prior year for both the three and nine month periods by 22 basis points. The net decrease was largely impacted by the continued shift in our deposit mix, as we increased our checking accounts (both interest bearing and non-interest bearing) and concurrently reduced balances of higher-cost time deposits. We will continue to seek opportunities to reduce the cost of specific deposit accounts where we believe the amount we are currently paying for those funds exceeds market pricing. However, we believe future decreases in our funding costs will become more limited compared to recent periods.

Additionally, lower levels of nonaccrual loans positively impacted our net interest margin during the three and nine months ended September 30, 2013 when compared to the same periods in 2012. Average nonaccrual loans were \$21.0 million for the nine months ended September 30, 2013, which was a decrease from \$40.1 million of average nonaccrual loans for the nine months ended September 30, 2012.

We continue to deploy various asset liability management strategies to manage our risk to interest rate fluctuations. We currently believe that short term rates will remain low for an extended period of time. We believe margin expansion over both the short and the long term will be challenging due to continued pressure on earning asset yields during this extended period of low interest rates. Loan pricing for creditworthy borrowers is very competitive in our markets and has limited our ability to increase pricing on new and renewed loans over the last several quarters and we anticipate that this challenging competitive environment will continue throughout the remainder of 2013 and into 2014. As a result, we anticipate loan yields will continue to remain depressed in 2013 and into 2014.

We continue to believe our net interest income should increase throughout 2013 compared to 2012 primarily due to an increase in average earning asset volumes, primarily loans.

Provision for Loan Losses. The provision for loan losses represents a charge to earnings necessary to establish an allowance for loan losses that, in management's evaluation, should be adequate to provide coverage for the inherent losses on outstanding loans. Based upon management's assessment of the loan portfolio, we adjust our allowance for loan losses to an amount deemed appropriate to adequately cover probable losses inherent in the loan portfolio. Our allowance for loan losses as a percentage of total loans decreased from 1.87% at December 31, 2012 to 1.70% at September 30, 2013. Our allowance for loan losses as a percentage of our nonaccrual loans has increased from 304.2% at December 31, 2012 to 336.6% at September 30, 2013. Based upon our evaluation of the loan portfolio, we believe the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at September 30, 2013. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management, they are necessarily approximate and imprecise. There are factors beyond our control, such as conditions in the local and national economy, local real estate market, or particular industry or borrower-specific conditions, which may materially negatively impact our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

The provision for loan losses amounted to \$0.7 million and \$1.4 million for the three months ended September 30, 2013 and 2012, respectively, and \$5.6 million and \$3.1 million for the nine months ended September 30, 2013 and 2012, respectively. Provision expense is impacted by the absolute level of loans, loan growth, by the credit quality of the loan portfolio and the resolution of troubled assets.

Noninterest Income. Our noninterest income is composed of several components, some of which vary significantly between quarterly and annual periods. Service charges on deposit accounts and other noninterest income generally reflect customer growth trends, while fees from our wealth management departments, the origination of mortgage loans and gains and losses on the sale of securities will often reflect market conditions and fluctuate from period to period.

The following is a summary of our noninterest income for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

| | Three months ended | | 2013-2012 | | Nine months ended | | 2013-2012 | |
|---|--------------------|----------|---------------------|----|-------------------|----------|---------------------|----|
| | September 30, | | Percent | | September 30, | | Percent | |
| | 2013 | 2012 | Increase (Decrease) | | 2013 | 2012 | Increase (Decrease) | |
| Noninterest income: | | | | | | | | |
| Service charges on deposit accounts | \$2,797 | \$2,532 | 10.5 | % | \$7,818 | \$7,295 | 7.2 | % |
| Investment services | 1,956 | 1,677 | 16.6 | % | 5,644 | 4,934 | 14.4 | % |
| Insurance sales commissions | 1,021 | 987 | 3.5 | % | 3,522 | 3,416 | 3.1 | % |
| Gains on mortgage loans sold, net | 1,326 | 1,979 | (33.0) |)% | 5,130 | 4,930 | 4.1 | % |
| Gain (loss) on sale of investment securities, net of OTTI | (1,441) | (50) | 2,795.0 | % | (1,466) | 163 | (1,001.2) |)% |
| Trust fees | 932 | 767 | 21.4 | % | 2,756 | 2,333 | 18.2 | % |
| Other noninterest income: | | | | | | | | |
| ATM and other consumer fees | 1,976 | 1,657 | 19.3 | % | 5,671 | 4,517 | 25.6 | % |
| Bank-owned life insurance | 568 | 242 | 134.7 | % | 1,539 | 723 | 112.9 | % |
| Loan swap fees | 268 | 20 | 1,240.0 | % | 665 | 130 | 411.5 | % |
| Alternative investments | (46) | (49) | (6.1) | %) | 122 | (118) | (203.4) | %) |
| Other noninterest income | 2,030 | 668 | 204.0 | % | 3,214 | 1,966 | 63.5 | % |
| Total other noninterest income | 4,796 | 2,538 | 89.0 | % | 11,211 | 7,218 | 55.3 | % |
| Total noninterest income | \$11,387 | \$10,430 | 9.2 | % | \$34,615 | \$30,289 | 14.3 | % |

The increase in service charges on deposit accounts in 2013 compared to the first nine months of 2012 is primarily related to increased analysis fees due to an increase in the volume and number of commercial checking accounts.

Income from our wealth management groups (investments, insurance and trust) are also included in noninterest income. For the nine months ended September 30, 2013 and 2012, commissions and fees from investment services at our financial advisory unit, Pinnacle Asset Management, a division of Pinnacle Bank, totaled \$5.6 million and \$4.9 million, respectively. At September 30, 2013, Pinnacle Asset Management was receiving commissions and fees in connection with approximately \$1.4 billion in brokerage assets held with Raymond James Financial Services, Inc. compared to \$1.2 billion at September 30, 2012. Insurance commissions were approximately \$1.0 million and \$3.5 million for the three and nine months ended September 30, 2013 compared to approximately \$1.0 million and \$3.4 million for the three and nine months ended September 30, 2012. Substantially all of our insurance revenue is attributable to our insurance subsidiary, Miller Loughry Beach. Included in insurance income for the first nine months of 2013 was \$333,000 of contingent income received in the first quarter of 2013 based on 2012 sales production compared to \$287,000 recorded in the first quarter in 2012. Additionally, at September 30, 2013, our trust department was receiving fees on approximately \$576.2 million of managed assets compared to \$466.0 million at September 30, 2012. Accordingly, trust fees increased by 18.2% between the year-to-date periods presented.

Gains on mortgage loans sold, net, consists of fees from the origination and sale of mortgage loans. These mortgage fees are for loans originated in both the Middle Tennessee and Knoxville markets that are subsequently sold to

third-party investors. All of these loan sales transfer servicing rights to the buyer. Generally, mortgage origination fees increase in lower interest rate environments and more robust housing markets and decrease in rising interest rate environments and more challenging housing markets. Mortgage origination fees will fluctuate from quarter to quarter as the rate environment changes. Gains on mortgage loans sold, net, were \$1.3 million and \$5.1 million for the three and nine months ended September 30, 2013 as compared to \$2.0 million and \$4.9 million for the same periods in the prior year.

Pinnacle Financial recorded an other-than-temporary-impairment charge in the third quarter of 2013 as a result of management's intention at September 30, 2013 to sell the securities as a loss. Subsequent to September 30, 2013, Pinnacle Financial sold additional available-for-sale securities with a fair market value of \$22.1 million and realized a loss of \$1.4 million. There is a risk that other-than-temporary impairment charges may occur in the future if management determines it is probable that Pinnacle Financial will not recover the entire amortized cost bases of these securities as a result of either the deterioration of the issuer's financial condition or a change in management's intention to hold these securities to maturity and or recovery.

Included in other noninterest income are ATM and other consumer fees, swap fees earned for the facilitation of derivative transactions for our clients, changes in the fair value of our alternative investments and gains from loan sales. ATM revenues and other consumer fees realized in the first nine months of 2013 increased approximately \$1.2 million as compared to the same period in the prior year. While we are exempt from the cap on debit interchange fees imposed under the Dodd-Frank Act because of our current asset size, we believe that there is the potential for downward pressure on interchange fees as debit networks compete for transaction volume. We believe that this potential reduction in interchange fees will likely happen gradually over an extended period of time.

Additionally, noninterest income from increases in the cash surrender value of bank-owned life insurance was \$568,000 and \$1.5 million for the three and nine months ended September 30, 2013 compared to \$242,000 and \$723,000 for the three and nine months ended September 30, 2012. During the first quarter of 2013, Pinnacle Financial purchased approximately \$30 million of bank-owned life insurance with terms similar to our existing policies. The assets that support these policies are administered by the life insurance carriers and the income we receive (i.e., increases or decreases in the cash surrender value of the policies) on these policies is dependent upon the returns the insurance carriers are able to earn on the underlying investments that support the policies. Earnings on these policies generally are not taxable.

Included in other noninterest income for the first nine months of 2013 was approximately \$665,000 of swap fees compared to approximately \$130,000 for the same period in the prior year. Also, during the first nine months of 2013 we recognized approximately \$122,000 in gains in the market value of our alternative investments compared to a loss of \$118,000 in the prior year's comparable period. Also included in other noninterest income is a \$1.1 million gain on the sale of the government guaranteed portion of a loan during the nine months ended September 30, 2013 compared to \$165,000 during the nine months ended September 30, 2012.

Noninterest Expense. Noninterest expense consists of salaries and employee benefits, equipment and occupancy expenses, other real estate expenses, and other operating expenses. The following is a summary of our noninterest expense for the three and nine months ended September 30, 2013 and 2012 (in thousands):

| | Three months ended | | 2013-2012 Percent Increase (Decrease) | | Nine months ended | | 2013-2012 Percent Increase (Decrease) | |
|---|-----------------------|----------|--|----|-----------------------|-----------|--|----|
| | September 30, 2013 | 2012 | | | September 30, 2013 | 2012 | | |
| Noninterest expense: | | | | | | | | |
| Salaries and employee benefits: | | | | | | | | |
| Salaries | \$11,829 | \$11,384 | 3.9 | % | \$34,787 | \$34,662 | 0.4 | % |
| Commissions | 1,156 | 1,051 | 10.0 | % | 3,451 | 3,189 | 8.2 | % |
| Cash incentives and related payroll taxes | 3,800 | 3,075 | 23.6 | % | 10,425 | 7,129 | 46.2 | % |
| Employee benefits and other | 4,225 | 3,961 | 6.7 | % | 12,490 | 13,520 | (7.6) |)% |
| Total salaries and employee benefits | 21,010 | 19,471 | 7.9 | % | 61,153 | 58,500 | 4.5 | % |
| Equipment and occupancy | 5,413 | 5,156 | 5.0 | % | 15,730 | 15,218 | 3.4 | % |
| Other real estate expense | 699 | 2,399 | (70.9) |)% | 2,811 | 10,180 | (72.4) |)% |
| Marketing and business development | 721 | 835 | (13.6) |)% | 2,499 | 2,360 | 5.9 | % |
| Postage and supplies | 581 | 638 | (8.9) |)% | 1,691 | 1,817 | (7.0) |)% |
| Amortization of intangibles | 247 | 683 | (63.9) |)% | 1,016 | 2,056 | (50.6) |)% |
| Other noninterest expense | 4,652 | 4,397 | 5.8 | % | 11,726 | 13,183 | (11.1) |)% |
| Total noninterest expense | \$33,323 | \$33,579 | (0.8) |)% | \$96,625 | \$103,314 | (6.5) |)% |

Total salaries and employee benefits expenses increased approximately 4.5% for the first nine months of 2013 over the same period in 2012.

We believe that cash and equity incentives are a valuable tool in motivating an employee base that is focused on providing our clients effective financial advice and increasing shareholder value. As a result, and unlike many other financial institutions, all of our non-commissioned associates participate in our annual cash incentive plan and all of our associates participate in our equity compensation plans. As compared to 2012, cash incentives and related payroll taxes increased by \$3.3 million to \$10.4 million for the nine months ended September 30, 2013. Under the annual cash incentive plan, the targeted level of incentive payments requires achievement of a certain soundness threshold, a revenue component and a targeted level of earnings (subject to certain adjustments). To the extent that the soundness threshold is met and revenues and earnings are above or below the targeted amount, the aggregate incentive payments are increased or decreased. Historically, we have paid between 0% and 120% of our targeted bonus. We currently believe that our performance for fiscal 2013 will exceed our targets and we are currently accruing incentive costs in 2013 above target levels. The increase as compared to prior year is attributable to our improved performance in fiscal 2013 as compared to 2012 as well our senior executives participating in our annual cash incentive program during the first half of 2013. Our senior executives were again eligible to participate in our cash incentive program in the second half of 2012 upon our redemption of the preferred stock issued to the U.S. Treasury in connection with our participation in the CPP.

Employee benefits include items such as payroll taxes, health insurance, and employer match for the 401(k) program. Additionally, included in employee benefits and other expense for the three and nine months ended September 30, 2013, were approximately \$1.0 million and \$3.0 million of compensation expenses related to stock options and restricted share awards compared to \$896,000 and \$2.8 million for the three and nine months ended September 30, 2012. We provide a broad-based equity incentive plan for all associates. We believe that equity incentives provide an excellent vehicle for all associates to become meaningful stockholders of Pinnacle Financial over an extended period of time and create a stockholder-centric culture throughout our organization.

Also included in employee benefits and other expenses are costs related to salary stock units issued to our senior executives during the first half of 2012. In connection with these awards, the executive officers received salary stock units which were settled in our common stock on a one-for-one basis. The program was terminated by the HRCC effective June 30, 2012 following the redemption of all of the preferred shares issued pursuant to the CPP that then remained outstanding, and these senior executives were deemed eligible to participate in our annual cash incentive plan effective July 1, 2012. For the nine months ended September 30, 2012, approximately \$1.0 million in costs were incurred related to the salary stock units compared to no salary stock expense during the nine months ended September 30, 2013.

Equipment and occupancy expenses for the three and nine months ended September 30, 2013, were slightly elevated as compared to the same periods in the prior year. We expanded our retail operations in the second quarter of 2013 in the Knoxville market with the opening of our Cedar Bluff location which in future periods may lead to higher equipment and occupancy expenses as well as related increases in salaries and benefits expense.

At September 30, 2013, we had \$15.5 million in OREO assets compared to \$18.6 million at December 31, 2012. Other real estate expense was \$0.7 million and \$2.8 million for the three and nine months ended September 30, 2013, compared to \$2.4 million and \$10.2 million for the same periods in the prior year. Approximately \$301,000 and \$1.8 million of the other real estate expense incurred during the three and nine months ended September 30, 2013, were realized losses on dispositions and holding losses due to reduced valuations of OREO properties compared to \$1.9 million and \$8.8 million for the same periods in the prior year. The remaining other real estate expense consisted of carrying costs to maintain or improve the properties.

Until we are able to significantly reduce the absolute level of our OREO portfolio, other real estate expense will likely remain elevated and could fluctuate quarter to quarter depending on market conditions as we maintain and market for sale various foreclosed properties. These properties could also be subject to future valuation adjustments as a result of updated appraisal information and possible further deterioration in real estate values, thus causing additional fluctuations in our quarterly other real estate expense. Additionally, we will continue to incur ongoing expenses associated with maintenance costs and property taxes associated with these assets.

Management's strategy has been to aggressively pursue disposition of nonaccrual loans and other real estate owned in order to ultimately reduce the expense associated with carrying these nonperforming assets. We believe this has allowed us to better position the firm for increased future profitability. Our disposition strategy generally has been to negotiate sales of foreclosed properties on a property-by-property basis, although we have also utilized both traditional and online auctions as well as bulk sales, all of which may result in increased losses in comparison to a negotiated transaction. Our use of online auctions has been primarily limited to individual residential homes and lots. Although we do not anticipate using bulk sales as a recurring strategy, our nonperforming asset disposition strategy is reviewed on an on-going basis and could change in the future.

The decrease in intangible amortization expense between the three and nine months ended September 30, 2013 as compared to the same periods in September 30, 2012 was attributable to the final amortization of the core deposit intangible associated with the 2006 acquisition of Cavalry Bancorp. The remaining expense for the amortization of intangibles relates primarily to the intangible acquired in the Mid-America merger in November 2007. This core deposit intangible is being amortized over ten years, using an accelerated method which anticipates the life of the underlying deposits to which the intangible is attributable. Amortization expense associated with this core deposit intangible will approximate \$700,000 to \$1.2 million per year for the next four years with amounts declining each year for the remaining amortization period. Additionally, in connection with our acquisition of Miller Loughry Beach, an insurance brokerage firm, in July of 2008, we recorded a customer list intangible of \$1,270,000 which is being amortized over 20 years on an accelerated basis. Amortization of the customer list intangible amounted to approximately \$23,000 and \$71,000 for the three and nine months ended September 30, 2013 and \$30,000 and \$78,000 for the three and nine months ended September 30, 2012, respectively. As a result, we expect total intangible

amortization expense to approximate \$1.3 million in 2013.

Total other noninterest expenses increased by \$0.3 million and decreased by \$1.5 million, respectively, during the three and nine months ended September 30, 2013 when compared to 2012. During the second quarter of 2013, a \$2.0 million allowance for off-balance sheet exposures was reversed against other noninterest expense as a result of the underlying letter of credit being funded. For the nine months ended September 30, 2013, this \$2.0 million expense reversal was partially offset by an approximate \$877,000 prepayment penalty we incurred due to the prepayment of \$35.0 million in FHLB advances in the first quarter of 2013.

Our efficiency ratio (ratio of noninterest expense to the sum of net interest income and noninterest income) was 59.5% and 58.4% for the three and nine months ended September 30, 2013 compared to 65.4% and 68.5% for the three and nine months ended September 30, 2012. The efficiency ratio measures the amount of expense that is incurred to generate a dollar of revenue. The improvement in our efficiency ratio is primarily related to decreased other real estate expense between the two periods.

Income Taxes. During the three and nine months ended September 30, 2013, we recorded income tax expense of \$7.3 million and \$20.9 million, respectively, compared to \$5.0 million and \$14.4 million, respectively, for the three and nine months ended September 30, 2012. Our income tax expense for the year-to-date period ended September 30, 2013 reflects an effective income tax rate of 33.0% compared to 32.3% for the year-to-date period ended September 30, 2012 which is principally impacted by our investments in municipal securities, our real estate investment trust and bank-owned life insurance offset in part by meals and entertainment expense and executive compensation, portions of which are non-deductible.

Financial Condition

Our consolidated balance sheet at September 30, 2013 reflects an increase in total loans outstanding to \$3.969 billion at September 30, 2013 compared to \$3.712 billion at December 31, 2012. Total deposits increased by \$318.4 million between December 31, 2012 and September 30, 2013. Total assets were \$5.391 billion at September 30, 2013 compared to \$5.041 billion at December 31, 2012.

Loans. The composition of loans at September 30, 2013 and at December 31, 2012 and the percentage (%) of each classification to total loans are summarized as follows (dollars in thousands):

| | September 30, 2013 | | December 31, 2012 | |
|-----------------------------------|--------------------|---------|-------------------|---------|
| | Amount | Percent | Amount | Percent |
| Commercial real estate – mortgage | \$1,326,839 | 33.4 % | \$1,178,196 | 31.7 % |
| Consumer real estate – mortgage | 687,258 | 17.3 % | 679,926 | 18.3 % |
| Construction and land development | 319,974 | 8.1 % | 313,552 | 8.5 % |
| Commercial and industrial | 1,513,631 | 38.1 % | 1,446,578 | 39.0 % |
| Consumer and other | 121,600 | 3.1 % | 93,910 | 2.5 % |
| Total loans | \$3,969,302 | 100.0 % | \$3,712,162 | 100.0 % |

The primary changes within the composition of our loan portfolio at September 30, 2013 as compared to December 31, 2012 reflect increased loan demand in the commercial real estate segment. The commercial real estate – mortgage category includes owner-occupied commercial real estate loans. At September 30, 2013, approximately 48.1% of the outstanding principal balance of our commercial real estate mortgage loans was secured by owner-occupied properties. Owner-occupied commercial real estate is similar in many ways to our commercial and industrial lending in that these loans are generally made to businesses on the basis of the cash flows of the business rather than on the valuation of the real estate. Growth in the consumer and other segment is primarily the result of increased indirect automobile lending.

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The following table classifies our fixed and variable rate loans at September 30, 2013 according to contractual maturities of (1) one year or less, (2) after one year through five years, and (3) after five years. The table also classifies our variable rate loans pursuant to the contractual repricing dates of the underlying loans (dollars in thousands):

| | Amounts at September 30, 2013 | | | Percentage At September 30, 2013 | |
|---------------------------------------|-------------------------------|----------------|-------------|----------------------------------|---|
| | Fixed Rates | Variable Rates | Totals | | |
| Based on contractual maturity: | | | | | |
| Due within one year | \$203,984 | \$796,767 | \$1,000,751 | 25.2 | % |
| Due in one year to five years | 901,984 | 794,333 | 1,696,317 | 42.7 | % |
| Due after five years | 510,925 | 761,309 | 1,272,234 | 32.1 | % |
| Totals | \$1,616,893 | \$2,352,409 | \$3,969,302 | 100.0 | % |
| Based on contractual repricing dates: | | | | | |
| Daily floating rate (*) | \$- | \$2,093,771 | \$2,093,771 | 52.7 | % |
| Due within one year | 203,984 | 81,419 | 285,403 | 7.2 | % |
| Due in one year to five years | 901,984 | 166,154 | 1,068,138 | 26.9 | % |
| Due after five years | 510,925 | 11,065 | 521,990 | 13.2 | % |
| Totals | \$1,616,893 | \$2,352,409 | \$3,969,302 | 100.0 | % |

The above information does not consider the impact of scheduled principal payments.

(*) Daily floating rate loans are tied to Pinnacle Bank's prime lending rate or a national interest rate index with the underlying loan rates changing in relation to changes in these indexes. Interest rate floors are currently in effect on approximately \$844.6 million of our daily floating rate loan portfolio and on approximately \$498.3 million of the variable rate loan portfolio at varying maturities. The weighted average rate of the floors for the daily floating rate portfolio is 4.54% compared to the average coupon of 3.76% for this portfolio. The weighted average rate of the floors for the remaining variable rate portfolio is 4.17% compared to the average coupon rate of 3.15% for this portfolio. As a result, interest income on these loans will not adjust until the contractual rate on the underlying loan exceeds the interest rate floor.

Accruing Loans in Past Due Status. The following table is a summary of our accruing loans that were past due at least 30 days but less than 89 days and 90 days or more past due as of September 30, 2013 and December 31, 2012 (dollars in thousands):

| | September 30, 2013 | December 31, 2012 |
|---|--------------------|-------------------|
| Accruing loans past due 30 to 89 days: | | |
| Commercial real estate – mortgage | \$ 3,894 | \$ 503 |
| Consumer real estate – mortgage | 2,022 | 3,870 |
| Construction and land development | 41 | 3,511 |
| Commercial and industrial | 5,293 | 2,549 |
| Consumer and other | 1,782 | 444 |
| Total accruing loans past due 30 to 89 days | \$ 13,032 | \$ 10,877 |
| Accruing loans past due 90 days or more: | | |
| Commercial real estate – mortgage | \$ - | \$ - |
| Consumer real estate – mortgage | - | - |
| Construction and land development | - | - |

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| | | |
|---|------|------|
| Commercial and industrial | - | - |
| Consumer and other | - | - |
| Total accruing loans past due 90 days or more | \$ - | \$ - |

Ratios:

| | | | | |
|--|------|---|------|---|
| Accruing loans past due 30 to 89 days as a percentage of total loans | 0.33 | % | 0.29 | % |
| Accruing loans past due 90 days or more as a percentage of total loans | 0.00 | % | 0.00 | % |
| Total accruing loans in past due status as a percentage of total loans | 0.33 | % | 0.29 | % |

Potential Problem Loans. Potential problem loans, which are not included in nonperforming assets, amounted to approximately \$71.1 million or 1.8% of total loans at September 30, 2013 compared to \$105.4 million or 3.1% of total loans at December 31, 2012. Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by Pinnacle Bank's primary regulators, for loans classified as substandard, excluding the impact of substandard nonaccrual loans and substandard troubled debt restructurings. Troubled debt restructurings are not included in potential problem loans. Approximately \$6.1 million of potential problem loans were past due at least 30 days but less than 90 days as of September 30, 2013.

Nonperforming Assets and Troubled Debt Restructurings. At September 30, 2013, we had \$35.5 million in nonperforming assets compared to \$41.4 million at December 31, 2012. Included in nonperforming assets were \$20.0 million in nonaccrual loans and \$15.5 million in OREO at September 30, 2013 and \$22.8 million in nonaccrual loans and \$18.6 million in OREO assets at December 31, 2012. At September 30, 2013 and December 31, 2012, there were \$19.7 million and \$27.5 million, respectively, of troubled debt restructurings, all of which were accruing as of the restructured date and remain on accrual status but are considered impaired loans pursuant to U.S. GAAP.

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The following table is a summary of our nonperforming assets and troubled debt restructurings at September 30, 2013 and December 31, 2012 (dollars in thousands):

| | At December 31, 2012 | Payments, Sales and Reductions ⁽²⁾ | Foreclosures ⁽³⁾ ⁽⁴⁾ | Inflows | At September 30, 2013 |
|--|----------------------------|---|--|-----------|--------------------------------|
| Nonperforming assets: | | | | | |
| Nonaccrual loans: | | | | | |
| Commercial real estate – mortgage | \$ 9,291 | \$ (8,437) | \$ (640) | \$ 10,303 | \$ 10,517 |
| Consumer real estate – mortgage | 5,906 | (7,873) | (2,571) | 9,733 | 5,195 |
| Construction and land development | 4,509 | (4,389) | - | 1,187 | 1,307 |
| Commercial and industrial ⁽¹⁾ | 3,038 | (15,022) | - | 14,712 | 2,728 |
| Consumer and other | 79 | (544) | (334) | 1,042 | 243 |
| Total nonaccrual loans ⁽⁵⁾ | 22,823 | (36,265) | (3,545) | 36,977 | 19,990 |
| Other real estate owned | 18,580 | (6,603) | 3,545 | - | 15,522 |
| Total nonperforming assets | 41,403 | (42,868) | - | 36,977 | 35,512 |
| Troubled debt restructurings: | | | | | |
| Commercial real estate – mortgage | 20,264 | (6,788) | - | - | 13,476 |
| Consumer real estate – mortgage | 6,311 | (2,741) | - | 428 | 3,998 |
| Construction and land development | 71 | (5) | - | 50 | 116 |
| Commercial and industrial | 687 | (446) | - | 1,537 | 1,778 |
| Consumer and other | 119 | (85) | - | 259 | 293 |
| Total troubled debt restructurings | 27,452 | (10,065) | - | 2,274 | 19,661 |
| Total nonperforming assets and troubled debt restructurings | \$ 68,855 | \$ (52,933) | \$ - | \$ 39,251 | \$ 55,173 |
| Ratios: | | | | | |
| Nonaccrual loans to total loans | 0.61 | % | | | 0.50 % |
| Nonperforming assets to total loans plus other real estate owned | 1.11 | % | | | 0.89 % |
| Nonperforming assets plus troubled debt restructurings to total loans and other real estate owned | 1.35 | % | | | 1.38 % |
| Nonperforming assets, potential problem loans and troubled debt restructurings to Pinnacle Bank Tier I capital and allowance for loan losses | 31.04 | % | | | 21.21 % |

Nonperforming loan inflows and payments, sales and reductions for the year-to-date period ended September 30, (1) 2013, include one \$8.7 million standby letter of credit that funded during the second quarter of 2013 and became a nonperforming loan. This nonperforming loan was resolved during the second quarter of 2013.

Payments, sales and reductions in nonaccrual loans are primarily attributable to payments we have collected from borrowers, charge-offs of recorded balances and nonaccrual loans that have been returned to accruing status during the nine months ended September 30, 2013. Payments, sales and reductions in other real estate owned represent (2) either the sale, disposition or valuation adjustment on properties which had previously been foreclosed upon or acquired by deed in lieu of foreclosure. Payments, sales and reductions in troubled debt restructurings are those loans which were previously restructured whereby the borrower has reduced the outstanding balance of the loan or re-defaulted on the terms of the loan and therefore been charged-off.

(3) Foreclosures in nonaccrual loans and troubled debt restructurings are representative of transfers of balances to OREO during the nine months ended September 30, 2013.

(4)

Inflows in nonaccrual loans are attributable to loans where we have discontinued the accrual of interest at some point during the nine months ended September 30, 2013. Increases in OREO represent the value of properties that have been foreclosed upon or acquired by deed in lieu of foreclosure during 2013. Increases in troubled debt restructurings are those loans where we have granted the borrower a concession due to the deteriorating financial condition of the borrower during 2013. These concessions can be in the form of a reduced interest rate, extended maturity date or other matters.

(5) Approximately \$8.7 million, or 43.4%, and \$9.4 million, or 41.0%, as of September 30, 2013 and December 31, 2012, respectively, of nonaccrual loans included above are currently paying pursuant to their contractual terms.

At September 30, 2013, we owned \$15.5 million in other real estate which we had acquired (usually through foreclosure) from borrowers, compared to \$18.6 million at December 31, 2012, substantially all of which is located within our principal markets. We segment our OREO into three categories: developed lots, undeveloped land, and other. The other category primarily consists of office buildings and existing homes. The following table shows the classification of our OREO (dollars in thousands):

| | September 30, 2013 | December 31, 2012 |
|------------------|--------------------------|-------------------------|
| Developed lots | \$ 1,361 | \$ 1,835 |
| Undeveloped land | 12,139 | 13,285 |
| Other | 2,022 | 3,460 |
| | \$ 15,522 | \$ 18,580 |

Allowance for Loan Losses (allowance). We maintain the allowance at a level that our management deems appropriate to adequately cover the probable losses inherent in the loan portfolio. As of September 30, 2013 and December 31, 2012, our allowance for loan losses was approximately \$67.3 million and \$69.4 million, respectively, which our management deemed to be adequate at each of the respective dates. The judgments and estimates associated with our allowance determination are described under Critical Accounting Estimates in our Annual Report on Form 10-K for the year ended December 31, 2012.

The following table sets forth, based on management's best estimate, the allocation of the allowance to categories of loans as well as the unallocated portion as of September 30, 2013 and December 31, 2012 and the percentage of loans in each category to total loans (dollars in thousands):

| | September 30, 2013 | | December 31, 2012 | |
|-----------------------------------|-----------------------|---------|----------------------|---------|
| | Amount | Percent | Amount | Percent |
| Commercial real estate - mortgage | \$20,850 | 33.4 % | \$19,634 | 31.7 % |
| Consumer real estate - mortgage | 7,909 | 17.3 % | 8,762 | 18.3 % |
| Construction and land development | 8,034 | 8.1 % | 9,164 | 8.5 % |
| Commercial and industrial | 24,399 | 38.1 % | 24,738 | 39.0 % |
| Consumer and other | 1,485 | 3.1 % | 1,094 | 2.5 % |
| Unallocated | 4,603 | NA | 6,025 | NA |
| Total allowance for loan losses | \$67,280 | 100.0 % | \$69,417 | 100.0 % |

The following is a summary of changes in the allowance for loan losses for the year-to-date period ended September 30, 2013 and for the year ended December 31, 2012 and the ratio of the allowance for loan losses to total loans as of the end of each period (dollars in thousands):

| | Nine months ended September 30, 2013 | Year ended December 31, 2012 |
|-----------------------------------|--|---------------------------------------|
| Balance at beginning of period | \$ 69,417 | \$ 73,975 |
| Provision for loan losses | 5,631 | 5,569 |
| Charged-off loans: | | |
| Commercial real estate – mortgage | (3,888) | (4,667) |
| Consumer real estate – mortgage | (2,097) | (6,731) |

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| | | | | |
|---|-----------|-----------|------|---|
| Construction and land development | (1,351) | (2,530) | | |
| Commercial and industrial | (5,643) | (4,612) | | |
| Consumer and other loans | (1,109) | (1,117) | | |
| Total charged-off loans | (14,088) | (19,657) | | |
| Recoveries of previously charged-off loans: | | | | |
| Commercial real estate – mortgage | 176 | 285 | | |
| Consumer real estate – mortgage | 1,127 | 818 | | |
| Construction and land development | 862 | 1,155 | | |
| Commercial and industrial | 3,961 | 7,175 | | |
| Consumer and other loans | 194 | 97 | | |
| Total recoveries of previously charged-off loans | 6,320 | 9,530 | | |
| Net charge-offs | (7,768) | (10,127) | | |
| Balance at end of period | \$ 67,280 | \$ 69,417 | | |
| Ratio of allowance for loan losses to total loans outstanding at end of period | 1.70 | % | 1.87 | % |
| Ratio of net charge-offs to average total loans outstanding for the period ⁽¹⁾ | 0.27 | % | 0.29 | % |

(1) Net charge-offs for the year-to-date period ended September 30, 2013 have been annualized.

Management assesses the adequacy of the allowance prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, the views of Pinnacle Bank's regulators, adverse situations that may affect the borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

For further discussion regarding our allowance for loan losses, refer to the Annual Report on Form 10-K as of and for the year ended December 31, 2012.

Investments. Our investment portfolio, consisting primarily of U.S. Treasuries, Federal agency bonds, mortgage-backed securities, and state and municipal securities amounted to \$743.9 million and \$707.2 million at September 30, 2013 and December 31, 2012, respectively. Our investment portfolio serves many purposes including serving as a stable source of income, collateral for public funds and as a potential liquidity source. A summary of our investment portfolio at September 30, 2013 and December 31, 2012 follows:

| | September 30, 2013 | December 31, 2012 |
|-------------------------|--------------------|-------------------|
| Weighted average life | 5.47 years | 4.77 years |
| Effective duration | 4.30% | 3.16% |
| Weighted average coupon | 3.53% | 3.88% |
| Tax equivalent yield | 3.04% | 3.26% |

Deposits and Other Borrowings. We had approximately \$4.334 billion of deposits at September 30, 2013 compared to \$4.015 billion at December 31, 2012. Our deposits consist of noninterest and interest-bearing demand accounts, savings accounts, money market accounts and time deposits. Additionally, we entered into agreements with certain customers to sell certain securities under agreements to repurchase the security the following day. These agreements (which are typically associated with comprehensive treasury management programs for our clients and provide them with short-term returns for their excess funds) amounted to \$84.0 million at September 30, 2013 and \$114.7 million at December 31, 2012. Additionally, at September 30, 2013, and December 31, 2012, Pinnacle Bank had borrowed \$115.7 million and \$75.9 million, respectively, in advances from the FHLB. At September 30, 2013, Pinnacle Bank also has approximately \$648.0 million in availability with the FHLB.

Generally, we have classified our funding base as either core funding or non-core funding. Core funding consists of all deposits other than time deposits issued in denominations greater than \$250,000. All other funding is deemed to be non-core. The following table represents the balances of our deposits and other funding and the percentage of each type to the total at September 30, 2013 and December 31, 2012 (dollars in thousands):

| | September 30, 2013 | Percent | December 31, 2012 | Percent | |
|--|--------------------------|---------|-------------------------|---------|--|
| Core funding: | | | | | |
| Transaction accounts | \$1,908,617 | 41.2 % | \$1,746,476 | 40.5 % | |
| Money market accounts | 1,560,578 | 33.7 % | 1,561,714 | 36.2 % | |
| Time deposit accounts less than \$250,000 | 433,806 | 9.4 % | 467,013 | 10.8 % | |
| Total core funding | 3,903,001 | 84.3 % | 3,775,203 | 87.6 % | |
| Non-core funding: | | | | | |
| Relationship based non-core funding: | | | | | |
| Reciprocating NOW deposits ⁽¹⁾ | 14,799 | 0.3 % | - | - | |
| Reciprocating money market accounts ⁽¹⁾ | 300,021 | 6.5 % | 100,542 | 2.3 % | |
| Reciprocating time deposits | 33,426 | 0.7 % | 52,239 | 1.2 % | |
| Other time deposits | 82,296 | 1.8 % | 87,204 | 2.0 % | |
| Securities sold under agreements to repurchase | 84,032 | 1.8 % | 114,667 | 2.7 % | |
| Total relationship based non-core funding | 514,574 | 11.1 % | 354,652 | 8.2 % | |
| Wholesale funding: | | | | | |
| Brokered deposits | - | 0.00 % | - | 0.00 % | |
| Federal Home Loan Bank advances | 115,671 | 2.5 % | 75,850 | 1.8 % | |
| Holding company loan | 16,807 | 0.4 % | 23,682 | 0.6 % | |
| Subordinated debt – Pinnacle Financial | 82,476 | 1.8 % | 82,476 | 1.9 % | |
| Total wholesale funding | 214,954 | 4.7 % | 182,008 | 4.2 % | |
| Total non-core funding | 729,528 | 15.8 % | 536,660 | 12.5 % | |
| Totals | \$4,632,529 | 100.0 % | \$4,311,863 | 100.0 % | |

The reciprocating categories consists of deposits we receive from the Certificate of Deposit Account Registry (1)Services network (CDARS) in exchange for deposits of our customers in excess of our FDIC coverage limit that we place with the CDARS network.

Our funding policies impose limits on the amount of non-core funding we can utilize. Periodically, we may exceed our policy limitations, at which time management will develop plans to bring our core funding ratios back within compliance. At September 30, 2013 and December 31, 2012, we were in compliance with our core funding policies. As noted in the table above, our core funding as a percentage of total funding decreased from 87.6% at December 31, 2012 to 84.3% at September 30, 2013.

Continuing to grow our core deposit base is a key strategic objective of our firm. Our core funding percentage decreased by 3.4% between December 31, 2012 and September 30, 2013 while our core deposits increased by \$127.8 million. The decrease in our core funding percentage was impacted by a number of factors including our strategic decision to acquire low cost funding from the Federal Home Loan Bank, increased participation in the CDARS program for money market accounts and increased competition for money market accounts in our market.

Additionally, we have numerous commercial and affluent consumer depositors that maintain significant balances in their transaction and money market accounts. These deposits are subject to significant fluctuations from time to time for such purposes as distributions to owners, taxes, business acquisitions, etc. As a result, our core funding ratios may also fluctuate meaningfully based on these factors.

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The amount of time deposits as of September 30, 2013 amounted to \$549.5 million. The following table shows our time deposits, in denominations of \$250,000 and less and those of denominations greater than \$250,000 by category based on time remaining until maturity of (1) three months or less, (2) over three but less than nine months, (3) over nine but less than twelve months and (4) over twelve months and the weighted average rate for each category (in thousands):

| | Balances | Weighted Avg. Rate | |
|---|------------|--------------------------|---|
| <u>Denominations less than \$250,000</u> | | | |
| Three months or less | \$ 118,127 | 0.44 | % |
| Over three but less than six months | 95,268 | 0.47 | % |
| Over six but less than twelve months | 132,158 | 0.56 | % |
| Over twelve months | 121,679 | 0.95 | % |
| | \$467,232 | 0.61 | % |
| <u>Denomination \$250,000 and greater</u> | | | |
| Three months or less | \$ 19,367 | 0.99 | % |
| Over three but less than six months | 17,392 | 0.55 | % |
| Over six but less than twelve months | 29,343 | 0.51 | % |
| Over twelve months | 16,194 | 1.58 | % |
| | \$82,296 | 0.84 | % |
| Totals | \$549,528 | 0.65 | % |

Subordinated debt and other borrowings. We have four wholly-owned Pinnacle Financial subsidiaries that are statutory business trusts. We are the sole sponsor of the Trusts and acquired each Trust's common securities. The Trusts were created for the exclusive purpose of issuing 30-year capital trust preferred securities and using the proceeds to acquire junior subordinated debentures (Subordinated Debentures) issued by Pinnacle Financial. The sole assets of the Trusts are the Subordinated Debentures. At September 30, 2013, our \$2,476,000 investment in the Trusts is included in other investments in the accompanying consolidated balance sheets and our \$82,476,000 obligation is reflected as subordinated debt.

| Date Established | Maturity | Common Securities | Subordinated Debentures | Floating Interest Rate | Interest Rate at September 30, 2013 |
|-----------------------------|--------------------|----------------------|----------------------------|------------------------|--|
| Trust I December 29, 2003 | December 30, 2033 | \$ 310,000 | \$ 10,000,000 | Libor + 2.80% | 3.07 % |
| Trust II September 15, 2005 | September 30, 2035 | 619,000 | 20,000,000 | Libor + 1.40% | 1.67 % |
| Trust III September 7, 2006 | September 30, 2036 | 619,000 | 20,000,000 | Libor + 1.65% | 1.92 % |
| Trust IV October 31, 2007 | September 30, 2037 | 928,000 | 30,000,000 | Libor + 2.85% | 3.12 % |

The securities bear a floating interest rate based on a spread over 3-month LIBOR which is set each quarter. Distributions are payable quarterly. The Trust Preferred Securities are subject to mandatory redemption upon repayment of the Subordinated Debentures at their stated maturity date or their earlier redemption in an amount equal to their liquidation amount plus accumulated and unpaid distributions to the date of redemption. We guarantee the payment of distributions and payments for redemption or liquidation of the Trust Preferred Securities to the extent of funds held by the Trusts. Pinnacle Financial's obligations under the Subordinated Debentures together with the guarantee and other back-up obligations, in the aggregate, constitute a full and unconditional guarantee by Pinnacle Financial of the obligations of the Trusts under the Trust Preferred Securities.

The Subordinated Debentures are unsecured, bear interest at a rate equal to the rates paid by the Trusts on the Trust Preferred Securities and mature on the same dates as those noted above for the Trust Preferred Securities. Interest is

payable quarterly. We may defer the payment of interest at any time for a period not exceeding 20 consecutive quarters provided that the deferral period does not extend past the stated maturity. During any such deferral period, distributions on the Trust Preferred Securities will also be deferred and our ability to pay dividends on our common shares and preferred shares will be restricted.

The Trust Preferred Securities may be redeemed prior to maturity at our option. The Trust Preferred Securities may also be redeemed at any time in whole (but not in part) in the event of unfavorable changes in laws or regulations that result in (1) the Trust becoming subject to federal income tax on income received on the Subordinated Debentures, (2) interest payable by the parent company on the Subordinated Debentures becoming non-deductible for federal tax purposes, (3) the requirement for the Trust to register under the Investment Company Act of 1940, as amended, or (4) loss of the ability to treat the trust preferred securities as "Tier I capital" under the Federal Reserve capital adequacy guidelines. Under current Federal Reserve regulations, the trust preferred securities qualify as Tier 1 capital. The Federal Reserve published final Basel III capital regulations in June 2013 which continued the treatment of preferred securities as Tier I capital for holding companies under \$15.0 billion in assets.

On June 15, 2012, Pinnacle Financial entered into a loan agreement with a bank for \$25 million. Pinnacle Financial's borrowings under the Loan Agreement bear interest at rates that, at Pinnacle Financial's option, can be either:

A base rate generally defined as the sum of (i) the highest of (x) the lender's "base" or "prime" rate, (y) the average overnight federal funds effective rate plus one-half percent (0.50%) per annum or (z) one-month LIBOR plus one percent (1%) per annum and (ii) an applicable margin as noted below; or

A LIBOR rate generally defined as the sum of (i) the average of the offered rates of interest quoted in the London Inter-Bank Eurodollar Market for U.S. Dollar deposits with prime banks (as published by Reuters or other commercially available source) for one, two or three months (all as selected by the Company), and (ii) an applicable margin.

The applicable margin under the Loan Agreement ranges from 2.25% (225 basis points) to 3.00% (300 basis points) depending on the total aggregate principal amount outstanding under the Loan Agreement. The initial applicable margin for both base rate and LIBOR rate loans is 3.00% (300 basis points).

Pinnacle Financial is required to make quarterly principal payments of \$625,000 beginning on September 30, 2012, and the loan matures on June 15, 2017. Pinnacle Financial is permitted to prepay all or a portion of the principal amount outstanding under the Loan Agreement without penalty (in minimum aggregate amounts of \$100,000) at any time so long as no event of default or unmatured event of default has occurred and is continuing. During the second quarter of 2013, Pinnacle Financial made a \$5.0 million prepayment on this loan. At September 30, 2013, the balance owed on this loan was \$16.8 million.

On October 2, 2013, the Loan Agreement was amended to permit Pinnacle Financial to pay dividends on its capital stock so long as no event of default was then existing or would be caused by the payment of such dividends.

Capital Resources. At September 30, 2013 and December 31, 2012, our stockholders' equity amounted to \$712.2 million and \$679.1 million, respectively, an increase of approximately \$33.1 million. Substantially all of this increase is attributable to our year-to-date net income offset by decreases in unrealized gains on our securities portfolio.

Dividends. Pursuant to Tennessee banking law, Pinnacle Bank may not, without the prior consent of the TDFI, pay any dividends to Pinnacle Financial in a calendar year in excess of the total of Pinnacle Bank's net profits for that year plus the retained profits for the preceding two years. During the nine months ended September 30, 2013, Pinnacle Bank paid dividends of \$8.9 million to Pinnacle Financial. As of September 30, 2013, Pinnacle Bank could pay approximately \$95.8 million of additional dividends to Pinnacle Financial without prior TDFI approval. On October 15, 2013, our Board of Directors approved the initiation of a quarterly cash dividend to common shareholders. The initial dividend of \$0.08 per share will be paid on December 20, 2013 to common shareholders of record as of the close of business on November 26, 2013. The amount and timing of all future dividend payments, if any, is subject to Board discretion and will depend on our earnings, capital position, financial condition and other factors, including new regulatory capital requirements, as they become known to us.

Our objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. Our Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management.

Interest Rate Sensitivity. In the normal course of business, we are exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements which we use to help us manage interest rate sensitivity include an earnings simulation model and an economic value of equity model. These measurements are used in conjunction with competitive pricing analysis.

Earnings simulation model. We believe interest rate risk is best measured by our earnings simulation modeling.

Earning assets, interest-bearing liabilities and off-balance sheet financial instruments are combined with ALCO forecasts of interest rates for the next 12 months and are combined with other factors in order to produce various earnings simulations. To limit interest rate risk, we have guidelines for our earnings at risk which seek to limit the variance of net interest income in both gradual and instantaneous changes to interest rates. For changes up or down in rates from management's flat interest rate forecast over the next twelve months, limits in the decline in net interest income are as follows:

- +/- 10.0% for a gradual change of 400 points; +/-20.0% for an instantaneous change of 400 basis points
- +/- 7.5% for a gradual change of 300 points; +/- 15.0% for an instantaneous change of 300 basis points
- +/- 5.0% for a gradual change of 200 points; +/- 10.0% for an instantaneous change of 200 basis points
- +/- 2.5% for a gradual change of 100 points; +/- 5.0% for an instantaneous change of 100 basis points

Economic value of equity. Our economic value of equity model measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are determined by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case economic value of equity. To help limit interest rate risk, we have a guideline stating that for an instantaneous 400 basis point change in interest rates up or down, the economic value of equity should not decrease by more than 40 percent from the base case; for a 300 basis point instantaneous change in interest rates up or down, the economic value of equity should not decrease by more than 30 percent; for a 200 basis point instantaneous change in interest rates up or down, the economic value of equity should not decrease by more than 20 percent; and for a 100 basis point instantaneous change in interest rates up or down, the economic value of equity should not decrease by more than 10 percent.

At September 30, 2013, our model results indicated that our balance sheet is slightly liability sensitive to parallel shifts in interest rates in increments of 100 to 150 basis points. The slight liability sensitivity present at the 100 to 150 basis point increment level is primarily attributable to the fact that our loan floors will prevent the rise in yields on our loan portfolio at these levels from out-pacing the potential rise in deposit costs. We become asset-sensitive once those rate increments reach 150 to 200 basis points as we break through interest rate floors placed on variable and floating rate loans at a more substantial level of interest rate increases. Absent any other asset liability strategies an interest rate increase of a 150 to 200 basis point level could result in slightly increased margins. Over time, we expect to reduce our slight liability sensitivity as we engage in initiatives to bring our firm toward an interest rate neutral position over the next several quarters.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios as part of its responsibility to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies.

We may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage our interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. We also enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments.

As discussed more fully in footnote 9 in the Notes to the Consolidated Financial Statements, during the second quarter of 2013, we entered into a cash flow hedge relationship to manage our future interest rate exposure. We account for derivative financial instruments in accordance with ASC 815 which requires recognition of all derivative instruments on the balance sheet as either an asset or liability measured at fair value through adjustments to either accumulated other comprehensive income within shareholders' equity or current earnings. Fair value is defined as the price that would be received to sell a derivative asset or paid to transfer a derivative liability in an orderly transaction between market participants on the transaction date. Fair value is determined using available market information and appropriate valuation methodologies. Amounts of collateral posted or received have not been netted within the related derivatives.

We have prepared written hedge documentation, identifying the risk management objective and designating the derivative instruments as part of a cash flow hedging relationship. This transaction was designated as an ASC 815 hedge and was assessed at inception and will be assessed on an ongoing basis as to the effectiveness of the derivative instrument in offsetting changes in cash flows of the hedged item. For a cash flow hedge, changes in the fair value of the derivative instrument, to the extent that it is effective, are recorded in accumulated other comprehensive income and subsequently reclassified to earnings as the hedged transaction impacts net income. Any ineffective portion of a cash flow hedge is recognized currently in earnings. Cash flows from derivative contracts will be reported as operating activities on the Consolidated Statements of Cash Flows.

Liquidity Risk Management. The purpose of liquidity risk management is to ensure that there are sufficient cash flows to satisfy loan demand, deposit withdrawals, and our other needs. Traditional sources of liquidity for a bank include asset maturities and growth in core deposits. A bank may achieve its desired liquidity objectives from the management of its assets and liabilities and by internally generated funding through its operations. Funds invested in marketable instruments that can be readily sold and the continuous maturing of other earning assets are sources of liquidity from an asset perspective. The liability base provides sources of liquidity through attraction of increased deposits and borrowing funds from various other institutions.

Changes in interest rates also affect our liquidity position. We currently price deposits in response to market rates and our management intends to continue this policy. If deposits are not priced in response to market rates, a loss of deposits could occur which would negatively affect our liquidity position.

Scheduled loan payments are a relatively stable source of funds, but loan payoffs and deposit flows fluctuate significantly, being influenced by interest rates, general economic conditions and competition. Additionally, debt

security investments are subject to prepayment and call provisions that could accelerate their payoff prior to stated maturity. We attempt to price our deposit products to meet our asset/liability objectives consistent with local market conditions. Our ALCO is responsible for monitoring our ongoing liquidity needs. Our regulators also monitor our liquidity and capital resources on a periodic basis.

In addition, Pinnacle Bank is a member of the FHLB. As a result, Pinnacle Bank receives advances from the FHLB, pursuant to the terms of various borrowing agreements, which assist it in the funding of its home mortgage and commercial real estate loan portfolios. Additionally, Pinnacle Financial recognized a discount on FHLB advances in conjunction with previous acquisitions. The remaining discount was \$175,000 at September 30, 2013. Under the borrowing agreements with the FHLB, Pinnacle Bank has pledged certain qualifying residential mortgage loans and, pursuant to a blanket lien, all qualifying commercial mortgage loans as collateral. At September 30, 2013, Pinnacle Bank had received advances from the FHLB totaling \$115.5 million at the following rates and maturities (dollars in thousands):

| Scheduled Maturities | Amount | Interest Rates ⁽¹⁾ | |
|--------------------------------|-----------|-------------------------------|---|
| 2013 | \$100,000 | 0.17 | % |
| 2014 | - | - | |
| 2015 | - | - | |
| 2016 | 15,000 | 2.39 | % |
| 2017 | - | - | |
| Thereafter | 496 | 2.44 | % |
| Total | \$115,496 | | |
| Weighted average interest rate | | 0.46 | % |

(1) Some FHLB advances include variable interest rates and could increase in the future. The table reflects rates in effect as of September 30, 2013.

As part of our asset liability policy, we seek to manage our interest rate risk and we utilize various strategies in order to achieve our goals. During the first quarter of 2013, we restructured approximately \$35.0 million of FHLB advances to reduce our ongoing funding costs. This restructuring was undertaken because the weighted average interest rate on those FHLB advances was 1.79%, significantly higher than the rate for replacement funding. Other than the interest rates associated with the individual advances, the terms of the replacement advances were similar to those of the advances restructured. In conjunction with this restructuring, we incurred a one-time charge to earnings of approximately \$877,000 during the first quarter of 2013.

Pinnacle Bank also has accommodations with upstream correspondent banks for unsecured short-term advances which aggregate \$155 million. These accommodations have various covenants related to their term and availability, and in most cases must be repaid within a month. There were no outstanding borrowings at September 30, 2013, or during the quarter then ended under these agreements. Pinnacle Bank also has approximately \$500 million in available Federal Reserve discount window lines of credit.

At September 30, 2013, excluding reciprocating time deposits issued through the CDARS network, we had no brokered certificates of deposit. Historically, we have issued brokered certificates through several different brokerage houses based on competitive bid. Typically, these funds have been for varying maturities of up to two years and were issued at rates which were competitive to rates we would be required to pay to attract similar deposits within our local markets as well as rates for FHLB advances of similar maturities. Although we consider these deposits to be a ready source of liquidity under current market conditions, we anticipate that these deposits will represent an insignificant percentage of our total funding in 2013 as we seek to maintain a higher level of core deposits.

At September 30, 2013, we had no significant commitments for capital expenditures. Our management believes that we have adequate liquidity to meet all known contractual obligations and unfunded commitments, including loan

commitments and reasonable borrower, depositor, and creditor requirements over the next twelve months. Federal regulators are in the process of defining additional liquidity guidelines for certain banks in the United States. We anticipate that ultimately some of these liquidity guidelines may be imposed on banks like ours such that an increase in the absolute level of liquidity on our balance sheet could be required. Consequently, this could result in lower net interest margins for us in future periods.

Off-Balance Sheet Arrangements. At September 30, 2013, we had outstanding standby letters of credit of \$62.4 million and unfunded loan commitments outstanding of \$1.2 billion. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, Pinnacle Bank has the ability to liquidate Federal funds sold or on a short-term basis to borrow and purchase Federal funds from other financial institutions.

Impact of Inflation

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with U.S. GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.

Recent Accounting Pronouncements

With the exception of those noted in the Notes to the Consolidated Financial Statements herein, there are currently no new accounting standards that have been issued that will have a significant impact on the Company's financial position, results of operations or cash flows upon adoption.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this Item 3 is included on pages 23 through 32 of Part I - Item 2 - "Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Pinnacle Financial maintains disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act"), that are designed to ensure that information required to be disclosed by it in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to Pinnacle Financial's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Pinnacle Financial carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this report. Based on the evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer concluded that Pinnacle Financial's disclosure controls and procedures were effective.

Changes in Internal Controls

There were no changes in Pinnacle Financial's internal control over financial reporting during Pinnacle Financial's fiscal quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect,

Pinnacle Financial's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Various legal proceedings to which Pinnacle Financial or a subsidiary of Pinnacle Financial is a party arise from time to time in the normal course of business. Except as described below, there are no material pending legal proceedings to which Pinnacle Financial or a subsidiary of Pinnacle Financial is a party or of which any of their property is the subject.

During the fourth quarter of 2011, a customer of Pinnacle Bank filed a putative class action lawsuit (styled John Higgins, et al, v. Pinnacle Financial Partners, Inc., d/b/a Pinnacle National Bank) in Davidson County, Tennessee Circuit Court against Pinnacle Bank and Pinnacle Financial, on his own behalf, as well as on behalf of a purported class of Pinnacle Bank's customers within the State of Tennessee alleging that Pinnacle Bank's method of ordering debit card transactions had caused customers of Pinnacle Bank to incur higher overdraft charges than had a different method been used. Pinnacle Financial and Pinnacle Bank reached a tentative settlement with the plaintiff during the second quarter of 2013. Although the settlement has not been finalized, Pinnacle Financial does not believe that any liability arising from this legal matter will have a material adverse effect on Pinnacle Financial's consolidated financial condition, operating results or cash flows.

ITEM 1A. RISK FACTORS

Investing in Pinnacle Financial involves various risks which are particular to our company, our industry and our market area. We believe all significant risks to investors in Pinnacle Financial have been outlined in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. However, other risks may prove to be important in the future, and new risks may emerge at any time. We cannot predict with certainty all potential developments which could materially affect our financial performance or condition. Except as set forth below or as described under Part II, Item 1A Risk Factors of our quarterly report on Form 10-Q for the quarter ended June 30, 2013, there has been no material change to our risk factors as previously disclosed in the above described Annual Report on Form 10-K.

Our ability to declare and pay dividends is limited.

While we have announced that our board of directors had approved the initiation of a quarterly cash dividend on our common stock there can be no assurance of whether or when we may pay dividends on our common stock in the future. Future dividends, if any, will be declared and paid at the discretion of our board of directors and will depend on a number of factors. Our principal source of funds used to pay cash dividends on our common stock will be dividends that we receive from Pinnacle Bank. Although Pinnacle Bank's asset quality, earnings performance, liquidity and capital requirements will be taken into account before we declare or pay any future dividends on our common stock, our board of directors will also consider our liquidity and capital requirements and our board of directors could determine to declare and pay dividends without relying on dividend payments from Pinnacle Bank.

Federal and state banking laws and regulations and state corporate laws restrict the amount of dividends we may declare and pay. For example, under guidance issued by the Federal Reserve Board, as a bank holding company, we are required to consult with the Federal Reserve before declaring dividends and are to consider eliminating, deferring or reducing dividends if (i) our net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends, (ii) our prospective rate of earnings retention is not consistent with our capital needs and overall current and prospective financial condition, or (iii) we will not meet, or are in danger of not meeting, our minimum regulatory capital adequacy ratios.

In addition, the terms of the indentures pursuant to which our subordinated debentures have been issued prohibit us from paying dividends on our common stock at times when we are deferring the payment of interest on our subordinated debentures. Moreover, the terms of our Loan Agreement prohibit us from paying dividends on our

common stock when there is an event of default or unmatured event of default under the Loan Agreement or when the payment of the dividend would result in an event of default or unmatured event of default under the Loan Agreement.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

| Period | Total Number of Shares Repurchased (1) | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares That May Yet Be Purchased Under the Plans or Programs |
|---|--|---------------------------------------|--|---|
| July 1, 2013 to July 31, 2013 | - | \$ - | - | - |
| August 1, 2013 to August 31, 2013 | 14,048 | 28.36 | - | - |
| September 1, 2013 to September 30, 2013 | 1,931 | 28.11 | - | - |
| Total | 15,979 | \$ 28.33 | - | - |

During the quarter ended September 30, 2013, 58,128 shares of restricted stock previously awarded to certain of (1) our associates and leadership team members vested. We withheld 15,979 shares to satisfy tax withholding requirements associated with the vesting of these restricted shares.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

- 10.1 First Amendment to Loan Agreement between U.S. Bank National Association and Pinnacle Financial Partners, Inc., dated October 2, 2013
 - 31.1 Certification pursuant to Rule 13a-14(a)/15d-14(a)
 - 31.2 Certification pursuant to Rule 13a-14(a)/15d-14(a)
 - 32.1 Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
 - 32.2 Certification pursuant to 18 USC Section 1350 – Sarbanes-Oxley Act of 2002
 - 101.INS XBRL Instance Document
 - 101.SCH XBRL Schema Document
 - 101.CAL XBRL Calculation Linkbase Document
 - 101.LAB XBRL Label Linkbase Document
 - 101.PRE XBRL Presentation Linkbase Document
 - 101.DEF XBRL Definition Linkbase Document
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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PINNACLE FINANCIAL PARTNERS, INC.

November 1, 2013 /s/ M. Terry Turner
M. Terry Turner
President and Chief Executive Officer

November 1, 2013 /s/ Harold R. Carpenter
Harold R. Carpenter
Chief Financial Officer

