CAPITAL MODEL 2.0 PROVES THAT PATIENT CAPITAL PAYS OFF

An Update on Southern Bancorp's Capital Campaign

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Southern Bancorp's mission is to create economic opportunity in rural and underserved communities by providing responsible and responsive financial products and services that balance profits with purpose.

INTRODUCTION

Since we released Raising Core Equity Capital for Community Development Banks — A New Capital Model[1] in 2020, Southern Bancorp, Inc. ('Southern') has delivered on its promise – the promise of a return 'of' and 'on' equity invested in a high impact community development financial institution ('CDFI'). By providing a quarterly common stock dividend combined with efficient exit mechanisms, Southern's track record demonstrates that community development banks can solve the liquidity dilemma that has limited their ability to access equity investments from conventional and impact investors. Southern has shown that community development banks can achieve their mission and margin goals without having to go public or dramatically alter their capital configurations. The ability of community development banks to provide reasonable financial returns while continuing to have high impact in underserved communities means that equity investments in CDFIs can take their deserved place in mainstream investment portfolios. By removing the liquidity impediment for CDFI bank investments, the ball is now in the court of investors to make meaningful equity investments into companies like Southern.

SETTING THE STAGE

The disproportionate impact on underserved communities, especially on communities of color, of the Covid-19 pandemic has not abated, with the economy weakening and inflation rising.[2] Minority-owned retail small businesses have been especially hard hit;[3] commercial real estate vacancies have increased and values decimated. Unemployment, while decreasing, is still almost twice as high among African

[1] www.BankSouthern.com/CapitalCampaignInsights
[2] https://www.chicagofed.org/publications/working-papers/2022/2022-32 and https://www.chicagofed.org/publications/economic-perspectives/2022/2
[3] https://www.nytimes.com/2021/04/04/business/ppp-loans-minority-businesses.html?searchResultPosition=1

Americans[4] as white Americans, unemployment for African Americans between the ages of 16 and 19 years is still in double digits[5]. Covid-19 has increased housing insecurity for people of color who already faced high rent burdens prior to the pandemic. Rates of infection and death from Covid-19[6] among Black and Brown people were much higher than the rest of the population during the height of the pandemic. As the pandemic winds down, the level of unemployment and underemployment,[7] food insecurity, housing instability, and homelessness[8] in communities of color are anticipated to remain elevated. These inequities were amplified in the summer of 2020 during the civil disruptions following the murder of George Floyd.

An unanticipated consequence of the pandemic and the racial injustice awakening has been the light cast on CDFIs that have "punched above their weight" in addressing these structural fault lines. CDFIs have taken the lead in administering state and local government pandemic relief programs for small businesses, homelessness, and affordable housing with alacrity and success. In a virtuous circle, CDFIs have benefited from increased support. Foundations, large financial institutions, and increasingly corporations and individual philanthropists have recognized their efforts and rewarded CDFIs with grants, attractively priced loans, and deposits. The federal government has significantly increased the funding of the US Treasury's CDFI Fund and created the $9.0 billion Emergency Capital Investment Program (ECIP) to increase the capitalization of CDFI banks, credit unions, and minority depositories.

Southern expanded its leading role in the CDFI industry during the pandemic. It was a major regional participant in the CARES Act Paycheck Protection Program (PPP), originating 2,614 PPP loans totaling $157.7 million through the end of the program on May 31, 2021, essentially all of which qualified for forgiveness and were forgiven by June 30, 2022. Southern created a grant program for struggling small businesses that did not qualify for PPP loans in 2020; this program awarded $128,000 to 128 grantees, mostly minority- and woman-owned businesses. The program was funded by Southern and its partners, including other community banks. In December 2021, Southern led the capitalization of an emerging CDFI microloan program, the Minority Business Empowerment Fund serving minority owned small businesses in central Arkansas, helping this emerging CDFI loan fund raise grant and debt capital. Southern's Volunteer Income Tax Assistance Program had record years in 2021 and 2022 helping file 3,800 and 3,815 tax returns respectively that generated $7.6 million and $7.3 million in income tax refunds and $2.6 million and $2.7 million in earned income tax credits.

[4] https://fred.stlouisfed.org/series/LNS14000006
[5] https://www.bls.gov/news.release/pdf/empsit.pdf
[6] https://www.wbez.org/stories/who-is-dying-of-covid-19-in-cook-county/d7fafa45-618a-409d-8ea5-4dfe537d4bef?utm_source=morning-10&utm_medium=email&utm_campaign=20220118&utm_content=article5-headline%20target%3D
[7] https://www.lisep.org/tru#race
[8] https://nlihc.org/sites/default/files/FAQs_COVID-19_Racial-Equity.pdf

Table One – Southern Bancorp, Inc. at a Glance

For decades, Southern's financial performance has been consistently strong. Southern earned a record $14.0 million in 2021 and $15.6 million in the first half of 2022. Southern Bancorp Bank limited non-performing loans to only 0.74% of loans outstanding at year-end 2021 and .50% at June 30, 2022. The Bank experienced net charge-offs of only 6 basis points in 2021 and 2 basis points for the first half of 2022. Southern has also enjoyed strong growth. In 2021 Southern acquired the $185 million Arkansas County Bank, headquartered in Stuttgart, Arkansas, and opened a new branch in Hattiesburg, Mississippi, which boosted its asset base by $374 million to $2.1 billion. In 2022, Southern acquired the $213 million Premier Bank in eastern Arkansas that propelled total consolidated assets up to $2.3 billion at June 30, 2022.

CAPITAL MODEL 2.0

As noted in **Raising Core Equity Capital for Community Development Banks — A New Capital Model**, prior to implementing its new capital model, Southern's outside common shareholders had limited to no opportunity to exit their investments. The only exit avenue was to donate shares to Southern's 501(c)(3) affiliate in exchange for a tax deduction. Prior to 2017, Southern paid common dividends only to its affiliated nonprofit. There was no secondary market for common shares and few shares ever changed hands. Putting patient capital to work at Southern effectively resulted in a permanent investment with no current yield. Southern management and board knew that a different capital strategy was necessary if the company was to attract the quantum of capital needed to fulfill its potential, expand its reach, and deliver even greater impact.

Southern launched a $50 million capital campaign in 2017, the largest and most successful in its history. To generate demand, Southern adopted Capital Model 2.0 to make its shares financially attractive to investors while preserving its mission. The pillars of the new model are:

- Providing a financial return both "on" and "of" capital to investors through regular, quarterly, common dividends and annual or semi-annual share repurchases,
- Protecting the company's long-term mission by becoming a benefit corporation and a certified B-Corp,
- Creating an employee ownership program linked to Southern's 401(k) program (referred to as a 'KSOP') to insure consistent shareholder liquidity and give its employees an ownership stake in the company. This also helped to protect the mission in that it added another patient investor committed to mission preservation, and
- All directors and executive officers became common shareholders, and executive compensation was tied to the company's delivery of mission impact, not just financial performance.

By the end of 2019, Southern had closed the initial phase of the capital campaign and succeeded raising $34.7 million in new common equity including $2.2 million from its KSOP and sales to officers and directors; 94% of Southern's eligible employees currently participate in the KSOP.

At the completion of the first phase of the capital campaign, one question remained unanswered. Southern assumed that if it paid quarterly common dividends and provided routine exit opportunities, it would be able to retain most of its existing shareholders. Further, it believed that those who did avail themselves of liquidity opportunities could be replaced. The theory was that Southern's investors would be less likely to pursue liquidity once they were assured of its availability, and that this would be true for more market-oriented investors as well as more mission-oriented investors.

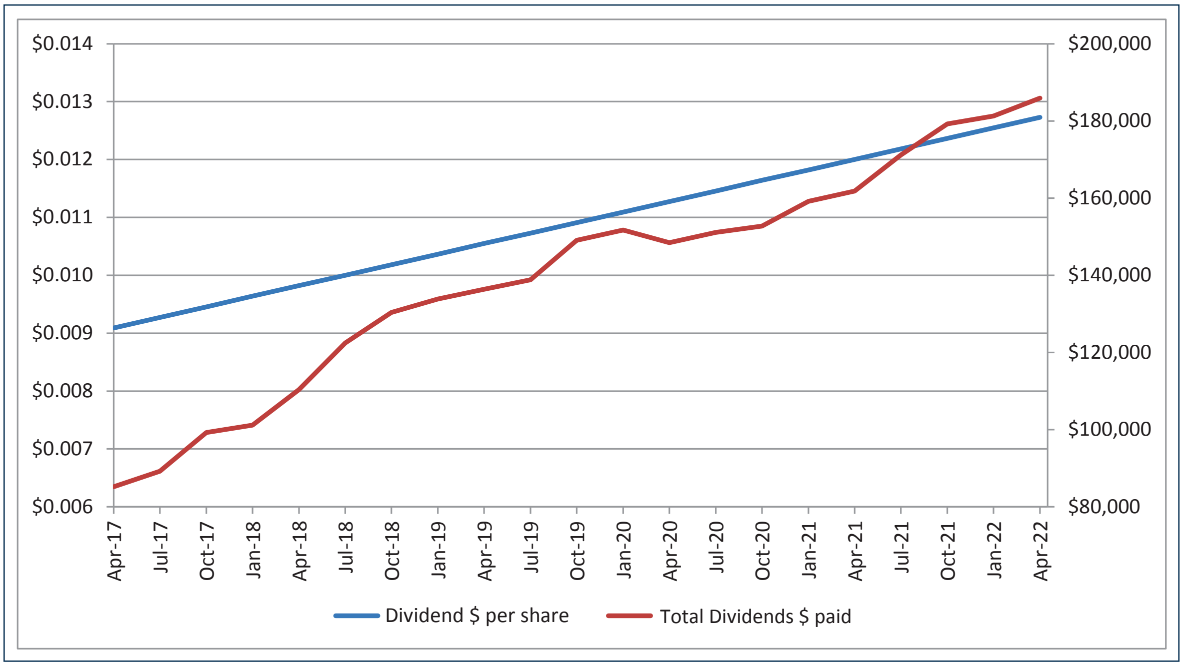
The past two and one-half years have supported those hypotheses in spite of the generally lack-luster performance of publicly traded bank stocks.[9] As liquidity and dividends became available and routinized, investors have for the most part retained their positions, and Southern has successfully attracted new investors to replace those who exited or sold shares.

RETURNS "ON" AND "OF" CAPITAL

As shown in Table Two, since the start of 2017, Southern has paid $2,938,942 in common dividends. Dividend payments, while intentionally modest, increased every quarter over this period. The dividend yield in the first half of 2022 was 0.35% annualized based on current dividends and a share value of $14.50. As Southern continues on its significant growth trajectory, dividends are set at a level to signal discipline of performance rather than maximum payout. Investors have supported this approach.

[9] The KBW Bank Index declined by 8.8% from 112.48 to 102.56 between year-end 2019 and June 30, 2022.

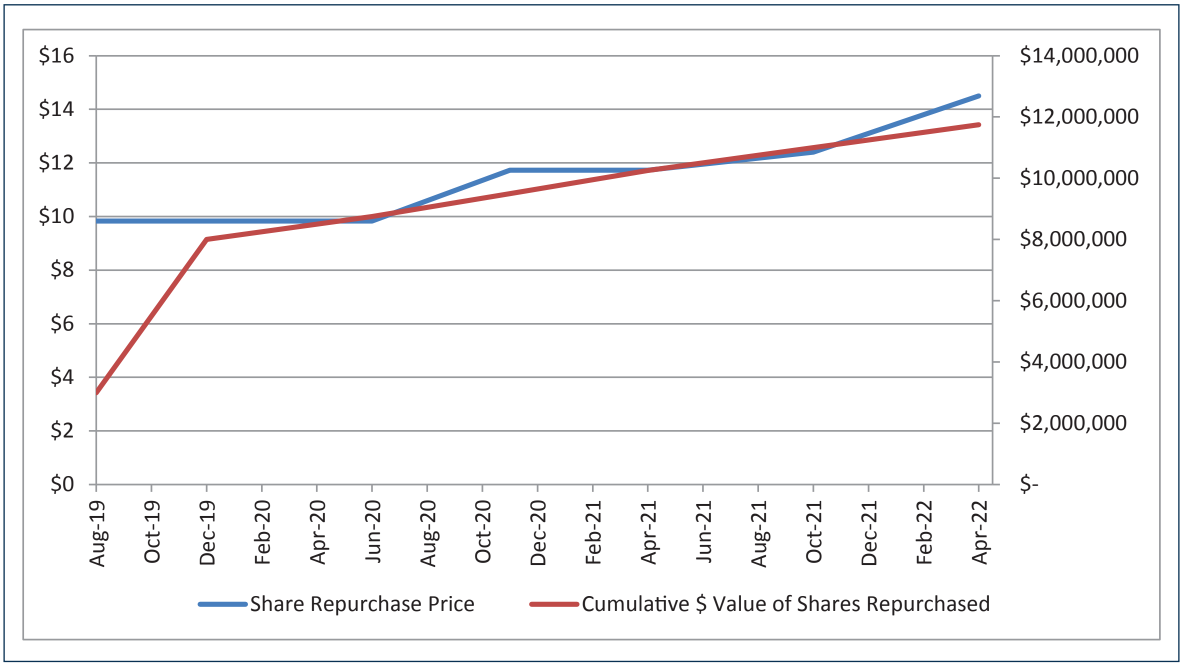
Table Two – Dividends per Share and Total Dividends Paid 2017 through Q2 2022



Share repurchases began in 2019. Through June 30, 2022, Southern has tendered for shares seven times, buying back 2.9 million shares for $11,749,970 with the latest share repurchase in April, 2022.

At the outset of the share repurchase program, there was pent-up demand for liquidity among Southern's legacy shareholders - those who had invested prior to 2000. This demand was anticipated, and as shown in Table Three, Southern met that demand by deploying $8.0 million to repurchase shares in 2019. As expected following satisfaction of that pent-up demand, the scale of the share repurchase program declined subsequently to $1.5 million annually including $749,998 in the first half of 2022. In the latest share repurchase, 18% of the tendered shares were repurchased. Table Three shows that after 2019 the demand for liquidity declined. In the first share repurchase in August 2019, shareholders tendered 1.5 million shares; in April 2022, only 285,390 shares were tendered in spite of Southern increasing the repurchase price from $9.83 in 2019 to $14.50 per share.

Table Three – Cumulative Value of Shares Repurchased and Share Repurchase Price 2017 through Q2 2022



Investment outcomes for Southern investors are indicative of the returns provided. The realized and unrealized returns for each investor have been surprisingly robust during a historically challenging economic period. These returns have benefitted both long-term investors in Southern and those who invested during the recent capital campaign.

The experience of three investors illustrates the broader experience of all of Southern's shareholders:

- A major Fortune 500 corporation (Corporation) with a long history of making impact investments that generate financial return and create positive, measurable social impact. The Corporation's investment closed in April 2018,
- An international global investment fund (Fund) that mobilizes and deploys capital to support growth and mission integrity of small and mid-sized financial institutions with banking models built on the principles of Sustainable Banking. The Fund invested in Southern in March 2018, and
- An individual investor who acquired his shares during Southern's initial private offering in 1987. The individual investor was a long-term, patient investor in racial justice causes before he invested in Southern. As he aged, the liquidity of his Southern investments became concerning for estate planning purposes.

The Corporation and the individual shareholder offered shares for repurchase in several of the tender offers; the Fund offered shares only in the April 2022 tender.

The investment outcomes for these three investors parallel other legacy and recent investors who have realized share liquidity while retaining significant ownership positions in Southern. These outcomes demonstrate the applicability of Capital Model 2.0 across varying types of investors and scenarios. Based on the amount he invested in Southern, the individual investor, as a legacy investor, received a current annualized yield of 2.0% from quarterly dividends when Southern began paying dividends in 2017 based on what he originally paid for his shares.[10]

[10] Calculated as the ratio of current dividends received divided by the acquisition price of the investor's shares.

The Fund and the Corporation, which invested thirty years later, enjoy a lower current annual yield of 0.61% based on Southern's most recent dividend and the price they paid for their shares.

The Corporation's investment in Southern has produced an IRR of 12.8%. The Fund, which invested a month earlier but at the same price, has enjoyed an even higher return of 13.9% as it held all its shares until the most recent tender in April 2022. Note that these IRRs compare favorably with the Keefe Bruyette and Woods Bank Index that decreased by approximately 2.4% since the Corporation and the Fund made their investments in Southern in the spring of 2018.

As Lata Reddy, Senior Vice President of Prudential, one of Southern's recent investors, noted, "Our equity investment in Southern Bancorp, Inc. has met all of Prudential's expectations. An investment in Southern was an ideal fit for our $1 billion impact investing portfolio since we realize that every dollar invested in a CDFI bank like Southern multiplies our impact in communities. We are especially concerned with increasing wealth in communities that historically have not had access to capital. That is exactly what Southern does."

Factoring in both dividends and share repurchases, the legacy investor realized an IRR of 5.5% through December 31, 2021 when he donated his remaining shares to SBCP. While his return is modest compared to those of the Corporation and the Fund, his expectation for return when he invested was moderate and uncertain. His primary objective was to help capitalize the first community development bank serving rural America. His primary financial objective was the return "of" his capital. Ultimately, his financial return was similar to what was available on government bonds in 1987 and well above the 2% to 3% a typical PRI investor would have realized at that time.

Two and one-half years since the close of the first phase of Southern's capital campaign, it is too soon to gauge the continuing appeal of Southern's common shares for new investors or the long-term success of Capital Model 2.0. Nonetheless, Southern raised $19.6 million in new common equity subsequent to 2019, exceeding the $50 million capital campaign target by $4.3 million. The latest investors were: Relyance Bank, Encore Bancshares, Square, Regions Bank, JPMorgan Chase, and Bank of America. While the new investors were motivated primarily by a desire to increase investments in communities of color and Covid-19 impacted small businesses, they clearly valued the demonstrated pathways to financial returns facilitated by Capital Model 2.0.

CONCLUSION

Over the past five and one-half years, Southern has successfully implemented Capital Model 2.0. It has paid regular quarterly common stock dividends and engaged in periodic share repurchases. It has proven that patient capital invested in a CDFI can pay off and demonstrated that other impact investors will be willing to invest once they see the disciplines of Capital Model 2.0 implemented.

Capital Model 2.0 attracted $54.3 million in common equity for Southern. While legacy shareholders have taken advantage of the share repurchase tenders, the vast majority have retained significant ownership stakes in the company. And the demand for exits has moderated even as the tender price has risen. Since investors now enjoy both liquidity and a current return, they have become comfortable maintaining their ownership positions. The $19.6 million sale of new shares to institutional investors since 2019 further supports the viability of Capital Model 2.0

Remaining questions are whether Capital Model 2.0 can be sustained through the post-Covid headwinds of spiking inflation, softening economic growth, and the recent stock market sell-off. It also remains to be seen whether Capital Model 2.0 can be applied to other types of CDFIs – many of which are reliant on philanthropic and government grants. As expressions of interest in CDFI investment opportunities continue to gain traction among both conventional and impact investors, a further question will be whether these investors will step forward to support community development banks like Southern now that one of their most commonly cited impediments has been removed. We will continue to monitor investor appetite and activity as we explore further questions related to the value proposition of investing capital in CDFI banks in future updates.

Endnotes

i George P. Surgeon is President and CEO of GSJ Advisors, Ltd. Laurie J. Spengler is CEO of Courageous Capital Advisors, LLC. Darrin L. Williams is Chief Executive Officer of Southern Bancorp, Inc. Nathan Pittman is Senior Vice President, Policy & Communications, of Southern Bancorp, Inc.

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