

PINNACLE FINANCIAL PARTNERS INC  
Form 10-K  
February 28, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

**For Annual and Transition Reports Pursuant to Sections 13 or 15(d)  
of the Securities and Exchange Act of 1934**

**[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

**OR**

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-31225

, INC.

(Exact name of registrant as specified in charter)

Tennessee  
(State or other jurisdiction  
of incorporation)

000-31225  
(Commission  
File Number)

62-1812853  
(I.R.S. Employer  
Identification No.)

211 Commerce Street, Suite 300, Nashville, Tennessee  
(Address of principal executive offices)

37201  
(Zip Code)

Registrant's telephone number, including area code: (615) 744-3700

Securities registered pursuant to Section 12 (b) of the Act:

<b>Title of Each Class</b>	<b>Securities registered pursuant to Section 12 (g) of the Act:</b>	<b>Name of Exchange on which Registered</b>
Common Stock, par value \$1.00	None	Nasdaq Global Select Market

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

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 ☐

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large Accelerated Filer ☐ Accelerated Filer ☒ Non-accelerated Filer ☐

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity as of the last business day of the registrant's most recently completed second fiscal quarter: \$423,200,000 as of June 30, 2006.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 15,472,121 shares of common stock as of February 26, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held April 17, 2007, are incorporated by reference into Part III of this Form 10-K.

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## FORWARD-LOOKING STATEMENTS

Pinnacle Financial Partners, Inc. ("Pinnacle Financial") may from time to time make written or oral statements, including statements contained in this report which may constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the "Exchange Act"). The words "expect," "anticipate," "intend," "consider," "plan," "believe," "seek," "should," "estimate," and similar expressions are intended to identify such forward-looking statements, but other statements may constitute forward-looking statements. These statements should be considered subject to various risks and uncertainties. Such forward-looking statements are made based upon management's belief as well as assumptions made by, and information currently available to, management pursuant to "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Pinnacle Financial's actual results may differ materially from the results anticipated in forward-looking statements due to a variety of factors. Such factors are described below in "Item 1A. Risk Factors" and include, without limitation, (i) unanticipated deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses, (ii) increased competition with other financial institutions, (iii) lack of sustained growth in the economy in the Nashville, Tennessee area, (iv) rapid fluctuations or unanticipated changes in interest rates, (v) the inability of our bank subsidiary, Pinnacle National Bank, to satisfy regulatory requirements for its expansion plans, and (vi) changes in the legislative and regulatory environment, including compliance with the various provisions of the Sarbanes-Oxley Act of 2002. 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 does not intend to update or reissue any forward-looking statements contained in this report as a result of new information or other circumstances that may become known to Pinnacle Financial. Forward-looking statements made by us in this report are also subject to those risks identified within "Item 1A. Risk Factors."

## PART I

*Unless this Form 10-K indicates otherwise or the context otherwise requires, the terms "we," "our," "us," "Pinnacle Financial Partners" or "Pinnacle Financial" as used herein refer to Pinnacle Financial Partners, Inc. and its subsidiary Pinnacle National Bank, which we sometimes refer to as "Pinnacle National," "our bank subsidiary" or "our bank" and its other subsidiaries. References herein to the fiscal years 2002, 2003, 2004, 2005 and 2006 mean our fiscal years ended December 31, 2002, 2003, 2004, 2005 and 2006, respectively.*

## ITEM 1. BUSINESS

### OVERVIEW

Pinnacle Financial is a Tennessee corporation that was incorporated on February 28, 2000 to organize and serve as the holding company for Pinnacle National, a national bank chartered under the laws of the United States. Pinnacle National commenced its banking operations on October 27, 2000, and operates as a community bank in primarily an urban market emphasizing personalized banking relationships with individuals and businesses located within the Nashville-Davidson-Murfreesboro, Tennessee metropolitan statistical area, which we sometimes refer to as the Nashville MSA. We own 100% of the capital stock of Pinnacle National.

On March 15, 2006, we consummated the acquisition of Cavalry Bancorp, Inc. ("Cavalry"), a one-bank holding company located in Murfreesboro, Tennessee with approximately \$672 million in assets as of the closing. During 2006, we successfully integrated Cavalry. We measured success on several criteria and we believe we successfully integrated Cavalry as a result of:

1. Achievement of all major integration milestones on time,
2. Achievement of the financial synergies that were proposed at the time of Cavalry transaction announcement,

3. No degradation in service quality as measured by internal client surveys, and
4. Continued loan and deposit growth for the combined firm at rates exceeding those of the previous period.

**Opportunity.** We believe there are three major trends in the Nashville MSA that strengthen our strategic market position as a locally managed community bank:

- Customers generally perceive that service levels at banks are declining. We believe this is largely attributable to merger-related integration issues resulting from consolidation in the bank and brokerage industries. Additionally, small business owners want a reliable point of contact that is knowledgeable about their business and the financial products and services that are important to the success of their business. In fact, Nashville is dominated by three large regional bank holding companies, which are headquartered elsewhere, each of whom is experiencing declining market share trends (other than after acquisitions) over the last six years;

- Client usage of more sophisticated financial products continues to grow, causing traditional banks to lose market share to other types of financial services companies, such as mutual fund companies and securities brokerage firms; and
- There is significant growth in the demand for convenient access to financial services, particularly through ATMs, telephone banking and Internet banking.

We believe that our primary market segments, which are small businesses with annual sales from \$1 million to \$50 million and households with investable assets over \$250,000, are more likely to be disaffected by the banking industry's perceived decline in customer service and lack of financial product sophistication. To overcome these customer perceptions and attract business from these market segments, we seek to hire only seasoned professionals, from both the banking and brokerage industries, and have strategically designed our banking, investment and insurance products to meet the expected needs of our targeted market segments. As an example, we consider our consumer brokerage and corporate treasury management products to be at least at parity with the large regional banks that dominate our target segment in the Nashville market. Accordingly, our marketing philosophy is centered on delivering exceptional service and effective financial advice through highly trained personnel who understand and care about the broad financial needs and objectives of our clients.

***Business Strategies.*** To carry out our marketing philosophy, our specific business strategies have been and will continue to be:

- Hire and retain highly experienced and qualified banking and financial professionals with successful track records and, for client contact personnel, established books of business with small businesses and affluent households within the Nashville MSA. On average, our senior customer contact personnel have in excess of 20 years experience in the Nashville MSA. We believe we will continue to experience success in attracting more market-best associates to our firm as well as retaining our highly experienced and successful group of associates.
- Provide individualized attention with consistent, local decision-making authority.
- Offer a full line of financial services to include traditional depository and credit products, as well as sophisticated investment, trust and insurance products. As of December 31, 2006, Pinnacle National's brokerage division, Pinnacle Asset Management, had accumulated approximately \$597 million in brokerage assets.
- Capitalize on customer dissatisfaction that we believe exists and that has been caused by what we believe to be our competitors' less than satisfactory response to the financial needs of today's sophisticated consumers and small- to medium-sized businesses. Since we began our company, we have historically surveyed our customers on numerous matters related to their relationship with us. Consistently, these surveys indicate that our service quality is significantly better than their prior banking relationships.
- Build on our directors' and officers' diverse personal and business contacts, community involvement and professional expertise.
- Establish a distribution strategy designed to prudently expand our physical and virtual market presence, thereby providing convenient banking access for our clients 24 hours a day. We opened two new offices in 2005 and intend to open two new offices in 2007. Our courier deposit pickup

service consistently receives high marks from our small business customers.

- Use technology and strategic alliances, including those established through Pinnacle Asset Management and Miller and Loughry Insurance Services to provide a broad array of sophisticated and convenient products and services.

We believe that our business strategies allow us to effectively distinguish ourselves from other financial institutions operating within the Nashville MSA and successfully attract and retain business relationships with small businesses and affluent households.

**Market Area.** Pinnacle National's primary service area, which comprises the Nashville MSA, includes Davidson County and twelve surrounding counties. This area represents a geographic area that covers approximately 4,000 square miles and a population in excess of 1.3 million people. For Pinnacle National, we concentrate our market efforts on Davidson, Williamson, Sumner and Rutherford counties which represent 77% of the Nashville MSA's population base and 85% of the deposit base (based on June 30, 2006 FDIC information).

The economic success of Pinnacle National's primary service area depends heavily upon the economic viability of the metropolitan Nashville, Tennessee area. Nashville is the capital of Tennessee and a city that we believe is an important transportation, business and tourism center within the United States. Additionally, the metropolitan Nashville area has attracted a number of significant business relocations resulting in an expansion of its labor force into many different industry sectors. In 2006, for the second year in a row "Expansion Management" magazine noted that Nashville ranked first among cities in the nation for companies that are looking to expand or relocate. Over the last few years, Nashville has been chosen by such companies as Louisiana Pacific, Nissan North America, CareMark and Dell to relocate their U.S. headquarters or to significantly expand their operations.

Our primary service area's economic strength comes from its large employer base, which includes several large enterprises such as Vanderbilt University and Medical Center, HCA Inc., Saturn Corporation and Nissan Motor Manufacturing Corporation USA. Additionally, according to the Nashville Area Chamber of Commerce, the regional economy has outperformed the state and national economies during the most recent time periods and continues to benefit from low unemployment, consistent job growth, substantial outside investment and expansion and a well trained and growing labor force. We anticipate that these factors will continue to cause more businesses to relocate to, or start operations in, the Nashville MSA and, in turn, will increase the demand for depository and lending services within our market at a pace faster than national averages. In comparing Nashville MSA deposits as of June 30, 2006 to those at June 30, 2005, the Nashville MSA deposits were 13.5% higher in 2006 than in 2005 which is 70% over the national average for deposit growth during the same time period.

Pinnacle National's main office is located in Nashville's central business district in downtown Nashville. The downtown market consists of a variety of commercial establishments and entertainment venues. We believe that the downtown area is an important location for financial institutions requiring visibility within Nashville's prominent commercial and private banking markets. Accordingly, we believe that this location is well suited for our bank's headquarters and principal business development efforts.

**Competitive Conditions.** The Nashville MSA banking market is very competitive, with 58 financial institutions with over \$28.5 billion in deposits in the market as of June 30, 2006. According to FDIC data, bank and thrift deposits in the Nashville MSA grew from approximately \$25.2 billion at June 30, 1995 to more than \$28.5 billion at June 30, 2006. As of June 30, 2006, approximately 70.4% of this deposit base was controlled by large, multi-state banks headquartered outside of Nashville, which included the six largest banks, Regions Financial (headquartered in Birmingham, Alabama), Bank of America (headquartered in Charlotte, North Carolina), First Horizon (headquartered in Memphis, Tennessee), US Bancorp (headquartered in Milwaukee, Wisconsin), SunTrust (headquartered in Atlanta, Georgia), and Fifth Third (headquartered in Cincinnati, Ohio). According to FDIC deposit information, the collective market share of deposits in the Nashville MSA of Regions Financial (including the acquired Union Planters National Bank, First American National Bank, and AmSouth Bank), Bank of America and SunTrust (including the acquired National Bank of Commerce) declined from 70.4% to 54.0% during the ten years ended June 30, 2006. Consequently, while large, multi-state institutions are well established in our market area, we believe the general trends indicate that a majority of the community banks in the Nashville MSA have been able to increase their deposit market share in recent years at the expense of these larger, multi-state banks. Furthermore, continued consolidation of our industry, particularly with respect to the larger regional banks that have presence in our market, we believe will create additional opportunities for us as we capitalize on customer dissatisfaction that usually occurs following a merger of these larger multistate banks.

We also believe that Pinnacle National's status as a community bank will not be enough to compete in today's financial industry. In the wake of modern technology and the prosperity of the United States' financial markets, banking clients have generally become more sophisticated in their approach to selecting financial services providers. We believe that the most important criteria to our bank's targeted clients when selecting a bank is their desire to receive exceptional and personal customer service while being able to enjoy convenient access to a broad array of sophisticated financial

products. Additionally, when presented with a choice, we believe that many of our bank's targeted clients would prefer to deal with a locally-owned institution headquartered in Nashville, like Pinnacle National, as opposed to a large, multi-state bank, where many important decisions regarding a client's financial affairs are made elsewhere.

### ***Lending Services***

Pinnacle National offers a full range of lending products, including commercial, real estate and consumer loans to individuals and small-to medium-sized businesses and professional entities. It competes for these loans with competitors who are well established in the Nashville MSA.

Pinnacle National's loan approval policies provide for various levels of officer lending authority. When the amount of total loans to a single borrower exceeds that individual officer's lending authority, officers with a higher lending limit, Pinnacle National's board of directors or the executive committee of the board will determine whether to approve the loan request.

Pinnacle National's lending activities are subject to a variety of lending limits imposed by federal law. Differing limits apply based on the type of loan or the nature of the borrower, including the borrower's relationship to Pinnacle National. In general, however, at December 31, 2006, Pinnacle National is able to loan any one borrower a maximum amount equal to approximately \$26.3 million plus an additional \$17.5 million, or a total of approximately \$43.8 million, for loans that meet certain additional federal collateral guidelines. These legal limits will increase or decrease as Pinnacle National's capital increases or decreases as a result of its earnings or losses, the injection of additional capital or other reasons. In addition to these regulatory limits, Pinnacle National currently imposes upon itself an internal lending limit of \$15 million, which is less than the prescribed legal lending limit.

The principal economic risk associated with each category of loans that Pinnacle National expects to make is the creditworthiness of the borrower. General economic factors affecting a commercial or consumer borrower's ability to repay include interest, inflation and unemployment rates, as well as other factors affecting a borrower's assets, clients, suppliers and employees. Many of Pinnacle National's commercial loans are made to small- to medium-sized businesses that are sometimes less able to withstand competitive, economic and financial pressures than larger borrowers. During periods of economic weakness, these businesses may be more adversely affected than larger enterprises, and may cause increased levels of nonaccrual or other problem loans, loan charge-offs and higher provision for loan losses.

Pinnacle National's commercial clients borrow for a variety of purposes. The terms of these loans will vary by purpose and by type of any underlying collateral and include equipment loans and working capital loans. Commercial loans may be unsecured or secured by accounts receivable or by other business assets. Pinnacle National also makes a variety of commercial real estate loans, residential real estate loans and real estate construction and development loans.

Pinnacle National also makes a variety of loans to individuals for personal, family, investment and household purposes, including secured and unsecured installment and term loans, residential first mortgage loans, home equity loans and home equity lines of credit.

### ***Investment Securities***

In addition to loans, Pinnacle National has other investments primarily in obligations of the United States government, obligations guaranteed as to principal and interest by the United States government and other securities. No investment in any of those instruments exceeds any applicable limitation imposed by law or regulation. The executive committee of the board of directors reviews the investment portfolio on an ongoing basis in order to ensure that the investments conform to Pinnacle National's asset liability management policy as set by the board of directors.

### ***Asset and Liability Management***

Our Asset Liability Management Committee (“ALCO”), composed of senior managers of Pinnacle National, manages Pinnacle National’s assets and liabilities and strives to provide a stable, optimized net interest income and margin, adequate liquidity and ultimately a suitable after-tax return on assets and return on equity. ALCO conducts these management functions within the framework of written policies that Pinnacle National’s board of directors has adopted. ALCO works to maintain a balanced position between rate sensitive assets and rate sensitive liabilities.

Additionally, we may use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities. We may use derivatives as one tool to manage our interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. At December 31, 2006 and 2005, we had not entered into any derivative contracts.

### ***Deposit Services***

Pinnacle National seeks to establish a broad base of core deposits, including savings, checking, interest-bearing checking, money market and certificate of deposit accounts. To attract deposits, Pinnacle National has employed a marketing plan in its overall service area and features a broad product line and competitive rates and services. The primary sources of deposits are residents and businesses located in the Nashville MSA. Pinnacle National generally obtains these deposits through personal solicitation by its officers and directors.

### ***Investment, Trust and Insurance Services***

Pinnacle National contracts with Raymond James Financial Service, Inc. ("RJFS"), a registered broker-dealer and investment adviser, to offer and sell various securities and other financial products to the public from Pinnacle National's locations through Pinnacle National employees that are also RJFS employees. RJFS is a subsidiary of Raymond James Financial, Inc.

Pinnacle National offers, through RJFS, non-FDIC insured investment products in order to assist Pinnacle National's clients in achieving their financial objectives consistent with their risk tolerances. Pinnacle National's suite of investment products include:

- Mutual Funds;
- Variable Annuities;
- Money Market Instruments;
- Treasury Securities;
- Bonds;
- Fixed Annuities;
- Stocks;
- Financial Planning;
- Asset Management Accounts; and
- Listed Options.

All of the financial products listed above are offered by RJFS from Pinnacle National's main office and its other offices. Additionally, we believe that the brokerage and investment advisory program offered by RJFS complements Pinnacle National's general banking business, and further supports its business philosophy and strategy of delivering to our clients those products and services that meet their financial needs. In addition to the compliance monitoring provided by RJFS, Pinnacle National has developed its own compliance-monitoring program to further ensure that Pinnacle National personnel deliver these products in a manner consistent with the various regulations governing such activities.

Pinnacle National receives a percentage of commission credits and fees generated by the program. Pinnacle National remains responsible for various expenses associated with the program, including promotional expenses, furnishings and equipment expenses and general personnel costs.

Pinnacle National also maintains a trust department which provides fiduciary and investment management services for individual and institutional clients. Account types include personal trust, endowments, foundations, individual retirement accounts, pensions and custody. Pinnacle Financial has also established Pinnacle Advisory Services, Inc., a registered investment advisor, to provide investment advisory services to its clients. Additionally, Miller and Loughry Insurance Services, Inc., a wholly-owned subsidiary of Pinnacle National provides insurance products, particularly in the property and casualty area, to its clients.

### ***Other Banking Services***

Given client demand for increased convenience in accessing banking and investment services, Pinnacle National also offers a broad array of convenience-centered products and services, including 24 hour telephone and Internet banking, debit cards, direct deposit and cash management services for small- to medium-sized businesses. Additionally, Pinnacle National is associated with a nationwide network of automated teller machines of other financial institutions that our clients are able to use throughout Tennessee and other regions. In most cases, Pinnacle National, in contrast to its competitors, reimburses its clients for any fees that may be charged to the client for utilizing the nationwide ATM network which enables us to demonstrate greater convenience as compared to these competitors.

Pinnacle National also offers its targeted commercial clients a courier service which picks up non-cash deposits from the client's place of business which also enables us to demonstrate convenience greater than most of the larger regional competitors. Pinnacle National provides this service through a third party that is approved by the State of Tennessee Public Service Commission for bank-related work.

### ***Employees***

At February 15, 2007, Pinnacle National employed 438 employees of which 397 were full time. Pinnacle National considers its relationship with all employees to be excellent. Additionally, during 2006, Pinnacle Financial was named by the Nashville Business Journal as the “Best Place to Work in Nashville” among Middle Tennessee’s large companies with more than 100 employees. This is the fourth consecutive year for Pinnacle to receive top honors in the annual awards program.

We are also one of a relatively small number of financial firms in the country that provide stock options for all associates in a broad-based stock option plan. We believe this broad-based stock option plan directly aligns our employee base with our shareholders, and that our associates have become even more engaged in the creation of shareholder value over the intermediate- and long-terms. Information concerning these plans is included in the “Notes to the Consolidated Financial Statements.”

Additionally, all of our non-commission based employees participate in an annual cash incentive plan whereby they receive a certain percentage of their annual base salary should the firm meet certain soundness and earnings targets for the year. Information concerning this plan is included in “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

### ***Available Information***

We file reports with the Securities and Exchange Commission (“SEC”), including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. The public may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. We are an electronic filer, and the SEC maintains an Internet site at <http://www.sec.gov> that contains the reports, proxy and information statements, and other information we have filed electronically. Our website address is [www.pnfp.com](http://www.pnfp.com). Please note that our website address is provided as an inactive textual reference only. We make available free of charge through our website, the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. The information provided on our website is not part of this report, and is therefore not incorporated by reference unless such information is otherwise specifically referenced elsewhere in this report.

We have posted our Corporate Governance Guidelines, our Corporate Code of Conduct for directors, officers and employees, and the charters of our Audit Committee, Human Resources and Compensation Committee, and Nominating and Corporate Governance Committee of our board of directors on the Corporate Governance section of our website at [www.pnfp.com](http://www.pnfp.com). Our corporate governance materials are available free of charge upon request to our Corporate Secretary, Pinnacle Financial Partners, Inc., 211 Commerce Street, Suite 300, Nashville, Tennessee 37201.

## **SUPERVISION AND REGULATION**

Both Pinnacle Financial and Pinnacle National are subject to extensive state and federal banking laws and regulations that impose restrictions on and provide for general regulatory oversight of Pinnacle Financial’s and Pinnacle National’s operations. These laws and regulations are generally intended to protect depositors and borrowers, not shareholders. The following discussion describes the material elements of the regulatory framework which apply.

### ***Pinnacle Financial***

We are a bank holding company under the federal Bank Holding Company Act of 1956. As a result, we are subject to the supervision, examination, and reporting requirements of the Bank Holding Company Act and the regulations of

the Federal Reserve.

***Acquisition of Banks.*** The Bank Holding Company Act requires every bank holding company to obtain the Federal Reserve's prior approval before:

- Acquiring direct or indirect ownership or control of any voting shares of any bank if, after the acquisition, the bank holding company will directly or indirectly own or control more than 5% of the bank's voting shares;
- Acquiring all or substantially all of the assets of any bank; or
- Merging or consolidating with any other bank holding company.

Additionally, the Bank Holding Company Act provides that the Federal Reserve may not approve any of these transactions if it would substantially lessen competition or otherwise function as a restraint of trade, or result in or tend to create a monopoly, unless the anticompetitive effects of the proposed transaction are clearly outweighed by the public interest in meeting the convenience and needs of the communities to be served. The Federal Reserve is also required to consider the financial and managerial resources and future prospects of the bank holding companies and banks concerned and the convenience and needs of the communities to be served. The Federal Reserve's consideration of financial resources generally focuses on capital adequacy, which is discussed below.

Under the Bank Holding Company Act, if adequately capitalized and adequately managed, we or any other bank holding company located in Tennessee may purchase a bank located outside of Tennessee. Conversely, an adequately capitalized and adequately managed bank holding company located outside of Tennessee may purchase a bank located inside Tennessee. In each case, however, state law restrictions may be placed on the acquisition of a bank that has only been in existence for a limited amount of time or will result in specified concentrations of deposits. For example, Tennessee law currently prohibits a bank holding company from acquiring control of a Tennessee-based financial institution until the target financial institution has been in operation for three years.

***Change in Bank Control.*** Subject to various exceptions, the Bank Holding Company Act and the Federal Change in Bank Control Act, together with related regulations, require Federal Reserve approval prior to any person or company acquiring "control" of a bank holding company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the bank holding company. Control is rebuttably presumed to exist if a person or company acquires 10% or more, but less than 25%, of any class of voting securities and either:

- The bank holding company has registered securities under Section 12 of the Securities Exchange Act of 1934; or
- No other person owns a greater percentage of that class of voting securities immediately after the transaction.

Our common stock is registered under the Securities Exchange Act of 1934. The regulations provide a procedure for challenge of the rebuttable control presumption.

***Permitted Activities.*** The Gramm-Leach-Bliley Act of 1999 amended the Bank Holding Company Act and expanded the activities in which bank holding companies and affiliates of banks are permitted to engage. The Gramm-Leach-Bliley Act eliminates many federal and state law barriers to affiliations among banks and securities firms, insurance companies, and other financial service providers. Generally, if we qualify and elect to become a financial holding company, which is described below, we may engage in activities that are:

- Financial in nature;
- Incidental to a financial activity; or
- Complementary to a financial activity and do not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The Gramm-Leach-Bliley Act expressly lists the following activities as financial in nature:

- Lending, trust and other banking activities;
-

Insuring, guaranteeing, or indemnifying against loss or harm, or providing and issuing annuities, and acting as principal, agent, or broker for these purposes, in any state;

- Providing financial, investment, or advisory services;
- Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly;
- Underwriting, dealing in or making a market in securities;
- Activities that the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper incident to banking or managing or controlling banks;

- Activities permitted outside of the United States that the Federal Reserve has determined to be usual in connection with banking or other financial operations abroad;
- Merchant banking through securities or insurance affiliates; and
- Insurance company portfolio investments.

The Gramm-Leach-Bliley Act also authorizes the Federal Reserve, in consultation with the Secretary of the Treasury, to determine activities in addition to those listed above that are financial in nature or incidental to such financial activity. In determining whether a particular activity is financial in nature or incidental or complementary to a financial activity, the Federal Reserve must consider (1) the purpose of the Bank Holding Company and Gramm-Leach-Bliley Acts, (2) changes or reasonably expected changes in the marketplace in which financial holding companies compete and in the technology for delivering financial services, and (3) whether the activity is necessary or appropriate to allow financial holding companies to effectively compete with other financial service providers and to efficiently deliver information and services.

To qualify to become a financial holding company, any of our depository institution subsidiaries must be well capitalized and well managed and must have a Community Reinvestment Act rating of at least “satisfactory.” Additionally, we must file an election with the Federal Reserve to become a financial holding company and provide the Federal Reserve with 30 days written notice prior to engaging in a permitted financial activity. Although we do not have any immediate plans to file an election with the Federal Reserve to become a financial holding company, one of the primary reasons we selected the holding company structure was to have increased flexibility. Accordingly, if deemed appropriate in the future, we may seek to become a financial holding company.

Under the Bank Holding Company Act, a bank holding company, which has not qualified or elected to become a financial holding company, is generally prohibited from engaging in or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in nonbanking activities unless, prior to the enactment of the Gramm-Leach-Bliley Act, the Federal Reserve found those activities to be so closely related to banking as to be a proper incident to the business of banking. Activities that the Federal Reserve has found to be so closely related to banking as to be a proper incident to the business of banking include:

- Factoring accounts receivable;
- Acquiring or servicing loans;
- Leasing personal property;
- Conducting discount securities brokerage activities;
- Performing selected data processing services;
- Acting as agent or broker in selling credit life insurance and other types of insurance in connection with credit transactions; and
- Performing selected insurance underwriting activities.

Despite prior approval, the Federal Reserve may order a bank holding company or its subsidiaries to terminate any of these activities or to terminate its ownership or control of any subsidiary when it has reasonable cause to believe that the bank holding company’s continued ownership, activity or control constitutes a serious risk to the financial safety, soundness, or stability of any of its bank subsidiaries.

***Support of Subsidiary Institutions.*** Under Federal Reserve policy, we are expected to act as a source of financial strength for our subsidiary, Pinnacle National, and to commit resources to support Pinnacle National. This support may be required at times when, without this Federal Reserve policy, we might not be inclined to provide it. In the unlikely event of our bankruptcy, any commitment by us to a federal bank regulatory agency to maintain the capital of Pinnacle National would be assumed by the bankruptcy trustee and entitled to a priority of payment.

### ***Pinnacle National***

Pinnacle National is a national bank chartered under the federal National Bank Act. As a result, it is subject to the supervision, examination and reporting requirements of the National Bank Act and the regulations of the Office of the Comptroller of the Currency (the "OCC"). The OCC regularly examines Pinnacle National's operations and has the authority to approve or disapprove mergers, the establishment of branches and similar corporate actions. The OCC also has the power to prevent the continuance or development of unsafe or unsound banking practices or other violations of law. Additionally, Pinnacle National's deposits are insured by the FDIC to the maximum extent provided by law. Pinnacle National also is subject to numerous state and federal statutes and regulations that will affect its business, activities and operations.

***Branching.*** While the OCC has authority to approve branch applications, national banks are required by the National Bank Act to adhere to branching laws applicable to state chartered banks in the states in which they are located. With prior regulatory approval, Tennessee law permits banks based in the state to either establish new or acquire existing branch offices throughout Tennessee. Pinnacle National and any other national or state-chartered bank generally may branch across state lines by merging with banks in other states if allowed by the applicable states' laws. Tennessee law, with limited exceptions, currently permits branching across state lines either through interstate merger or branch acquisition. Tennessee, however only permits an out-of-state bank, short of an interstate merger, to branch into Tennessee through branch acquisition if the state of the out-of-state bank permits Tennessee based banks to acquire branches there.

***FDIC Insurance.*** The FDIC has adopted a risk-based assessment system for insured depository institutions that takes into account the risks attributable to different categories and concentrations of assets and liabilities. In early 2006, Congress passed the Federal Deposit Insurance Reform Act of 2005, which made certain changes to the Federal deposit insurance program. These changes included merging the Bank Insurance Fund and the Savings Association Insurance Fund, increasing retirement account coverage to \$250,000 and providing for inflationary adjustments to general coverage beginning in 2010, providing the FDIC with authority to set the fund's reserve ratio within a specified range, and requiring dividends to banks if the reserve ratio exceeds certain levels. The new statute grants banks an assessment credit based on their share of the assessment base on December 31, 1996, and the amount of the credit can be used to reduce assessments in any year subject to certain limitations. Because it was not organized until 2000, Pinnacle National was not eligible to receive this one-time assessment credit, however, approximately \$297,000 in credits will be available to Pinnacle National as a result of the acquisition of Cavalry.

The FDIC may terminate its insurance of deposits if it finds that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

### ***Capital Adequacy***

Both Pinnacle Financial and Pinnacle National are required to comply with the capital adequacy standards established by the Federal Reserve, in our case, and the OCC, in the case of Pinnacle National. The Federal Reserve has established a risk-based and a leverage measure of capital adequacy for bank holding companies. Pinnacle National is also subject to risk-based and leverage capital requirements adopted by the OCC, which are substantially similar to those adopted by the Federal Reserve for bank holding companies.

The risk-based capital standards are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance-sheet exposure, and to minimize disincentives for holding liquid assets. Assets and off-balance-sheet items, such as letters of credit and unfunded loan commitments, are assigned to broad risk categories, each with appropriate risk weights. The resulting capital ratios

represent capital as a percentage of total risk-weighted assets and off-balance-sheet items.

The minimum guideline for the ratio of total capital to risk-weighted assets is 8%. Total capital consists of two components, Tier 1 capital and Tier 2 capital. Tier 1 capital generally consists of common stock, minority interests in the equity accounts of consolidated subsidiaries, noncumulative perpetual preferred stock, and a limited amount of cumulative perpetual preferred stock, less goodwill and other specified intangible assets. Tier 1 capital must equal at least 4% of risk-weighted assets. Tier 2 capital generally consists of subordinated debt, other preferred stock, and a limited amount of loan loss reserves. The total amount of Tier 2 capital is limited to 100% of Tier 1 capital.

In addition, the Federal Reserve has established minimum leverage ratio guidelines for bank holding companies. These guidelines provide for a minimum ratio of Tier 1 capital to average assets, less goodwill and other specified intangible assets, of 3% for bank holding companies that meet specified criteria, including having the highest regulatory rating and implementing the Federal Reserve's risk-based capital measure for market risk. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. The guidelines also provide that bank holding companies experiencing high internal growth, as is our case, or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels. Furthermore, the Federal Reserve has indicated that it will consider a bank holding company's Tier 1 capital leverage ratio, after deducting all intangibles, and other indicators of capital strength in evaluating proposals for expansion or new activities.

Information concerning our regulatory ratios at December 31, 2006 is included in the "Notes to the Consolidated Financial Statements."

If our growth rate continues, as we presently anticipate, our assets will grow faster than our capital and our capital ratios will decline. In order to maintain capital at Pinnacle National at appropriate levels, we may be required to incur borrowings or issue additional trust preferred or equity securities.

Failure to meet capital guidelines could subject a bank or bank holding company to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting brokered deposits, and other restrictions on its business. As described above, significant additional restrictions can be imposed on FDIC-insured depository institutions that fail to meet applicable capital requirements.

#### ***Prompt Corrective Action***

The Federal Deposit Insurance Corporation Improvement Act of 1991 establishes a system of prompt corrective action to resolve the problems of undercapitalized financial institutions. Under this system, the federal banking regulators have established five capital categories (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) into one of which all institutions are placed. Federal banking regulators are required to take various mandatory supervisory actions and are authorized to take other discretionary actions with respect to institutions in the three undercapitalized categories. The severity of the action depends upon the capital category in which the institution is placed. Generally, subject to a narrow exception, the banking regulator must appoint a receiver or conservator for an institution that is critically undercapitalized. The federal banking agencies have specified by regulation the relevant capital level for each category.

An institution that is categorized as undercapitalized, significantly undercapitalized, or critically undercapitalized is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. A bank holding company must guarantee that a subsidiary depository institution meets its capital restoration plan, subject to various limitations. The controlling holding company's obligation to fund a capital restoration plan is limited to the lesser of 5% of an undercapitalized subsidiary's assets or the amount required to meet regulatory capital requirements. An undercapitalized institution is also generally prohibited from increasing its average total assets, making acquisitions, establishing any branches or engaging in any new line of business, except under an accepted capital restoration plan or with FDIC approval. The regulations also establish procedures for downgrading an institution and a lower capital category based on supervisory factors other than capital. As of December 31, 2006, we believe Pinnacle National would be considered "well capitalized" by its primary regulator.

#### ***Payment of Dividends***

We are a legal entity separate and distinct from Pinnacle National. Over time, the principal source of our cash flow, including cash flow to pay dividends to our holders of trust preferred securities and to our common stock

shareholders, will be dividends that Pinnacle National pays to us as its sole shareholder. Statutory and regulatory limitations apply to Pinnacle National's payment of dividends to us as well as to our payment of dividends to our shareholders. Until we require dividends from Pinnacle National, our cash flow requirements will be satisfied through our existing cash balances, additional equity offerings or additional offerings of trust preferred securities.

Pinnacle National is required by federal law to obtain the prior approval of the OCC for payments of dividends if the total of all dividends declared by its board of directors in any year will exceed (1) the total of Pinnacle National's net profits for that year, plus (2) Pinnacle National's retained net profits of the preceding two years, less any required transfers to surplus. We do not anticipate that Pinnacle Financial will require any dividends from Pinnacle National in 2007.

The payment of dividends by Pinnacle National and us may also be affected by other factors, such as the requirement to maintain adequate capital above regulatory guidelines. If, in the opinion of the OCC, Pinnacle National was engaged in or about to engage in an unsafe or unsound practice, the OCC could require, after notice and a hearing, that Pinnacle National stop or refrain from engaging in the practice. The federal banking agencies have indicated that paying dividends that deplete a depository institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under the Federal Deposit Insurance Corporation Improvement Act of 1991, a depository institution may not pay any dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the federal agencies have issued policy statements that provide that bank holding companies and insured banks should generally only pay dividends out of current operating earnings. See "Prompt Corrective Action" above.

### ***Restrictions on Transactions with Affiliates***

Both Pinnacle Financial and Pinnacle National are subject to the provisions of Section 23A of the Federal Reserve Act. Section 23A places limits on the amount of:

- A bank's loans or extensions of credit to affiliates;
- A bank's investment in affiliates;
- Assets a bank may purchase from affiliates, except for real and personal property exempted by the Federal Reserve;
- The amount of loans or extensions of credit to third parties collateralized by the securities or obligations of affiliates; and
- A bank's guarantee, acceptance or letter of credit issued on behalf of an affiliate.

The total amount of the above transactions is limited in amount, as to any one affiliate, to 10% of a bank's capital and surplus and, as to all affiliates combined, to 20% of a bank's capital and surplus. In addition to the limitation on the amount of these transactions, each of the above transactions must also meet specified collateral requirements. Pinnacle National must also comply with other provisions designed to avoid the taking of low-quality assets.

Pinnacle Financial and Pinnacle National are also subject to the provisions of Section 23B of the Federal Reserve Act which, among other things, prohibits an institution from engaging in the above transactions with affiliates unless the transactions are on terms substantially the same, or at least as favorable to the institution or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies.

Pinnacle National is also subject to restrictions on extensions of credit to its executive officers, directors, principal shareholders and their related interests. These extensions of credit (1) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties, and (2) must not involve more than the normal risk of repayment or present other unfavorable features.

### ***Community Reinvestment***

The Community Reinvestment Act requires that, in connection with examinations of financial institutions within their respective jurisdictions, the Federal Reserve, the OCC or the FDIC shall evaluate the record of each financial institution in meeting the credit needs of its local community, including low- and moderate-income neighborhoods. These facts are also considered in evaluating mergers, acquisitions, and applications to open a branch or facility. Failure to adequately meet these criteria could impose additional requirements and limitations on Pinnacle National.

Additionally, banks are required to publicly disclose the terms of various Community Reinvestment Act-related agreements. During 2006, Pinnacle National received a “satisfactory” CRA rating from the OCC.

***Privacy***

Under the Gramm-Leach-Bliley Act, financial institutions are required to disclose their policies for collecting and protecting confidential information. Customers generally may prevent financial institutions from sharing personal financial information with nonaffiliated third parties except for third parties that market the institutions’ own products and services. Additionally, financial institutions generally may not disclose consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing through electronic mail to consumers. Pinnacle National has established a privacy policy to ensure compliance with federal requirements.

### ***Other Consumer Laws and Regulations***

Interest and other charges collected or contracted for by Pinnacle National are subject to state usury laws and federal laws concerning interest rates. For example, under the Soldiers' and Sailors' Civil Relief Act of 1940, a lender is generally prohibited from charging an annual interest rate in excess of 6% on any obligations for which the borrower is a person on active duty with the United States military. Pinnacle National's loan operations are also subject to federal laws applicable to credit transactions, such as the:

- Federal Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
- Bank Secrecy Act, governing how banks and other firms report certain currency transactions which may involve "money laundering" activities;
- Soldiers' and Sailors' Civil Relief Act of 1940, governing the repayment terms of, and property rights underlying, secured obligations of persons in military service; and
- Rules and regulations of the various federal agencies charged with the responsibility of implementing the federal laws.

Pinnacle National's deposit operations are subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records; and
- Electronic Funds Transfer Act and Regulation E issued by the Federal Reserve to implement that act, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

### ***Anti-Terrorism Legislation***

On October 26, 2001, the President of the United States signed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001. Under the USA PATRIOT Act, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers.

In addition, the USA PATRIOT Act authorizes the Secretary of the Treasury to adopt rules increasing the cooperation and information sharing between financial institutions, regulators, and law enforcement authorities regarding individuals, entities and organizations engaged in, or reasonably suspected based on credible evidence of engaging in, terrorist acts or money laundering activities. Any financial institution complying with these rules will not be deemed to have violated the privacy provisions of the Gramm-Leach-Bliley Act, as discussed above. Pinnacle National currently has policies and procedures in place designed to comply with the USA PATRIOT Act.

***Proposed Legislation and Regulatory Action***

New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation's financial institutions. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

***Effect of Governmental Monetary Policies***

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve's monetary policies have had, and are likely to continue to have, an important impact on the operating results of commercial banks through the Federal Reserve's statutory power to implement national monetary policy in order, among other things, to curb inflation or combat a recession. The Federal Reserve, through its monetary and fiscal policies, affects the levels of bank loans, investments and deposits through its control over the issuance of United States government securities, its regulation of the discount rate applicable to member banks and its influence over reserve requirements to which member banks are subject. We cannot predict the nature or impact of future changes in monetary and fiscal policies.

**ITEM 1A. RISK FACTORS**

*Investing in our common stock involves various risks which are particular to our company, our industry and our market area. Several risk factors regarding investing in our common stock are discussed below. This listing should not be considered as all-inclusive. If any of the following risks were to occur, we may not be able to conduct our business as currently planned and our financial condition or operating results could be negatively impacted. These matters could cause the trading price of our common stock to decline in future periods.*

**We are geographically concentrated in the Nashville, Tennessee MSA, and changes in local economic conditions impact our profitability.**

We operate primarily in the Nashville, Tennessee MSA, and substantially all of our loan customers and most of our deposit and other customers live or have operations in the Nashville MSA. Accordingly, our success significantly depends upon the growth in population, income levels, deposits and housing starts in the Nashville MSA, along with the continued attraction of business ventures to the area. Our profitability is impacted by the changes in general economic conditions in this market. Additionally, unfavorable local or national economic conditions could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations.

We are less able than a larger institution to spread the risks of unfavorable local economic conditions across a large number of diversified economies. Moreover, we cannot give any assurance that we will benefit from any market growth or favorable economic conditions in our primary market areas if they do occur.

**Our continued growth may require the need for additional capital and further regulatory approvals which, if not obtained, could adversely impact our profitability and implementation of our current business plan.**

To continue to grow, we will need to provide sufficient capital to Pinnacle National through earnings generation, additional equity or trust preferred offerings or borrowed funds or any combination of these sources of funds. Should we incur indebtedness, we are required to obtain certain regulatory approvals beforehand. Should our growth exceed our expectations, as has been the case to-date, we may need to raise additional capital over our projected capital needs. However, our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial performance. Accordingly, we cannot assure our ability to raise additional capital if needed on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand and grow our operations could be materially impaired. Additionally, our current plan involves increasing our branch network, which will require capital expenditures. Our expansion efforts may also require certain regulatory approvals. Should we not be able to obtain such approvals or otherwise not be able to grow our asset base, our ability to attain our long-term profitability goals will be more difficult.

**We have a concentration of credit exposure to borrowers in certain industries and we also target small to medium-sized businesses.**

At December 31, 2006, we had significant credit exposures to borrowers in the trucking industry; commercial and residential building lessors; new home builders and to land subdividers. If any of these industries experience an economic slowdown and, as a result, the borrowers in these industries are unable to perform their obligations under their existing loan agreements, our earnings could be negatively impacted, causing the value of our common stock to decline.

Additionally, a substantial focus of our marketing and business strategy is to serve small to medium-sized businesses in the Nashville MSA. As a result, a relatively high percentage of our loan portfolio consists of commercial loans primarily to small to medium-sized business. At December 31, 2006, our commercial loans accounted for 70% of our total loans. During periods of economic weakness, small to medium-sized businesses may be impacted more severely than larger businesses. Consequently, the ability of such businesses to repay their loans may deteriorate, which would adversely impact our results of operations and financial condition.

Changes to current laws and regulations could adversely impact not only our results, but the results of our borrowers. New legislation or the loss of a significant governmental contract could adversely impact a particular borrower's business model and, thus, cause their credit worthiness to deteriorate. Additionally, changes in employment law, including increasing the minimum wage, could also adversely impact our borrowers.

**With its acquisition of Cavalry, Pinnacle Financial significantly increased its real estate construction and development loans, which have a greater credit risk than residential mortgage loans.**

Following its acquisition of Cavalry, construction and development lending is a more significant portion of Pinnacle Financial's loan portfolio than it was prior to the acquisition. The percentage of commercial real estate construction loans in Pinnacle National's portfolio increased to approximately 10.8% of its total loans at December 31, 2006 from 4.7% at December 31, 2005. This type of lending is generally considered to have more complex credit risks than traditional single-family residential lending because the principal is concentrated in a limited number of loans with repayment dependent on the successful operation of the related real estate project. Consequently, these loans are more sensitive to adverse conditions in the real estate market or the general economy. These loans are generally less predictable and more difficult to evaluate and monitor and collateral may be difficult to dispose of in a market decline. Additionally, Pinnacle National may experience significant construction loan loss because independent appraisers or project engineers inaccurately estimate the cost and value of construction loan projects. Also, due to a general economic downturn in the construction industry, Pinnacle Financial's results of operations may be adversely impacted and its net book value may be reduced.

**If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings will decrease.**

If loan customers with significant loan balances fail to repay their loans according to the terms of these loans, our earnings would suffer. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of any collateral securing the repayment of our loans. We maintain an allowance for loan losses in an attempt to cover the inherent risks associated with lending. In determining the size of this allowance, we rely on an analysis of our loan portfolio based on volume and types of loans, internal loan classifications, trends in classifications, volume and trends in delinquencies, nonaccruals and charge-offs, national and local economic conditions, industry and peer bank loan quality indications, other factors and other pertinent information. Because we are a relatively young organization, our allowance estimation may be less reflective of our historical loss experience than a more mature organization. If our assumptions are inaccurate, our current allowance may not be sufficient to cover potential loan losses, and additional provisions may be necessary

which would decrease our earnings.

In addition, federal and state regulators periodically review our loan portfolio and may require us to increase our allowance for loan losses or recognize loan charge-offs. Their conclusions about the quality of our loan portfolio may be different than ours. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory agencies could have a negative effect on our operating results.

**Fluctuations in interest rates could reduce our profitability.**

Changes in interest rates may affect our level of interest income, the primary component of our gross revenue, as well as the level of our interest expense. Interest rate fluctuations are caused by many factors which, for the most part, are not under our direct control. For example, national monetary policy plays a significant role in the determination of interest rates. Additionally, competitor pricing and the resulting negotiations that occur with our customers also impact the rates we collect on loans and the rates we pay on deposits.

As interest rates change, we expect that we will periodically experience “gaps” in the interest rate sensitivities of our assets and liabilities, meaning that either our interest-bearing liabilities will be more sensitive to changes in market interest rates than our interest-earning assets, or vice versa. In either event, if market interest rates should move contrary to our position, this “gap” may work against us, and our earnings may be negatively affected.

Changes in the level of interest rates also may negatively affect our ability to originate real estate loans, the value of our assets and our ability to realize gains from the sale of our assets, all of which ultimately affect our earnings. A decline in the market value of our assets may limit our ability to borrow additional funds. As a result, we could be required to sell some of our loans and investments under adverse market conditions, upon terms that are not favorable to us, in order to maintain our liquidity. If those sales are made at prices lower than the amortized costs of the investments, we will incur losses.

The slope of the yield curve will impact our results over the long-term. The present slope of the yield curve has been classified as “inverted” by economists due to yields on investments of shorter duration having a higher yield than investments which have longer duration. The impact of an inverted yield curve is believed by many banking professionals to have a negative impact on bank earnings. We concur with this and believe that should the current inverted yield curve exist for an extended period of time that this circumstance will likely have a negative impact on our results.

**Loss of our senior executive officers or other key employees could impair our relationship with our customers and adversely affect our business.**

We have assembled a senior management team which has a substantial background and experience in banking and financial services in the Nashville market. Loss of these key personnel could negatively impact our earnings because of their skills, customer relationships and/or the potential difficulty of promptly replacing them.

**Competition with other banking institutions could adversely affect our profitability.**

A number of banking institutions in the Nashville market have higher lending limits, more banking offices, and a larger market share. In addition, our asset management division competes with numerous brokerage firms and mutual fund companies which are also much larger. In some respects, this may place these competitors in a competitive advantage, although many of our customers have selected us because of service quality concerns at the larger enterprises. This competition may limit or reduce our profitability, reduce our growth and adversely affect our results of operations and financial condition.

**We may issue additional common stock or other equity securities in the future which could dilute the ownership interest of existing shareholders.**

In order to maintain our capital at desired or regulatory-required levels, we may be required to issue additional shares of common stock, or securities convertible into, exchangeable for or representing rights to acquire shares of common stock. We may sell these shares at prices below the current market price of shares, and the sale of these shares may significantly dilute shareholder ownership. We could also issue additional shares in connection with acquisitions of other financial institutions.

**Even though our common stock is currently traded on the Nasdaq Stock Market’s Global Select Market, it has less liquidity than the average stock quoted on a national securities exchange.**

The trading volume in our common stock on the Nasdaq Global Select Market has been relatively low when compared with larger companies listed on the Nasdaq Global Select Market or other stock exchanges. Although we have experienced increased liquidity in our stock, we cannot say with any certainty that a more active and liquid trading

market for our common stock will continue to develop. Because of this, it may be more difficult for shareholders to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares.

We cannot predict the effect, if any, that future sales of our common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of our common stock. We can give no assurance that sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of our common stock to decline or impair our future ability to raise capital through sales of our common stock.

The market price of our common stock may fluctuate in the future, and these fluctuations may be unrelated to our performance. General market price declines or overall market volatility in the future could adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

**If a change in control or change in management is delayed or prevented, the market price of our common stock could be negatively affected.**

Provisions in our corporate documents, as well as certain federal and state regulations, may make it difficult and expensive to pursue a tender offer, change in control or takeover attempt that our board of directors opposes. As a result, our shareholders may not have an opportunity to participate in such a transaction, and the trading price of our stock may not rise to the level of other institutions that are more vulnerable to hostile takeovers. Anti-takeover provisions contained in our charter also will make it more difficult for an outside shareholder to remove our current board of directors or management.

**Holders of Pinnacle Financial's junior subordinated debentures have rights that are senior to those of Pinnacle Financial's common shareholders.**

Pinnacle Financial has supported its continued growth through the issuance of trust preferred securities from special purpose trusts and accompanying junior subordinated debentures. At December 31, 2006, Pinnacle Financial had outstanding trust preferred securities and accompanying junior subordinated debentures totaling \$51.5 million. Payments of the principal and interest on the trust preferred securities of these trusts are conditionally guaranteed by Pinnacle Financial. Further, the accompanying junior subordinated debentures Pinnacle Financial issued to the trusts are senior to Pinnacle Financial's shares of common stock. As a result, Pinnacle Financial must make payments on the junior subordinated debentures before any dividends can be paid on its common stock and, in the event of Pinnacle Financial's bankruptcy, dissolution or liquidation, the holders of the junior subordinated debentures must be satisfied before any distributions can be made on Pinnacle Financial's common stock. Pinnacle Financial has the right to defer distributions on its junior subordinated debentures (and the related trust preferred securities) for up to five years, during which time no dividends may be paid on its common stock.

**The amount of common stock owned by, and other compensation arrangements with, our officers and directors may make it more difficult to obtain shareholder approval of potential takeovers that they oppose.**

As of February 27, 2007, directors and executive officers beneficially owned approximately 13.2% of our common stock. Employment agreements with our senior management also provide for significant payments under certain circumstances following a change in control. These compensation arrangements, together with the common stock, option and warrant ownership of our board and management, could make it difficult or expensive to obtain majority support for shareholder proposals or potential acquisition proposals of us that our directors and officers oppose.

**Our business is dependent on technology, and an inability to invest in technological improvements may adversely affect our results of operations and financial condition.**

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. We have made significant investments in data processing, management information systems and internet banking accessibility. Our future success will depend in part upon our ability to create additional efficiencies in our operations through the use of technology, particularly in light of our past and projected growth strategy. Many of our competitors have substantially greater resources to invest in technological improvements. We cannot make assurances that our technological improvements will increase our operational efficiency or that we will be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

**Our internal control over financial reporting may have weaknesses or inadequacies that may be material.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to perform an evaluation of our internal control over financial reporting and our auditor to attest to such evaluation on an annual basis. Management concluded that our internal control over financial reporting was effective at December 31, 2006 and our independent registered public accounting firm attested to such conclusion. Management's report on internal control over financial reporting is included on page 46 of this Form 10-K and the report of our independent registered public accounting firm on these matters is included on page 48 of this Form 10-K. Ongoing compliance with these requirements is expected to be expensive and time-consuming and may negatively impact our results of operations. While our management did not identify any material weaknesses in our internal control over financial reporting at December 31, 2006, and concluded that our internal control over financial reporting was effective, we cannot make any assurances that material weaknesses in our internal control over financial reporting will not be identified in the future. If any material weaknesses are identified in the future, we may be required to make material changes in our internal control over financial reporting which could negatively impact our results of operations. In addition, upon such occurrence, our management may not be able to conclude that our internal control

over financial reporting is effective or our independent registered public accounting firm may not be able to attest that our internal control over financial reporting was effective. If we cannot conclude that our internal control over financial reporting is effective or if our independent registered public accounting firm is not able to timely attest to such evaluation, we may be subject to regulatory scrutiny, and a loss of public confidence in our internal control over financial reporting which may cause the value of our common stock to decrease.

**We are subject to various statutes and regulations that may limit our ability to take certain actions.**

We operate in a highly regulated industry and are subject to examination, supervision, and comprehensive regulation by various regulatory agencies. Our compliance with these regulations is costly and restricts certain of our activities, including payment of dividends, mergers and acquisitions, investments, loans and interest rates charged, interest rates paid on deposits and locations of offices. We are also subject to capitalization guidelines established by our regulators, which require us to maintain adequate capital to support our growth.

The laws and regulations applicable to the banking industry could change at any time, and we cannot predict the effects of these changes on our business and profitability. Because government regulation greatly affects the business and financial results of all commercial banks and bank holding companies, our cost of compliance could adversely affect our ability to operate profitably.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

Pinnacle Financial's principal offices are located at 211 Commerce Street in Nashville, Tennessee in Davidson County. Pinnacle Financial leases these offices from an unrelated third party but owns the leasehold improvements.

Pinnacle National leases additional offices at One Nashville Place, 150 Fourth Avenue North in Nashville, Tennessee. Pinnacle Financial leases these offices from an unrelated third party but owns the leasehold improvements. Pinnacle National leases the land for its Brentwood branch office building located in Williamson County, Tennessee, from an unrelated third party but owns the building and leasehold improvements. Pinnacle National also leases the land and office space in a detached building on an adjacent lot for its Green Hills office location in Davidson County from an unrelated third party, but also owns the building and leasehold improvements. Pinnacle National also leases the land and building for its West End office location in Davidson County from unrelated third parties, but owns the leasehold improvements. Pinnacle National owns the land and buildings and all improvements for its Rivergate, Cool Springs and Franklin branch offices. Additionally, all office facilities and land acquired in the Cavalry Bancorp, Inc. transaction are now owned by Pinnacle National.

A summary of Pinnacle Financial's leased facilities follows:

<b>Property Description</b>	<b>Approximate Sq. Footage</b>	<b>2006 Lease Payments</b>	<b>Base Lease Expiration Date</b>	<b>Base Lease Term with Renewal Periods</b>
Office space at 211 Commerce Street	30,000	\$ 527,000	August 31, 2010	20 years
Brentwood branch office	Land only	\$ 105,000	March 31, 2010	20 years
Green Hills branch office	3,700 & land	\$ 71,711	April 21, 2021	40 years
West End branch office building and land	8,000	\$167,000	March 28, 2014	20 years

Office space at 150 4 <sup>th</sup> Avenue North	6,400	\$ 53,000	June 30, 2009	3 years
---	-------	-----------	---------------	---------

Other than normal commercial real estate lending activities of Pinnacle National and its subsidiaries, the acquisition of mortgage-backed securities held in Pinnacle National and its subsidiaries' investment securities portfolio, the ownership of branch office facilities, and consumer mortgage lending, Pinnacle National and its subsidiaries generally do not invest in real estate, interests in real estate or securities of or interests in persons primarily engaged in real estate activities.

**ITEM 3. LEGAL PROCEEDINGS**

As of the date hereof, there are no material pending legal proceedings to which Pinnacle Financial or any of its subsidiaries is a party or of which any of its or its subsidiaries' properties are subject; nor are there material proceedings known to Pinnacle Financial or any of its subsidiaries to be contemplated by any governmental authority; nor are there material proceedings known to Pinnacle Financial or any of its subsidiaries, pending or contemplated, in which any director, officer or affiliate or any principal security holder of Pinnacle Financial or any of its subsidiaries or any associate of any of the foregoing, is a party adverse to Pinnacle Financial or any of its subsidiaries or has a material interest adverse to Pinnacle Financial or any of its subsidiaries.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Pinnacle Financial's common stock is traded on the Nasdaq Global Select Market's under the symbol "PNFP" and has traded on that market since July 3, 2006. Prior to that date, Pinnacle Financial's common stock traded on the Nasdaq National Market for the periods presented. The following table shows the high and low sales price information for Pinnacle Financial's common stock for each quarter in 2006 and 2005 as reported on the Nasdaq Global Select Market, or its predecessor the Nasdaq National Market.

	Price Per Share	
	High	Low
<b>2006:</b>		
First quarter	\$ 28.84	\$ 24.75
Second quarter	30.92	27.09
Third quarter	37.41	28.93
Fourth quarter	36.17	31.23
<b>2005:</b>		
First quarter	\$ 24.05	\$ 20.72
Second quarter	25.14	20.50
Third quarter	26.65	22.67
Fourth quarter	25.96	21.70

As of February 15, 2007, Pinnacle Financial had approximately 900 shareholders of record and, additionally, approximately 5,600 beneficial owners.

Pinnacle Financial has not paid any cash dividends since inception, and it does not anticipate that it will consider paying dividends until Pinnacle National has achieved a level of profitability appropriate to fund such dividends and support asset growth. See ITEM 1. "Business - Supervision and Regulation - Payment of Dividends" and ITEM 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for additional information on dividend restrictions applicable to Pinnacle Financial.

Pinnacle Financial did not repurchase any shares of its common stock during the quarter ended December 31, 2006.



**ITEM 6. SELECTED FINANCIAL DATA**

	2006 <sup>(1)</sup>	2005	2004	2003	2002
(in thousands, except per share data, ratios and percentages)					
<b>Statement of Financial Condition Data:</b>					
Total assets	\$ 2,142,187	\$ 1,016,772	\$ 727,139	\$ 498,421	\$ 305,279
Loans, net of unearned income	1,497,735	648,024	472,362	297,004	209,743
Allowance for loan losses	(16,118)	(7,858)	(5,650)	(3,719)	(2,677)
Total securities	346,494	279,080	208,170	139,944	73,980
Goodwill and core deposit intangibles	125,673	--	--	--	--
Deposits and securities sold under agreements to repurchase	1,763,427	875,985	602,655	405,619	249,067
Advances from FHLB	53,726	41,500	53,500	44,500	21,500
Subordinated debt	51,548	30,929	10,310	10,310	--
Stockholders' equity	256,017	63,436	57,880	34,336	32,404
<b>Income Statement Data:</b>					
Interest income	\$ 109,696	\$ 46,308	\$ 27,679	\$ 18,262	\$ 12,561
Interest expense	48,743	17,270	7,415	5,363	4,362
Net interest income	60,953	29,038	20,264	12,899	8,199
Provision for loan losses	3,732	2,152	2,948	1,157	938
Net interest income after provision for loan losses	57,221	26,886	17,316	11,742	7,261
Noninterest income	15,786	5,394	4,978	3,035	1,732
Noninterest expense	46,624	21,032	14,803	10,796	7,989
Income before income taxes	26,383	11,248	7,491	3,981	1,004
Income tax expense	8,456	3,193	2,172	1,426	356
Net income	\$ 17,927	\$ 8,055	\$ 5,319	\$ 2,555	\$ 648
<b>Per Share Data:</b>					
Earnings per share - basic	\$ 1.28	\$ 0.96	\$ 0.69	\$ 0.35	\$ 0.11
Weighted average shares outstanding - basic	13,954,077	8,408,663	7,750,943	7,384,106	6,108,942
Earnings per share - diluted	\$ 1.18	\$ 0.85	\$ 0.61	\$ 0.32	\$ 0.10
Weighted average shares outstanding - diluted	15,156,837	9,464,500	8,698,139	7,876,006	6,236,844
Book value per share	\$ 16.57	\$ 7.53	\$ 6.90	\$ 4.65	\$ 4.39
Common shares outstanding at end of period	15,446,074	8,426,551	8,389,232	7,384,106	7,384,106
<b>Performance Ratios and Other Data:</b>					
Return on average assets	1.01%	0.93%	0.89%	0.66%	0.29%
Return on average stockholders' equity	8.66%	13.23%	12.31%	7.70%	2.47%
Net interest margin (2)	3.90%	3.60%	3.62%	3.53%	3.81%

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Net interest spread (3)	3.20%	3.16%	3.34%	3.23%	3.42%
Noninterest income to average assets	0.89%	0.62%	0.83%	0.78%	0.76%
Noninterest expense to average assets	2.61%	2.42%	2.48%	2.78%	3.50%
Efficiency ratio (4)	60.80%	61.1%	58.6%	67.8%	80.4%
Average loan to average deposit ratio	88.73%	81.3%	79.0%	85.5%	98.5%
Average interest-earning assets to average interest-bearing liabilities	122.10%	120.0%	120.0%	118.9%	119.6%
Average equity to average total assets ratio	11.64%	7.00%	7.23%	8.54%	11.58%

**Asset Quality Ratios:**

Allowance for loan losses to nonperforming assets	199.9%	1,708.3%	1,006.9%	981.3%	143.4%
Allowance for loan losses to total loans	1.08%	1.21%	1.20%	1.25%	1.28%
Nonperforming assets to total assets	0.37%	0.05%	0.08%	0.08%	0.61%
Nonaccrual loans to total loans	0.47%	0.07%	0.12%	0.13%	0.89%
Net loan charge-offs (recoveries) to average loans	0.05%	(0.01)%	0.27%	0.05%	0.05%

**Capital Ratios:**

Leverage (5)	9.5%	9.9%	9.7%	9.7%	11.1%
Tier 1 risk-based capital	10.9%	11.7%	11.7%	11.8%	12.7%
Total risk-based capital	11.8%	12.6%	12.7%	12.8%	13.8%

- (1) Information for 2006 fiscal year includes the operations of Cavalry, which Pinnacle Financial merged with on March 15, 2006 and reflects approximately 6.9 million shares of Pinnacle Financial common stock issued in connection with the merger.
- (2) Net interest margin is the result of net interest income for the period divided by average interest earning assets.
- (3) Net interest spread is the result of the difference between the interest yield earned on interest earning assets less the interest paid on interest bearing liabilities.
- (4) Efficiency ratio is the result of noninterest expense divided by the sum of net interest income and noninterest income.
- (5) Leverage ratio is computed by dividing Tier 1 capital by average total assets for the fourth quarter of each year.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion of our financial condition at December 31, 2006 and 2005 and our results of operations for each of the three-years ended December 31, 2006. The purpose of this discussion is to focus on information about our financial condition and results of operations which is not otherwise av>

Change in operations<sup>(a)</sup>

0.14

50.0

pp<sup>(b)</sup>

Change in equity method investments<sup>(a)</sup>

(0.03

)

(10.7

)

pp

Change in interest expense<sup>(a)</sup>

(0.01

)

(3.6

)

pp

Change in weighted average shares outstanding<sup>(c)</sup>

0.02

7.1

pp

Change in effective tax rate

0.01

3.6

pp

Basic and diluted earnings per share for the quarter ended March 31, 2016

\$

0.41

46.4

%

(a) Changes are net of tax based on the effective tax rate for each base year.

(b) Percentage points ("pp").

(c) Weighted average shares outstanding change primarily due to the vesting of employee restricted stock units, the granting of Common Stock to directors, the purchase of vested stock by the Company from employees to pay withholding taxes, and repurchases by the Company of Common Stock.

Earnings per share increased to \$0.41 in the quarter ended March 31, 2016 from \$0.28 in the quarter ended March 31, 2015, primarily due to performance from operations, the decline in weighted average shares outstanding due to a repurchase of Common Stock in 2015, partially offset by lower equity method investment earnings (see Note 2) and higher interest expense quarter-over-quarter.

## SEGMENT RESULTS

## DISTILLERY PRODUCTS

The following table shows selected financial information for our distillery products segment for the quarters ended March 31, 2016 and 2015.

	PRODUCT GROUP NET SALES					Quarter-versus-Quarter Volume Increase / (Decrease)	(a)
	Quarter Ended March 31,		Quarter-versus-Quarter Net Sales Change Increase / (Decrease)				
	2016	2015	\$ Change	% Change			
	Amount	Amount					
Food grade alcohol <sup>(a)</sup>	\$54,206	\$55,304	\$ (1,098 )	(2.0 )%			
Fuel grade alcohol <sup>(a)</sup>	1,855	2,419	(564 )	(23.3 )			
Distillers feed and related co-products	5,780	6,787	(1,007 )	(14.8 )			
Warehouse revenue	2,001	1,352	649	48.0			
Total distillery products	\$63,842	\$65,862	\$ (2,020 )	(3.1 )%	(15.3 )%		

	Other Financial Information				
	Quarter Ended March 31,		Quarter-versus-Quarter Increase / (Decrease)		
	2016	2015	\$ Change	% Change	
Gross profit	\$ 14,850	\$ 11,487	\$ 3,363	29.3	%
Gross margin %	23.3	% 17.4	%	5.9	pp <sup>(b)</sup>

<sup>(a)</sup> Volume change for alcohol products.

<sup>(b)</sup> Percentage points ("pp").

Driven by strong demand for our premium bourbon and rye whiskeys, net sales of higher margin premium beverage alcohol products within food grade alcohol increased over the year-ago quarter, while lower margin alcohol products, net sales decreased resulting in an overall food grade alcohol net sales decrease of \$1,098, or 2.0 percent. Declines in net sales of the lower margin co-products of fuel grade alcohol and distillers feed were partially offset by an increase in warehouse revenue generated by increased storage of customer barrels of whiskey.

Gross profit increased quarter-versus-quarter by \$3,363, or 29.3 percent. Gross margin for the quarter ended March 31, 2016 was 23.3 percent compared to 17.4 percent for the quarter ended March 31, 2015, which was due to the continuing shift in alcohol product sales mix to premium spirits, a higher average selling price, and a decrease in input costs.

## INGREDIENT SOLUTIONS

The following table shows selected financial information for our ingredient solutions segment for the quarters ended March 31, 2016 and 2015.

PRODUCT GROUP NET SALES					
	Quarter Ended March 31,		Quarter-versus-Quarter Net Sales Change Increase / (Decrease)		Quarter-versus-Quarter Volume Increase / (Decrease)
	2016 Amount	2015 Amount	\$ Change	% Change	% Change
Specialty wheat starches	\$6,176	\$7,729	\$ (1,553 )	(20.1 )%	
Specialty wheat proteins	4,989	4,479	510	11.4	
Commodity wheat starch	1,612	1,987	(375 )	(18.9 )	
Commodity wheat protein	216	356	(140 )	(39.3 )	
Total ingredient solutions	\$12,993	\$14,551	\$ (1,558 )	(10.7 )%	(13.3 )%

Other Financial Information					
	Quarter Ended March 31,		Quarter-versus-Quarter Increase / (Decrease)		
	2016	2015	\$ Change	% Change	
Gross profit	\$2,196	\$1,901	\$ 295	15.5 %	
Gross margin %	16.9 %	13.1 %		3.8	pp <sup>(a)</sup>

<sup>(a)</sup> Percentage points ("pp").

Total ingredient solutions net sales for the quarter ended March 31, 2016 decreased by \$1,558, or 10.7 percent, compared to the quarter ended March 31, 2015. This decline was driven by decreased product sales volume of 13.3 percent, partially offset by a higher average selling price. Net sales of specialty wheat proteins increased \$510 quarter-versus-quarter, while net sales of specialty wheat starches decreased \$1,553 quarter-versus-quarter. Lower margin commodity products net sales continued to decrease quarter-versus-quarter as part of our strategic plan to maximize sales of higher value products.

Gross profit increased quarter-versus-quarter by \$295, or 15.5 percent. Gross margin for the quarter ended March 31, 2016 was 16.9 percent compared to 13.1 percent for the quarter ended March 31, 2015, primarily due to the shift in product sales mix to higher value specialty wheat proteins, and a decrease in input costs, partially offset by a decrease in net sales of specialty wheat starches and commodity products.

## CASH FLOW, FINANCIAL CONDITION AND LIQUIDITY

We believe our financial condition continues to be of high quality, as evidenced by our ability to generate adequate cash from operations while having ready access to capital at competitive rates.

Operating cash flow and debt through our Credit Agreement (see Note 1 for Credit Agreement details) provide the primary sources of cash to fund operating needs and capital expenditures. These same sources of cash are used to fund shareholder dividends and other discretionary uses such as share repurchases. Going forward, we expect to use cash to implement our invest to grow strategy, particularly in the distillery products segment. The overall liquidity of the Company reflects our strong business results and an effective cash management strategy that takes into account liquidity management, economic factors, and tax considerations. We expect our sources of cash, including our credit

facility, to be adequate to provide for budgeted capital expenditures and anticipated operating requirements.

## Operating Cash Flow

Cash flow from operations decreased \$7,762 to \$(1,641) for the quarter ended March 31, 2016, from \$6,121 for the quarter ended March 31, 2015. This decrease in operating cash flow was primarily the result of net cash outflows related to the changes in inventory, accounts payable, and accrued expenses, partially offset by cash inflows related to increased net income, after giving effect to adjustments to reconcile net income to net cash provided by operating activities (depreciation and amortization, distribution received from equity method investee, deferred income taxes, including change in valuation allowance, share-based compensation, and equity method investment earnings) and the increase in income taxes payable.

**Increases to Operating Cash Flow.** Net income after giving effect to adjustments to reconcile net income to net cash provided by operating activities, increased by \$4,135, to \$13,176 for the quarter ended March 31, 2016 from \$9,041 for the quarter ended March 31, 2015. The increase quarter-versus-quarter consists of an increase in net income of \$1,989, an increase in depreciation and amortization of \$213, a distribution received from our equity method investee of \$3,300, a decrease in deferred income taxes, including change in valuation allowance, of \$2,649, an increase in share-based compensation of \$447 and a decrease in equity method investment earnings of \$835. Accounts payable decreased \$4,236 for the quarter ended March 31, 2016 compared to an increase of \$819 for the quarter ended March 31, 2015. The \$5,055 change was primarily due to the timing of current cash disbursements. Receivables, net, increased \$534 for the quarter ended March 31, 2016 compared to an increase of \$194 for the quarter ended March 31, 2015. The resulting \$340 change was primarily due to the timing of collections. Accrued expenses decreased \$3,958 for the quarter ended March 31, 2016 compared to a decrease of \$1,248 for the quarter ended March 31, 2015. The \$2,710 change was primarily due to decreases in incentive compensation accruals.

**Decreases to Operating Cash Flow.** Inventory increased \$9,682 for the quarter ended March 31, 2016, compared to an increase of \$3,213 for the quarter ended March 31, 2015, resulting in a \$6,469 change. Increased investment in barreled distillate inventory for aging quarter-versus-quarter of \$4,450 and increased investment in finished product safety stock quarter-versus-quarter of \$2,376 accounted for the change.

## Investing Cash Flow

Net investing cash outflow for the quarter ended March 31, 2016 was \$3,053 compared to net investing cash outflow of \$5,030 for the quarter ended March 31, 2015, for a net decrease in cash used in investing activities of \$1,977.

**Capital Spending.** We manage capital spending to support our business growth plans. Capital expenditures, primarily to support capacity expansion and facility improvements and sustenance were \$4,872 and \$5,246, respectively, for the quarters ended March 31, 2016 and 2015, of which \$3,053 and \$5,030, respectively, were uses of cash and \$1,819 and \$216, respectively, remained payable. We expect approximately \$24,000 in capital expenditures in 2016 for facility improvement and expansion (including our warehouse expansion), facility sustenance projects, and environmental health and safety projects. On October 21, 2015, we announced a \$16,400 major expansion in warehousing capacity on a 20-acre campus adjoining our current Lawrenceburg facility as part of the implementation of our five-year strategic plan to grow the whiskey category. In December 2015, our Board of Directors approved an additional \$3,800 for a portion of the next phase of the project, for a total approved investment of \$20,200. As of March 31, 2016, we had spent \$14,040 of the total approved warehouse expansion investment.

## Financing Cash Flow

**Long-Term and Short-Term Debt.** We maintain debt levels we consider appropriate after evaluating a number of factors, including cash flow expectations, cash requirements for ongoing operations, investment and financing plans (including brand development and share repurchase activities) and the overall cost of capital. Total debt was \$37,444 (net of unamortized loan fees of \$667) at March 31, 2016 and \$33,460 at December 31, 2015. During the quarters

ended March 31, 2016 and 2015, we had net borrowings / (payments) of \$4,453, and \$348, respectively, on our Credit Agreement (see Note 1 for Credit Agreement details). Our payments on long-term debt totaled \$438 and \$398 for quarters ended March 31, 2016 and 2015, respectively.

#### Financial Condition and Liquidity

Our principal uses of cash in the ordinary course of business are for input costs used in our production processes, salaries, capital expenditures, and investments supporting our strategic plan, such as the aging of barreled distillate. Generally, during periods when commodities prices are rising, our operations require increased use of cash to support inventory levels.

Our principal sources of cash are product sales and borrowing on our Credit Agreement. Under our Credit Agreement, we must meet certain financial covenants and include other restrictions as disclosed in Note 1 of this Report on Form 10-Q and in Note 4 of the Form 10-K/A for the year ended December 31, 2015.

At March 31, 2016, our current assets exceeded our current liabilities by \$63,767 largely due to our inventories of \$68,383. At March 31, 2016 our cash balance was \$0 and we have used our Credit Agreement for liquidity purposes, with \$53,352 remaining for additional borrowings. We anticipate being able to support our short-term liquidity and operating needs largely through cash generated from operations. We regularly assesses our cash needs and the available sources to fund these needs. We utilize short- and long-term debt to fund discretionary items, such as capital investments and share repurchases. In addition, we have strong operating results such that financial institutions, if needed, should provide sufficient credit funding to meet short-term financing requirements.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Certain commodities we use in our production process are exposed to market price risk due to volatility in the prices for those commodities. Our grain supply agreements for our Lawrenceburg and Atchison facilities permit us to purchase grain for delivery up to 12 months into the future at negotiated prices. The pricing for contracts is based on a formula using several factors. We have determined that the firm commitments to purchase grain under the terms of the supply agreements meet the normal purchases and sales exception as defined under Accounting Standards Codification ("ASC") 815, Derivatives and Hedging, and have excluded the fair value of these commitments from recognition within our consolidated financial statements until the actual contracts are physically settled.

Our production process also involves the use of wheat flour and natural gas. The contracts for wheat flour and natural gas range from monthly contracts to multi-year supply arrangements; however, because the quantities involved have always been for amounts to be consumed within the normal expected production process, we have determined that the contracts meet the criteria for the normal purchases and sales exception and have excluded the fair value of these commitments from recognition within our consolidated financial statements until the actual contracts are physically settled.

**Interest Rate Exposures.** Our Credit Agreement with Wells Fargo Bank, as amended March 21, 2016, provides for interest either on a Base Rate model or a LIBOR Rate model. For LIBOR Rate Loans, the interest rate is equal to the per annum LIBOR Rate (based on 1, 2, 3 or 6 months) plus 1.75 - 2.75 percent (depending on the Average Excess Availability). For Base Rate Loans, the interest rate is the greatest of (a) 1 percent per annum, (b) the Federal Funds Rate plus one-half percent, (c) the one-month LIBOR Rate plus 1 percent, and (d) Wells Fargo's "prime rate" as announced from time to time, plus 0.75 - 1.75 percent (depending on the Average Excess Availability). The default rate is equal to 2 percentage points above the per annum rate otherwise applicable, in the lender's discretion.

Increases in market interest rates would cause interest expense to increase and earnings before income taxes to decrease. The change in interest expense and earnings before income taxes would be dependent upon the weighted average outstanding borrowings during the reporting period following an increase in market interest rates. Based on weighted average outstanding borrowings at March 31, 2016, a 100 basis point increase over the non-default rates actually in effect at such date would increase our interest expense on an annualized basis by \$353.

### ITEM 4. CONTROLS AND PROCEDURES.

**Evaluation of Disclosure Controls and Procedures.** As of the quarter ended March 31, 2016, our Chief Executive Officer and Chief Financial Officer have each reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have each concluded that our current disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits

under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

**Changes in Internal Controls.** There has been no change in the Company's internal control over financial reporting required by Exchange Act Rule 13a-15 that occurred during the quarter ended March 31, 2016 that has materially affected, or is reasonably likely to materially affect the Company's internal control over financial reporting.

## PART II – OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

Reference is made to Part I, Item 3, Legal Proceedings of our Report on Form 10-K/A for the year ended December 31, 2015 and Note 4 of this Report on Form 10-Q for information on certain proceedings to which we are subject.

We are a party to various other legal proceedings in the ordinary course of business, none of which is expected to have a material adverse effect on us.

## ITEM 1A. RISK FACTORS

Risk Factors are described in "Item 1A. Risk Factors" of our Report on Form 10-K/A for the year ended December 31, 2015. There have been no material changes thereto during the quarter ended March 31, 2016.

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

There was no unregistered sale of equity securities during the quarter ended March 31, 2016.

## ISSUER PURCHASES OF EQUITY SECURITIES

	(1) Total Number of Shares (or Units) Purchased	(2) Average Price Paid per Share (or Unit)	(3) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(4) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
January 1, 2016 through January 31, 2016	—	\$ —	—	\$ —
February 1, 2016 through February 29, 2016	—	—	—	—
March 1, 2016 through March 31, 2016	—	—	—	—
Total	—	—	—	—

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit Number	Description of Exhibit
10.1	Third Amended and Restated Credit Agreement, by and among the lenders identified therein, Wells Fargo Bank, National Association, as administrative agent for the lenders, sole lead arranger and sole book runner, MGP Ingredients, Inc., MGPI Processing, Inc., MGPI Pipeline, Inc., and MGPI of Indiana, LLC, dated March 21, 2016 (Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed March 25, 2016)
*31.1	CEO Certification pursuant to Rule 13a-14(a)
*31.2	CFO Certification pursuant to Rule 13a-14(a)
*32.1	CEO and Certification furnished pursuant to Rule 13a-14(b) and 18 U.S.C. 1350
*32.2	CFO Certification furnished pursuant to Rule 13a-14(b) and 18 U.S.C. 1350
*101	The following financial information from MGP Ingredients, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2016, formatted in XBRL (Extensible Business Reporting Language) includes: (i) Condensed Consolidated Balance Sheets as of March 31, 2016, and December 31, 2015, (ii) Condensed Consolidated Statements of Comprehensive Income for the three months ended March 31, 2016 and 2015, (iii) Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015, (iv) Condensed Consolidated Statement of Changes in Stockholders' Equity, and (v) the Notes to Condensed Consolidated Financial Statements.

\*Filed herewith

SIGNATURES

Pursuant to the requirements on 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.

MGP INGREDIENTS, INC.

Date: May 4, 2016 By/s/ Augustus C. Griffin

Augustus C. Griffin, President and Chief Executive Officer

Date: May 4, 2016 By/s/ Thomas K. Pigott

Thomas K. Pigott, Vice President, Finance and Chief Financial Officer

Exhibit Index

Exhibit Number	Description of Exhibit
10.1	Third Amended and Restated Credit Agreement, by and among the lenders identified therein, Wells Fargo Bank, National Association, as administrative agent for the lenders, sole lead arranger and sole book runner, MGP Ingredients, Inc., MGPI Processing, Inc., MGPI Pipeline, Inc., and MGPI of Indiana, LLC, dated March 21, 2016 (Incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed March 25, 2016)
*31.1	CEO Certification pursuant to Rule 13a-14(a)
*31.2	CFO Certification pursuant to Rule 13a-14(a)
*32.1	CEO and Certification furnished pursuant to Rule 13a-14(b) and 18 U.S.C. 1350
*32.2	CFO Certification furnished pursuant to Rule 13a-14(b) and 18 U.S.C. 1350
*101	The following financial information from MGP Ingredients, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2016, formatted in XBRL (Extensible Business Reporting Language) includes: (i) Condensed Consolidated Balance Sheets as of March 31, 2016, and December 31, 2015, (ii) Condensed Consolidated Statements of Comprehensive Income for the three months ended March 31, 2016 and 2015, (iii) Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015, (iv) Condensed Consolidated Statement of Changes in Stockholders' Equity, and (v) the Notes to Condensed Consolidated Financial Statements.

\*Filed herewith