

MIDSOUTH BANCORP INC
Form 10-Q
August 09, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

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 1-11826
MIDSOUTH BANCORP, INC.
(Exact name of registrant as specified in its charter)

Louisiana 72-1020809
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

102 Versailles Boulevard, Lafayette, Louisiana 70501
(Address of principal executive offices, including zip code)
(337) 237-8343
(Registrant's telephone number, including area code)

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

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES NO

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

YES NO

As of August 9, 2018, there were 16,639,650 shares of the registrant's Common Stock, par value \$0.10 per share, outstanding.

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Part I – Financial Information

Item 1. Financial Statements.

MidSouth Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(dollars in thousands, except share data)

	June 30, 2018 (unaudited)	December 31, 2017 (audited)
Assets		
Cash and due from banks, including required reserves of \$10,470 and \$6,741, respectively	\$31,145	\$34,775
Interest-bearing deposits in banks	241,492	114,839
Federal funds sold	6,139	3,350
Securities available-for-sale, at fair value (cost of \$317,251 at June 30, 2018 and \$312,584 at December 31, 2017)	308,937	309,191
Securities held-to-maturity (fair value of \$66,758 at June 30, 2018 and \$80,920 at December 31, 2017)	67,777	81,052
Other investments	14,927	12,214
Loans held for sale	—	15,737
Loans	1,057,963	1,183,426
Allowance for loan losses	(23,514)	(26,888)
Loans, net	1,034,449	1,156,538
Bank premises and equipment, net	56,834	59,057
Accrued interest receivable	7,131	8,283
Goodwill	42,171	42,171
Intangibles	2,962	3,515
Cash surrender value of life insurance	15,002	14,896
Other real estate	1,365	2,001
Assets held for sale	3,995	3,995
Other assets	24,591	19,538
Total assets	\$1,858,917	\$1,881,152
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Non-interest-bearing	\$419,517	\$416,547
Interest-bearing	1,103,503	1,063,142
Total deposits	1,523,020	1,479,689
Securities sold under agreements to repurchase	14,886	67,133
Short-term Federal Home Loan Bank advances	27,500	40,000
Long-term Federal Home Loan Bank advances	10,011	10,021
Junior subordinated debentures	22,167	22,167
Other liabilities	12,661	8,127
Total liabilities	1,610,245	1,627,137
Commitments and contingencies		
Shareholders' equity:		
Series B Preferred stock, no par value; 5,000,000 shares authorized, 32,000 shares issued and outstanding at June 30, 2018 and December 31, 2017	32,000	32,000
	8,987	8,987

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Series C Preferred stock, no par value; 100,000 shares authorized, 89,875 shares issued and outstanding at June 30, 2018 and December 31, 2017

Common stock, \$0.10 par value; 30,000,000 shares authorized, 16,619,894 and 16,548,829 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	1,662	1,655
Additional paid-in capital	168,863	168,412
Unearned ESOP shares	(876) (937)
Accumulated other comprehensive loss	(5,400) (1,828)
Retained earnings	43,436	45,726
Total shareholders' equity	248,672	254,015
Total liabilities and shareholders' equity	\$1,858,917	\$1,881,152

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries
Consolidated Statements of Operations (unaudited)
(in thousands, except share and per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Interest income:				
Loans, including fees	\$15,344	\$16,731	\$31,359	\$33,353
Securities and other investments:				
Taxable	2,093	2,416	4,140	4,743
Nontaxable	277	374	593	781
Federal funds sold	21	9	39	15
Time and interest bearing deposits in other banks	912	150	1,426	235
Other investments	92	78	179	162
Total interest income	18,739	19,758	37,736	39,289
Interest expense:				
Deposits	1,410	973	2,647	1,908
Securities sold under agreements to repurchase	25	236	66	470
Short-term FHLB advances	75	—	159	—
Long-term FHLB advances	45	91	90	179
Junior subordinated debentures	259	212	479	420
Total interest expense	1,814	1,512	3,441	2,977
Net interest income	16,925	18,246	34,295	36,312
Provision for loan losses	440	12,500	440	15,300
Net interest income after provision for loan losses	16,485	5,746	33,855	21,012
Non-interest income:				
Service charges on deposits	2,065	2,396	4,271	4,876
Gain on sale of securities, net	—	3	—	9
Loss on equity securities, other investments	(51)	—	(51)	—
ATM and debit card income	1,877	1,766	3,661	3,469
Other charges and fees	991	1,058	1,830	1,913
Total non-interest income	4,882	5,223	9,711	10,267
Non-interest expenses:				
Salaries and employee benefits	7,916	9,451	15,635	18,140
Occupancy expense	3,193	4,189	6,238	7,813
ATM and debit card expense	648	713	1,223	1,434
Data processing	666	667	1,331	1,288
FDIC insurance	507	430	937	827
Legal and professional fees	1,100	936	2,789	1,321
Loss on transfer of loans to held for sale	8	—	883	—
Other	8,235	3,218	15,109	6,011
Total non-interest expenses	22,273	19,604	44,145	36,834
Income before income tax benefit	(906)	(8,635)	(579)	(5,555)
Loss tax benefit	(237)	(3,221)	(271)	(2,632)

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Net loss	(669)	(5,414)	(308)	(2,923)
Dividends on preferred stock	810	811	1,620	1,622
Net loss available to common shareholders	\$(1,479)	\$(6,225)	\$(1,928)	\$(4,545)
Loss per share:				
Basic	\$(0.09)	\$(0.51)	\$(0.12)	\$(0.39)
Diluted	\$(0.09)	\$(0.51)	\$(0.12)	\$(0.39)
Weighted average number of shares outstanding:				
Basic	16,526	12,227	16,511	11,749
Diluted	16,529	12,237	16,514	11,762
Dividends declared per common share	\$0.01	\$0.09	\$0.02	\$0.18

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries
 Consolidated Statements of Comprehensive Loss (unaudited)
 (in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net loss	\$ (669)	\$ (5,414)	\$ (308)	\$ (2,923)
Other comprehensive (loss) income, net of tax:				
Unrealized (losses) gains on securities available-for-sale:				
Unrealized holding (loss) gains arising during the year	(873)	2,739	(4,922)	3,559
Less: reclassification adjustment for gains on sales of securities available-for-sale	—	(3)	—	(9)
Net change in unrealized (loss) gains on securities available-for-sale	(873)	2,736	(4,922)	3,550
Unrealized (loss) gain on derivative instruments designated as cash flow hedges:				
Unrealized holding gains on derivatives arising during the period	152	(136)	502	(123)
Less: reclassification adjustment for gains on derivative instruments	(63)	—	(102)	—
Net change in unrealized gain on derivative instruments	89	(136)	400	(123)
Total other comprehensive (loss) income, before tax	(784)	2,600	(4,522)	3,427
Income tax effect related to items of other comprehensive (loss) income	165	(910)	950	(1,200)
Total other comprehensive (loss) income, net of tax	(619)	1,690	(3,572)	2,227
Total comprehensive loss	\$ (1,288)	\$ (3,724)	\$ (3,880)	\$ (696)
See notes to unaudited consolidated financial statements.				

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MidSouth Bancorp, Inc. and Subsidiaries
Consolidated Statement of Shareholders' Equity (unaudited)
For the Six Months Ended June 30, 2018
(in thousands, except share and per share data)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Unearned ESOP Shares	Accumulated Other Comprehensive Loss	Retained Earnings	Total
	Shares	Amount	Shares	Amount					
Balance - December 31, 2017	121,875	\$40,987	16,548,829	\$1,655	\$168,412	\$(937)	\$(1,828)	\$45,726	\$254,015
Cumulative-effect adjustment due to the adoption of ASU 2016-01	—	—	—	—	—	—	31	(31)	—
Net loss	—	—	—	—	—	—	—	(308)	(308)
Dividends on Series B and Series C preferred stock	—	—	—	—	—	—	—	(1,621)	(1,621)
Dividends on common stock, \$0.02 per share	—	—	—	—	—	—	—	(330)	(330)
Restricted stock grant	—	—	66,335	7	(7)	—	—	—	—
Restricted stock forfeitures	—	—	(37,775)	(4)	4	—	—	—	—
ESOP shares released for allocation	—	—	—	—	—	61	—	—	61
ESOP compensation expense	—	—	—	—	20	—	—	—	20
Exercise of stock options	—	—	42,505	4	547	—	—	—	551
Stock option and restricted stock compensation expense	—	—	—	—	(113)	—	—	—	(113)
Change in accumulated other comprehensive loss	—	—	—	—	—	—	(3,603)	—	(3,603)
Balance - June 30, 2018	121,875	\$40,987	16,619,894	\$1,662	\$168,863	\$(876)	\$(5,400)	\$43,436	\$248,672

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries
Consolidated Statements of Cash Flows (unaudited)
(in thousands)

	For the Six Months Ended June 30,	
	2018	2017
Cash flows from operating activities:		
Net loss	\$(308)	\$(2,923)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	2,368	2,933
Accretion of purchase accounting adjustments	340	(101)
Provision for loan losses	440	15,300
Deferred tax expense (benefit)	8	(1,057)
Amortization of premiums on securities, net	1,457	1,390
Stock-based compensation expense	(113)	66
Net excess tax benefit from stock-based compensation	49	(357)
ESOP compensation expense	20	50
Net gain on sale of investment securities	—	(9)
Loss on mutual fund	51	—
Proceeds from sale of loans held for sale	15,623	—
Net loss on sale of other real estate owned	1	4
Net write down of other real estate owned	146	83
Write down of assets held for sale	—	570
Loss on transfer of loans to held for sale	883	—
Net loss on sale/disposal of premises and equipment	67	12
Change in accrued interest receivable	1,152	364
Change in accrued interest payable	(42)	3
Change in other assets & other liabilities, net	718	(2,874)
Net cash provided by operating activities	22,860	13,454
Cash flows from investing activities:		
Proceeds from maturities and calls of securities available-for-sale	24,297	28,100
Proceeds from maturities and calls of securities held-to-maturity	12,875	9,431
Proceeds from sale of securities available-for-sale	410	6,965
Proceeds from sale of security held-to-maturity	—	887
Purchases of securities available-for-sale	(32,532)	(39,172)
Proceeds from sale of other investments	—	57
Purchases of other investments	(703)	(368)
Net change in loans	121,129	28,616
Purchases of premises and equipment	(693)	(1,662)
Proceeds from sale of premises and equipment	481	249
Proceeds from sale of other real estate owned	504	1,611
Net cash provided by investing activities	125,768	34,714
Cash flows from financing activities:		
Change in deposits	43,331	(43,210)
Change in securities sold under agreements to repurchase	(52,247)	(3,662)
Borrowings on Federal Home Loan Bank advances	165,000	—
Repayments of Federal Home Loan Bank advances	(177,500)	(35)

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Proceeds from exercise of stock options	551	266
Proceeds from issuance of common stock	—	51,975
Stock offering expenses	—	(622)
Payment of dividends on preferred stock	(1,621)	(1,622)
Payment of dividends on common stock	(330)	(2,049)
Net cash used by financing activities	(22,816)	1,041
Net increase (decrease) in cash and cash equivalents	125,812	49,209
Cash and cash equivalents, beginning of period	152,964	82,228
Cash and cash equivalents, end of period	\$278,776	\$131,437
Supplemental cash flow information:		
Interest paid	\$3,482	\$2,975
Income taxes paid	—	2,500
Noncash investing and financing activities:		
Transfer of loans to other real estate	15	910
Transfer of loans to held for sale	221	—
Change in accrued common stock dividends	1	418
Change in unrealized gains/losses on securities available-for-sale, net of tax	(3,918)	2,307
Change in unrealized gains on derivative instruments, net of tax	315	(80)
Cumulative-effect adjustment to retained earnings due to ASU 2016-01, net of tax	31	—
Net change in loan to ESOP	61	219

See notes to unaudited consolidated financial statements.

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MidSouth Bancorp, Inc. and Subsidiaries
Notes to Interim Consolidated Financial Statements
June 30, 2018
(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements and notes thereto contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America (“GAAP”), the financial position of MidSouth Bancorp, Inc. (the “Company”) and its subsidiaries as of June 30, 2018 and the results of their operations and their cash flows for the periods presented. The interim financial information should be read in conjunction with the annual consolidated financial statements and the notes thereto included in the Company’s 2017 Annual Report on Form 10-K.

The results of operations for the six-month period ended June 30, 2018 are not necessarily indicative of the results to be expected for the entire year.

Use of Estimates — The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Summary of Significant Accounting Policies — The accounting and reporting policies of the Company conform with GAAP and general practices within the banking industry. There have been no material changes or developments in the application of accounting principles or in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be Critical Accounting Policies and Estimates as disclosed in our 2017 Annual Report on Form 10-K.

Recent Accounting Pronouncements — In May 2018, the FASB issued ASU 2018-06, Codification Improvements to Topic 942, Financial Services - Depository and Lending. ASU 2018-06 removes outdated guidance related to Circular 202 because that guidance has been rescinded by the Office of the Comptroller of the Currency. The amendments in this update are effective upon issuance. The adoption of this ASU did not have a material effect on the Company’s financial position, result of operations or cash flows.

ASU 2018-03, Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities was issued to clarify certain aspects of the guidance on recognizing and measuring financial assets and liabilities in ASU 2016-01:

- Clarification regarding the ability to discontinue application of the measurement alternative for equity securities without a readily determinable fair value
- Clarification of the measurement date for fair value adjustments to the carrying amount of equity securities without a readily determinable fair value for which the measurement alternative is elected
- Clarification of the unit of account for fair value adjustments to forward contracts and purchased options on equity securities without a readily determinable fair value for which the measurement alternative is expected to be elected
- Presentation requirements for certain hybrid financial liabilities for which the fair value option is elected
- Measurement of financial liabilities denominated in a foreign currency for which the fair value option is elected
- Transition guidance for equity securities without a readily determinable fair value

The effective date of this Update is for fiscal years beginning on or after December 15, 2017 and for interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning between December 15, 2017 and June 15, 2018 are not required to adopt the amendments until interim periods beginning after

June 15, 2018. Adoption of this Update is not expected to have a material effect on the Company's financial position, results of operations or its financial statement disclosures.

Adoption of New Accounting Standards —ASU 2016-01, Financial Statements - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities was issued in January 2016 to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This standard impacts how the Company measures certain equity investments and discloses and presents certain financial instruments through the application of the “exit price” notion. The Company adopted the amendments beginning January 1, 2018. Under the new guidance, equity investments can no longer be classified as trading or available for sale (AFS), and related unrealized holding gains and losses can no longer be recognized in OCI. Per the ASU, such equity investments should be measured at fair value, with adjustments recognized in earnings at the end of each reporting period. As such, the Company reclassified its portfolio of equity investments (approximately \$2.0 million at March 31, 2018) previously classified as AFS investment securities to “other investments.” As these equity investments were previously measured at fair value, implementation of the ASU did not impact the Company’s valuation method. In accordance with the ASU, the cumulative-effect adjustment from AOCI to retained earnings for previously recorded fair value adjustments related to these equity investments at adoption was immaterial. The

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Company elected the practical expedient measurement alternative to prospectively account for other equity investments that do not have readily determinable fair values at cost less impairment plus or minus observable price changes in orderly transactions for an identical or similar investment of the same issuer. These investments are immaterial overall and are classified within “other investments” on the Company’s consolidated balance sheets.

In May 2014, the FASB issued ASU 2014-09 - Revenue from Contracts with Customers, which created a new principle-based framework to determine when and how an entity recognizes revenue from its customer contracts. FASB has established a core principle for recognizing revenue within the new rules, which states that revenue should only be recorded when services are provided or goods are transferred to customers at the agreed price. The majority of our revenue-generating transactions are not subject to ASC Topic 606, including revenue generated from financial instruments, such as our loans, letters of credit and investment securities, as these activities are subject to other GAAP discussed elsewhere within our disclosures. Description of our revenue-generating activities that are within the scope of ASC Topic 606, which are presented in our income statements as components of non-interest income are as follows:

Service charges on deposits - We collect service charges on most of our non-maturity deposits accounts on a monthly basis. Our fee earned is collected monthly when a particular cycle for a non-maturity deposit account closes. Each cycle is monthly and the fee earned is for our service for the month just closed. Our performance obligations are to process transactions, pay interest (on interest-bearing accounts), collect deposits, and allow access to on-line banking applications and other services ancillary to a banking relationship. Each month when our fee is charged, our obligation is complete. The contract-relationship is a month to month obligation - i.e. our obligation to perform these services would end if the customer closes their deposit account with MidSouth.

ATM and debit card income - ATM fees primarily consist of surcharges assessed to our customers for using a non-Bank ATM or a non-Bank customer using our ATM. Debit card income represents revenues earned from interchange fees, which are earned on debit card transactions conducted with payment networks. Such fees are generally recognized concurrently with the delivery of services on a daily basis.

2. Investment Securities

The portfolio of investment securities consisted of the following (in thousands):

	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
Obligations of state and political subdivisions	\$20,473	\$ 82	\$ 746	\$19,809
GSE mortgage-backed securities	53,195	416	1,093	52,518
Collateralized mortgage obligations: residential	215,868	85	7,239	208,714
Collateralized mortgage obligations: commercial	2,149	—	48	2,101
Corporate debt securities	25,566	336	107	25,795
	\$317,251	\$ 919	\$ 9,233	\$308,937
	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
Obligations of state and political subdivisions	\$23,042	\$ 209	\$ 442	\$22,809

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GSE mortgage-backed securities	58,620	825	321	59,124
Collateralized mortgage obligations: residential	202,573	90	4,508	198,155
Collateralized mortgage obligations: commercial	2,274	—	34	2,240
Mutual funds	2,100	—	39	2,061
Corporate debt securities	23,975	837	10	24,802
	\$312,584	\$ 1,961	\$ 5,354	\$309,191

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	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity:				
Obligations of state and political subdivisions	\$27,486	\$ 169	\$ 95	\$27,560
GSE mortgage-backed securities	31,978	—	687	31,291
Collateralized mortgage obligations: residential	6,833	—	394	6,439
Collateralized mortgage obligations: commercial	1,480	—	12	1,468
	\$67,777	\$ 169	\$ 1,188	\$66,758

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity:				
Obligations of state and political subdivisions	\$35,908	\$ 265	\$ 22	\$36,151
GSE mortgage-backed securities	35,751	171	219	35,703
Collateralized mortgage obligations: residential	7,450	—	321	7,129
Collateralized mortgage obligations: commercial	1,943	—	6	1,937
	\$81,052	\$ 436	\$ 568	\$80,920

With the exception of one private-label collateralized mortgage obligations (“CMOs”) with a balance remaining of \$7,000 at June 30, 2018, all of the Company’s CMOs are government-sponsored enterprise (“GSE”) securities.

The following table presents the amortized cost and fair value of debt securities at June 30, 2018 by contractual maturity (in thousands). Actual maturities will differ from contractual maturities because of rights to call or repay obligations with or without penalties and scheduled and unscheduled principal payments on mortgage-backed securities and collateralized mortgage obligations.

	Amortized Cost	Fair Value
Available-for-sale:		
Due in one year or less	\$—	\$—
Due after one year through five years	8,672	8,638
Due after five years through ten years	47,548	47,394
Due after ten years	261,031	252,905
	\$317,251	\$308,937

	Amortized Cost	Fair Value
Held-to-maturity:		
Due in one year or less	\$515	\$515
Due after one year through five years	5,044	5,006
Due after five years through ten years	43,312	42,639
Due after ten years	18,906	18,598
	\$67,777	\$66,758

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Details concerning investment securities with unrealized losses are as follows (in thousands):

	June 30, 2018					
	Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Available-for-sale:						
Obligations of state and political subdivisions	\$576	\$ 24	\$12,405	\$ 722	\$12,981	\$ 746
GSE mortgage-backed securities	34,138	893	5,344	200	39,482	1,093
Collateralized mortgage obligations: residential	82,531	1,430	124,108	5,809	206,639	7,239
Collateralized mortgage obligations: commercial	—	—	2,101	48	2,101	48
Corporate debt securities	6,483	107	—	—	6,483	107
	\$123,728	\$ 2,454	\$143,958	\$ 6,779	\$267,686	\$ 9,233
	December 31, 2017					
	Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Available-for-sale:						
Obligations of state and political subdivisions	\$596	\$ 5	\$12,716	\$ 437	\$13,312	\$ 442
GSE mortgage-backed securities	29,725	224	5,858	97	35,583	321
Collateralized mortgage obligations: residential	57,665	548	137,598	3,960	195,263	4,508
Collateralized mortgage obligations: commercial	—	—	2,240	34	2,240	34
Mutual funds	2,061	39	—	—	2,061	39
Corporate debt securities	2,990	10	—	—	2,990	10
	\$93,037	\$ 826	\$158,412	\$ 4,528	\$251,449	\$ 5,354

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	June 30, 2018		Securities with losses under 12 months		Securities with losses over 12 months		Total	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Held-to-maturity:								
Obligations of state and political subdivisions	\$6,318	\$ 95	\$—	\$ —	\$6,318	\$ 95		
GSE mortgage-backed securities	\$26,853	\$ 475	\$4,438	\$ 212	\$31,291	\$ 687		
Collateralized mortgage obligations: residential	\$—	\$ —	\$6,439	\$ 394	\$6,439	\$ 394		
Collateralized mortgage obligations: commercial	1,468	12	—	—	1,468	12		
	\$34,639	\$ 582	\$10,877	\$ 606	\$45,516	\$ 1,188		
December 31, 2017								
	Securities with losses under 12 months		Securities with losses over 12 months		Total			
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Held-to-maturity:								
Obligations of state and political subdivisions	\$6,340	\$ 22	\$—	\$ —	\$6,340	\$ 22		
GSE mortgage-backed securities	11,201	89	4,961	130	16,162	219		
Collateralized mortgage obligations: residential	—	—	7,129	321	7,129	321		
Collateralized mortgage obligations: commercial	1,937	6	—	—	1,937	6		
	\$19,478	\$ 117	\$12,090	\$ 451	\$31,568	\$ 568		

Management evaluates each quarter whether unrealized losses on securities represent impairment that is other than temporary. For debt securities, the Company considers its intent to sell the securities or if it is more likely than not the Company will be required to sell the securities. If such impairment is identified, based upon the intent to sell or the more likely than not threshold, the carrying amount of the security is reduced to fair value with a charge to earnings. Upon the result of the aforementioned review, management then reviews for potential other than temporary impairment based upon other qualitative factors. In making this evaluation, management considers changes in market rates relative to those available when the security was acquired, changes in market expectations about the timing of cash flows from securities that can be prepaid, performance of the debt security, and changes in the market's perception of the issuer's financial health and the security's credit quality. If determined that a debt security has incurred other than temporary impairment, then the amount of the credit related impairment is determined. For equity securities, management reviews the near term prospects of the issuer, the nature and cause of the unrealized loss, the severity and duration of the impairments and other factors when determining if an unrealized loss is other than temporary. If a credit loss is evident, the amount of the credit loss is charged to earnings and the non-credit related impairment is recognized through other comprehensive income.

As of June 30, 2018, 103 securities had unrealized losses totaling 3.22% of the individual securities' amortized cost basis and 2.71% of the Company's total amortized cost basis. Of the 103 securities, 45 had been in an unrealized loss position for over twelve months at June 30, 2018. These 45 securities had an amortized cost basis and unrealized loss of \$162.2 million and \$7.4 million, respectively. The unrealized losses on debt securities at June 30, 2018 resulted from changing market interest rates over the yields available at the time the underlying securities were purchased. Management identified no impairment related to credit quality. At June 30, 2018, management had the intent and

ability to hold impaired securities and no impairment was evaluated as other than temporary. As a result, no other than temporary impairment losses were recognized during the three months ended June 30, 2018.

During the six months ended June 30, 2018, the Company sold 1 security classified as available-for-sale for \$410,000 which resulted in neither a gain nor a loss. During the six months ended June 30, 2017, the Company sold 10 securities classified as available-for-sale and 1 security classified as held-to-maturity. Of the available-for-sale securities, 7 securities were sold with gains totaling \$111,000 and 3 securities were sold at a loss of \$109,000 for a net gain of \$2,000. The decision to sell the 1 held-to-maturity security, which was sold

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at a gain of \$7,000, was based on the pre-refunding of the bond which would accelerate the maturity of the bond by 15 years with an anticipated call date within six months.

Securities with an aggregate carrying value of approximately \$207.4 million and \$177.9 million at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public funds on deposit and for other purposes required or permitted by law.

3. Credit Quality of Loans and Allowance for Loan Losses

The loan portfolio consisted of the following (in thousands):

	June 30, 2018	December 31, 2017
Commercial, financial and agricultural	\$ 354,944	\$ 435,207
Real estate – construction	98,108	90,287
Real estate – commercial	414,526	448,406
Real estate – residential	141,104	146,751
Installment loans to individuals	47,406	56,398
Lease financing receivable	632	732
Other	1,243	5,645
	1,057,963	1,183,426
Less allowance for loan losses	(23,514)	(26,888)
	\$ 1,034,449	\$ 1,156,538

The Company monitors loan concentrations and evaluates individual customer and aggregate industry leverage, profitability, risk rating distributions, and liquidity for each major standard industry classification segment. At June 30, 2018, one industry segment concentration, the oil and gas industry, constituted more than 10% of the loan portfolio. The Company's exposure in the oil and gas industry, including related service and manufacturing industries, totaled approximately \$153.6 million, or 14.5% of total loans. Additionally, the Company's exposure to loans secured by commercial real estate is monitored. At June 30, 2018, loans secured by commercial real estate (including commercial construction, farmland and multifamily loans) totaled approximately \$481.0 million, or 45.5% of total loans, of which 52% are secured by owner-occupied commercial properties. Of the \$481.0 million in loans secured by commercial real estate, \$31.4 million, or 6.5%, were on nonaccrual status at June 30, 2018.

Allowance for Loan Losses

The allowance for loan losses is a valuation account available to absorb probable losses on loans. All losses are charged to the allowance for loan losses when the loss actually occurs or when a determination is made that a loss is likely to occur. Recoveries are credited to the allowance for loan losses at the time of recovery. Quarterly, the probable level of losses in the existing portfolio is estimated through consideration of various factors. Based on these estimates, the allowance for loan losses is increased by charges to earnings and decreased by charge offs (net of recoveries).

The allowance is composed of general reserves and specific reserves. General reserves are determined by applying loss percentages to segments of the portfolio. The loss percentages are based on each segment's historical loss experience, generally over the past three to five years, and adjustment factors derived from conditions in the Company's internal and external environment. All loans considered to be impaired are evaluated on an individual basis to determine specific reserve allocations in accordance with GAAP. Loans for which specific reserves are provided are excluded from the calculation of general reserves.

Loans acquired in business combinations are initially recorded at fair value, which includes an estimate of credit losses expected to be realized over the remaining lives of the loans, and therefore no corresponding allowance for loan losses is recorded for these loans at acquisition. Methods utilized to estimate any subsequently required allowance for loan losses for acquired loans not deemed credit-impaired at acquisition are similar to originated loans; however, the estimate of loss is based on the unpaid principal balance and then compared to any remaining unaccreted purchase discount. The current analysis indicates no additional allowance is necessary on our acquired loan portfolio as of June 30, 2018. To the extent that the calculated loss is greater than the remaining unaccreted purchase discount, an allowance is recorded for such difference.

The Company has an internal loan review department that is independent of the lending function to challenge and corroborate the loan grade assigned by the lender and to provide additional analysis in determining the adequacy of the allowance for loan losses. Additionally, the Company utilizes the services of a third party to supplement its loan review efforts.

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A rollforward of the activity within the allowance for loan losses by loan type and recorded investment in loans for the six months ended June 30, 2018 and 2017 is as follows (in thousands):

	June 30, 2018							Total
	Real Estate				Installment Lease			
	Compl, Fin, and Agric	Construction	Commercial	Residential	loans to individuals	financing receivable	Other	
Allowance for loan losses:								
Beginning balance	\$20,577	\$596	\$3,893	\$837	\$957	\$3	\$25	\$26,888
Charge-offs	(3,647)	(6)	(216)	(321)	(448)	—	—	(4,638)
Recoveries	696	—	6	1	121	—	—	824
Provision	172	(201)	(460)	623	323	—	(17)	440
Ending balance	\$17,798	\$389	\$3,223	\$1,140	\$953	\$3	\$8	\$23,514
Ending balance: individually evaluated for impairment	\$4,452	\$49	\$126	\$198	\$13	\$—	\$—	\$4,838
Ending balance: collectively evaluated for impairment	\$13,346	\$340	\$3,097	\$942	\$940	\$3	\$8	\$18,676
Loans:								
Ending balance	\$354,944	\$98,108	\$414,526	\$141,104	\$47,406	\$632	\$1,243	\$1,057,963
Ending balance: individually evaluated for impairment	\$40,228	\$717	\$29,917	\$3,623	\$65	\$—	\$—	\$74,550
Ending balance: collectively evaluated for impairment	\$314,716	\$97,391	\$384,609	\$137,481	\$47,341	\$632	\$1,243	\$983,413

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June 30, 2017

	Real Estate				Installment Lease			Total
	Coml, Fin, and Agric	Constructi	Commercial	Residential	loans to individuals	financing receivable	Other	
Allowance for loan losses:								
Beginning balance	\$16,057	\$585	\$5,384	\$940	\$1,395	\$5	\$6	\$24,372
Charge-offs	(11,319)	(1)	(3,448)	(198)	(599)	—	—	(15,565)
Recoveries	290	—	33	96	148	—	—	567
Provision	13,272	623	1,845	(438)	(1)	(2)	1	15,300
Ending balance	\$18,300	\$1,207	\$3,814	\$400	\$943	\$3	\$7	\$24,674
Ending balance:								
individually evaluated for impairment	\$3,092	\$9	\$1,120	\$28	\$103	\$—	\$—	\$4,352
Ending balance:								
collectively evaluated for impairment	\$15,208	\$1,198	\$2,694	\$372	\$840	\$3	\$7	\$20,322
Loans:								
Ending balance	\$451,767	\$98,695	\$461,064	\$156,394	\$70,031	\$866	\$1,436	\$1,240,253
Ending balance:								
individually evaluated for impairment	\$35,276	\$25	\$19,526	\$1,325	\$311	\$—	\$—	\$56,463
Ending balance:								
collectively evaluated for impairment	\$416,491	\$98,670	\$441,108	\$155,003	\$69,720	\$866	\$1,436	\$1,183,294
Ending balance: loans acquired with deteriorated credit quality	\$—	\$—	\$430	\$66	\$—	\$—	\$—	\$496

Non-Accrual and Past Due Loans

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the probability of collection of interest is deemed insufficient to warrant further accrual. For loans placed on non-accrual status, the accrual of interest is discontinued and subsequent payments received are applied to the principal balance. Interest income is recorded after principal has been satisfied and as payments are received. Non-accrual loans may be returned to accrual status if all principal and interest amounts contractually owed are reasonably assured of repayment within a reasonable period and there is a period of at least six months to one year of repayment performance by the borrower depending on the contractual payment terms.

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An age analysis of past due loans (including both accruing and non-accruing loans) is as follows (in thousands):

	June 30, 2018						
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 days and Accruing
Commercial, financial, and agricultural	\$8,504	\$4,347	\$24,762	\$37,613	\$317,331	\$354,944	\$ 3
Real estate - construction	1,175	—	220	1,395	96,713	98,108	—
Real estate - commercial	1,655	9,523	18,102	29,280	385,246	414,526	—
Real estate - residential	1,077	99	1,692	2,868	138,236	141,104	—
Installment loans to individuals	215	27	61	303	47,103	47,406	—
Lease financing receivable	—	—	—	—	632	632	—
Other loans	51	10	—	61	1,182	1,243	—
	\$12,677	\$14,006	\$44,837	\$71,520	\$986,443	\$1,057,963	\$ 3
	December 31, 2017						
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 days and Accruing
Commercial, financial, and agricultural	\$1,195	\$1,893	\$14,847	\$17,935	\$417,272	\$435,207	\$ 545
Real estate - construction	616	—	190	806	89,481	90,287	125
Real estate - commercial	5,889	6,402	4,163	16,454	431,952	448,406	58
Real estate - residential	1,065	235	559	1,859	144,892	146,751	—
Installment loans to individuals	276	32	34	342	56,056	56,398	—
Lease financing receivable	—	—	—	—	732	732	—
Other loans	—	—	—	—	5,645	5,645	—
	\$9,041	\$8,562	\$19,793	\$37,396	\$1,146,030	\$1,183,426	\$ 728

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Non-accrual loans are as follows (in thousands):

	June 30, December 31,	
	2018	2017
Commercial, financial, and agricultural	\$39,218	\$ 37,418
Real estate - construction	1,531	66
Real estate - commercial	29,916	11,128
Real estate - residential	2,808	618
Installment loans to individuals	65	48
	\$73,538	\$ 49,278

The amount of interest that would have been recorded on non-accrual loans, had the loans not been classified as non-accrual, totaled approximately \$3.4 million and \$1.7 million for the six months ended June 30, 2018 and 2017, respectively. Interest received on non-accrual loans subsequent to their transfer to non-accrual status totaled \$176,000 and \$195,000 for the six months ended June 30, 2018 and 2017, respectively.

Impaired Loans

Loans are considered impaired when, based upon current information, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. All loans classified as special mention, substandard, or doubtful, based on credit risk rating factors, are reviewed to determine whether impairment testing is appropriate. All loan relationships with an outstanding commitment balance above a specified threshold are evaluated for potential impairment. All loan relationships with an outstanding commitment balance below the specified threshold are assigned an allowance allocation percentage that is determined by management and adjusted periodically based on certain factors. An allowance for each impaired loan is calculated based on the present value of expected future cash flows discounted at the loan's effective interest rate or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. All impaired loans are reviewed, at a minimum, on a quarterly basis. Existing valuations are reviewed to determine if additional discounts or new appraisals are required. After this review, when comparing the resulting collateral valuation to the outstanding loan balance, if the discounted collateral value exceeds the loan balance, no specific allocation is reserved.

The following table presents loans that are individually evaluated for impairment (in thousands). Interest income recognized represents interest on accruing loans modified in a troubled debt restructuring (TDR).

	June 30, 2018				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial, financial, and agricultural	\$28,188	\$ 32,776	\$ —	\$ 26,424	\$ 32
Real estate - construction	1,164	1,164	—	582	—
Real estate - commercial	29,020	30,242	—	19,745	—
Real estate - residential	1,599	1,599	—	950	—
Installment loans to individuals	24	24	—	12	—
Finance leases	—	—	—	—	—
Subtotal:	59,995	65,805	—	47,713	32
With an allowance recorded:					
Commercial, financial, and agricultural	12,040	13,959	4,452	13,079	—
Real estate - construction	367	367	49	216	—
Real estate - commercial	897	1,028	126	777	—

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Real estate - residential	1,210	1,897	198	763	—
Installment loans to individuals	41	41	13	45	—
Finance leases	—	—	—	—	—
Subtotal:	14,555	17,292	4,838	14,880	—
Totals:					

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Commercial	70,145	78,005	4,578	60,025	32
Construction	1,531	1,531	49	798	—
Residential	2,809	3,496	198	1,713	—
Consumer	65	65	13	57	—
Grand total:	\$74,550	\$83,097	\$ 4,838	\$ 62,593	\$ 32

December 31, 2017

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial, financial, and agricultural	\$24,659	\$30,630	\$ —	\$ 19,880	\$ 90
Real estate - construction	—	—	—	5	—
Real estate - commercial	10,471	11,965	—	11,590	—
Real estate - residential	302	302	—	602	—
Installment loans to individuals	—	—	—	37	—
Subtotal:	35,432	42,897	—	32,114	90
With an allowance recorded:					
Commercial, financial, and agricultural	14,119	14,150	7,197	15,245	1
Real estate - construction	66	136	23	33	—
Real estate - commercial	657	657	131	8,318	—
Real estate - residential	316	316	5	620	—
Installment loans to individuals	48	50	14	258	—
Subtotal:	15,206	15,309	7,370	24,474	1
Totals:					
Commercial	49,906	57,402	7,328	55,033	91
Construction	66	136	23	38	—
Residential	618	618	5	1,222	—
Consumer	48	50	14	295	—
Grand total:	\$50,638	\$58,206	\$ 7,370	\$ 56,588	\$ 91

Credit Quality

The Company manages credit risk by observing written underwriting standards and the lending policy established by the Board of Directors and management to govern all lending activities. The risk management program requires that each individual loan officer review his or her portfolio on a quarterly basis and assign recommended credit ratings on each loan. These efforts are supplemented by independent reviews performed by a loan review officer and other validations performed by the internal audit department. The results of the reviews are reported directly to the Audit Committee of the Board of Directors.

Loans are categorized into risk categories based on relevant information about the ability of borrowers to serve their debt, such as: current financial information, historical payment experience, credit documentation, public information, current economic trends, and other factors. Loans are analyzed individually and classified according to their credit risk. This analysis is performed on a continuous basis. The following definitions are used for risk ratings:

Special Mention: Weakness exists that could cause future impairment, including the deterioration of financial ratios, past due status, and questionable management capabilities. Collateral values generally afford adequate coverage but may not be immediately marketable.

Substandard: Specific and well-defined weaknesses exist that may include poor liquidity and deterioration of financial ratios. Currently the borrower maintains the capacity to service the debt. The loan may be past due and related deposit accounts experiencing overdrafts. Immediate corrective action is necessary.

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Doubtful: Specific weaknesses characterized as Substandard exist that are severe enough to make collection in full unlikely. There is no reliable secondary source of full repayment. Loans classified as Doubtful will usually be placed on non-accrual status. The probability of some loss is extremely high but because of certain important and reasonably specific factors, the amount of loss cannot be determined.

Loans not meeting the criteria above that are analyzed individually as part of the above-described process are considered to be Pass rated loans.

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The following tables present the classes of loans by risk rating (in thousands):

June 30, 2018

Commercial Credit Exposure
Credit Risk Profile by
Creditworthiness Category

	Commercial, financial, and agricultural	Real estate - commercial	Total	% of Total
Pass	\$ 275,744	\$ 361,281	\$ 637,025	82.79 %
Special mention	21,320	9,985	31,305	4.07 %
Substandard	57,880	43,260	101,140	13.14 %
	\$ 354,944	\$ 414,526	\$ 769,470	100.00 %

Construction Credit Exposure
Credit Risk Profile by
Creditworthiness Category

	Real estate - construction	% of Total
Pass	\$ 96,225	98.08 %
Special mention	85	0.09 %
Substandard	1,798	1.83 %
	\$ 98,108	100.00 %

Residential Credit Exposure
Credit Risk Profile by
Creditworthiness Category

	Real estate - residential	% of Total
Pass	\$ 134,952	95.64 %
Special mention	602	0.43 %
Substandard	5,550	3.93 %
	\$ 141,104	100.00 %

Consumer and Other Credit Exposure
Credit Risk Profile Based on
Payment Activity

	Installment loans to individuals	Lease financing receivable	Other	Total	% of Total
Performing	\$47,355	\$ 632	\$ 1,243	\$ 49,230	99.90 %
Nonperforming	51	—	—	51	0.10 %
	\$47,406	\$ 632	\$ 1,243	\$ 49,281	100.00 %

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December 31, 2017

Commercial Credit Exposure
Credit Risk Profile by
Creditworthiness Category

	Commercial, financial, and agricultural	Real estate - commercial	Total	% of Total
Pass	\$ 358,373	\$ 411,280	\$ 769,653	87.10 %
Special mention	9,687	3,823	13,510	1.53 %
Substandard	67,147	33,303	100,450	11.37 %
	\$ 435,207	\$ 448,406	\$ 883,613	100.00 %

Construction Credit Exposure
Credit Risk Profile by
Creditworthiness Category

		Real estate - construction	% of Total
Pass		\$ 89,323	98.93 %
Special mention		600	0.67 %
Substandard		364	0.40 %
		\$ 90,287	100.00 %

Residential Credit Exposure
Credit Risk Profile by
Creditworthiness Category

		Real estate - residential	% of Total
Pass		\$ 144,250	98.30 %
Special mention		1,233	0.84 %
Substandard		1,268	0.86 %
		\$ 146,751	100.00 %

Consumer and Other Credit Exposure
Credit Risk Profile Based on
Payment Activity

	Installment loans to individuals	Lease financing receivable	Other	Total	% of Total
Performing	\$ 56,041	\$ 699	\$ 5,645	\$ 62,385	99.38 %
Nonperforming	357	33	—	390	0.62 %
	\$ 56,398	\$ 732	\$ 5,645	\$ 62,775	100.00 %

Troubled Debt Restructurings

A TDR is a restructuring of a debt made by the Company to a debtor for economic or legal reasons related to the debtor's financial difficulties that it would not otherwise consider. The Company grants the concession in an attempt to protect as much of its investment as possible.

The following tables present information about TDRs that were modified during the periods presented by portfolio segment (in thousands):

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	Three months ended	
	June 30, 2018	June 30, 2017
	Number of recorded loans	Number of recorded loans
	investment	investment
Commercial, financial and agricultural	— \$	— \$

	Six months ended	
	June 30, 2018	June 30, 2017
	Number of recorded loans	Number of recorded loans
	investment	investment
Commercial, financial and agricultural	— \$	1 \$ 1,984

During the three month periods ending June 30, 2018 and 2017, there were no defaults on any loans that were modified as TDRs during the preceding twelve months. During the six months ended June 30, 2018 there were no defaults on any loans that were modified as TDRs during the preceding twelve months. During the six months ended June 30, 2017, there was one loan relationship with a pre-modification balance of \$2.0 million identified as a TDR after a reduction in payments. There were no defaults on any loans that were modified as TDRs during the preceding twelve months. The Company defines a payment default as any loan that is greater than 30 days past due or was past due greater than 30 days at any point during the reporting period, or since the date of modification, whichever is shorter.

For purposes of the determination of an allowance for loan losses on these TDRs, as an identified TDR, the Company considers a loss probable on the loan and, as a result is reviewed for specific impairment in accordance with the Company's allowance for loan loss methodology. If it is determined losses are probable on such TDRs, either because of delinquency or other credit quality indicator, the Company establishes specific reserves for these loans. As of June 30, 2018, there were no commitments to lend additional funds to debtors owing sums to the Company whose terms have been modified in TDRs.

4. Intangibles

A summary of core deposit intangible assets as of June 30, 2018 and December 31, 2017 is as follows (in thousands):

	June 30, 2018	December 31, 2017
Gross carrying amount	\$11,674	\$ 11,674
Less accumulated amortization	(8,712)	(8,159)
Net carrying amount	\$2,962	\$ 3,515

5. Derivatives

On July 6, 2016, the Company entered into two forward interest rate swap contracts on a reverse repurchase agreement and long-term FHLB advances. The interest rate swap contracts were designated as derivative instruments in a cash flow hedge under ASC Topic 815, Derivatives and Hedging to convert forecasted variable interest payment to a fixed rate and the Company has concluded that the forecasted transactions are probable of occurring. For cash flow hedges, the effective portion of the gain or loss related to the derivative instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings when the forecasted

transaction affects earnings or when the hedge is terminated. The ineffective portion of the gain or loss is reported in earnings immediately.

No ineffectiveness related to the interest rate swaps designated as cash flow hedges was recognized in the consolidated statements of income for the six months ended June 30, 2018. The accumulated net after-tax income related to the effective cash flow hedge included in accumulated other comprehensive income is reflected in Note 6 - Other Comprehensive (Loss) Income.

The following table discloses the notional amounts and fair value of derivative instruments in the Company's balance sheet as of June 30, 2018 and December 31, 2017 (in thousands):

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	Type of Hedge	Notional Amounts		Fair Value	
		June 30, 2018	December 31, 2017	June 30, 2018	December 31, 2017
Derivatives designated as hedging instruments:					
Interest rate swaps included in other assets	Cash Flow	\$27,500	\$ 27,500	\$1,477	\$ 1,078

The following tables present the pre-tax effect of hedging derivative instruments on the Company's consolidated statements of operations:

	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)	Location of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	
			Three Months Ended June 30, 2018	Three Months Ended June 30, 2017
Interest rate swaps	90 (136)	Interest Expense	63	—
	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)	Location of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	
	Six Months Ended June 30, 2018		Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Interest rate swaps	400 (123)	Interest Expense	102	—

6. Other Comprehensive (Loss) Income

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The following is a summary of the tax effects allocated to each component of other comprehensive (loss) income (in thousands):

	Three Months Ended June 30,					
	2018			2017		
	Before Tax Amount	Tax Effect	Net of Tax Amount	Before Tax Amount	Tax Effect	Net of Tax Amount
Other comprehensive (loss) income:						
Securities available-for-sale:						
Change in unrealized gains/losses during period	\$(873)	\$184	\$(689)	\$2,739	\$(959)	\$1,780
Reclassification adjustment for gains included in net income	—	—	—	(3)	1	(2)
Derivative instruments designated as cash flow hedges:						
Change in fair value of derivative instruments designated as cash flow hedges	152	(32)	120	(136)	48	(88)
Reclassification adjustment for gains included in net income	(63)	13	(50)	—	—	—
Total other comprehensive (loss) income	\$(784)	\$165	\$(619)	\$2,600	\$(910)	\$1,690

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	Six Months Ended June 30,					
	2018			2017		
	Before Tax Amount	Tax Effect	Net of Tax Amount	Before Tax Amount	Tax Effect	Net of Tax Amount
Other comprehensive (loss) income:						
Securities available-for-sale:						
Change in unrealized gains/losses during period	\$(4,922)	\$1,034	\$(3,888)	\$3,559	\$(1,246)	\$2,313
Reclassification adjustment for gains included in net income	—	—	—	(9)	3	(6)
Derivative instruments designated as cash flow hedges:						
Change in fair value of derivative instruments designated as cash flow hedges	502	(105)	397	(123)	43	(80)
Reclassification adjustment for gains included in net income	(102)	21	(81)	—	—	—
Total other comprehensive (loss) income	\$(4,522)	\$950	\$(3,572)	\$3,427	\$(1,200)	\$2,227

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The reclassifications out of accumulated other comprehensive (loss) income into net income are presented below (in thousands):

	Three Months Ended June 30, 2018	2017
	Reclassifications Out of Accumulated Other Comprehensive (Loss) Income	Reclassifications Out of Accumulated Other Comprehensive (Loss) Income
Details about Accumulated Other Comprehensive (Loss) Income Components	Income Statement Other Line Item Comprehensive (Loss) Income	Income Statement Other Line Item Comprehensive (Loss) Income
Unrealized gains and losses on securities available-for-sale:		
	\$— Gain on sale of securities, net	\$(3) Gain on sale of securities, net
	— Tax expense	1 Tax expense
	\$— Net of tax	\$(2) Net of tax
Gains on derivative instruments:		
	\$(63) Interest expense	\$— Interest expense
	13 Tax expense	— Tax expense
	\$(50) Net of tax	\$— Net of tax
	Six Months Ended June 30, 2018	2017
	Reclassifications Out of Accumulated Other Comprehensive (Loss) Income	Reclassifications Out of Accumulated Other Comprehensive (Loss) Income
Details about Accumulated Other Comprehensive (Loss) Income Components	Income Statement Other Line Item Comprehensive (Loss) Income	Income Statement Other Line Item Comprehensive (Loss) Income
Unrealized gains and losses on securities available-for-sale:		
	\$— Gain on sale of securities, net	\$(9) Gain on sale of securities, net
	— Tax expense	3 Tax expense
	\$— Net of tax	\$(6) Net of tax
Gains on derivative instruments:		
	\$(102) Interest expense	\$— Interest expense
	21 Tax expense	— Tax expense
	\$(81) Net of tax	\$— Net of tax

7. Earnings Per Common Share

Following is a summary of the information used in the computation of earnings per common share (in thousands):

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net loss available to common shareholders	\$(1,479)	\$(6,225)	\$(1,928)	\$(4,545)
Dividends on Series C preferred stock	—	—	—	—
Adjusted net loss available to common shareholders	\$(1,479)	\$(6,225)	\$(1,928)	\$(4,545)
Weighted average number of common shares outstanding used in computation of basic loss per common share	16,526	12,227	16,511	11,749
Effect of dilutive securities:				
Stock options	3	10	3	13
Restricted stock	—	—	—	—
Weighted average number of common shares outstanding plus effect of dilutive securities – used in computation of diluted loss per share	16,529	12,237	16,514	11,762

On July 11, 2017, the Company completed the sale of an additional 516,700 shares of its common stock, pursuant to the partial exercise of the option to purchase additional shares granted to the underwriter in connection with the Company's recently completed public offering of 4,583,334 shares at \$12.00 per share. The partial exercise of the underwriter's option to purchase additional shares resulted in additional gross proceeds of approximately \$6.2 million bringing the total gross proceeds to approximately \$61.2 million and total net proceeds to approximately \$57.2 million.

Following is a summary of the securities that were excluded from the computation of diluted earnings per share because the effects of the shares were anti-dilutive (in thousands):

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
Stock options	31	84	31	84
Restricted stock	—	—	—	—
Shares subject to the outstanding warrant issued in connection with the CPP transaction	104	104	104	104
Convertible preferred stock	500	505	500	505

8. Fair Value Measurement

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used for assets and liabilities which are either recorded or disclosed at fair value.

Cash and Due From Banks, Interest-Bearing Deposits in Banks and Federal Funds Sold—The carrying value of these short-term instruments is a reasonable estimate of fair value.

Securities Available-for-Sale—Securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange and U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter market funds.

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Securities are classified as Level 2 within the valuation hierarchy when the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things. Level 2 inputs are used to value U.S. Agency securities, mortgage-backed securities, asset-backed securities, municipal securities, single issue trust preferred securities, certain pooled trust preferred securities, collateralized debt obligations and certain equity securities that are not actively traded.

Securities Held-to-Maturity—The fair value of securities held-to-maturity is estimated using the same measurement techniques as securities available-for-sale.

Other Investments—The carrying value of other investments is a reasonable estimate of fair value.

Loans—For disclosure purposes, the fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. The Company does not record loans at fair value on a recurring basis. No adjustment to fair value is taken related to illiquidity discounts. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management uses one of three methods to measure impairment, which, include collateral value, market value of similar debt, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. Impaired loans where an allowance is established based on the fair value of collateral or where the loan balance has been charged down to fair value require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and adjusts the appraisal value by taking an additional discount for market conditions and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

For non-performing loans, collateral valuations currently in file are reviewed for acceptability in terms of timeliness and applicability. Although each determination is made based on the facts and circumstances of each credit, generally valuations are no longer considered acceptable when there has been physical deterioration of the property from when it was last appraised, or there has been a significant change in the underlying assumptions of the appraisal. If the valuation is deemed to be unacceptable, a new appraisal is ordered. New appraisals are typically received within 4-6 weeks. While awaiting new appraisals, the valuation in the file is utilized, net of discounts. Discounts are derived from available relevant market data, selling costs, taxes, and insurance. Any perceived collateral deficiency utilizing the discounted value is specifically reserved (as required by ASC Topic 310) until the new appraisal is received or charged off. Thus, provisions or charge-offs are recognized in the period the credit is identified as non-performing.

The following sources are utilized to set appropriate discounts: in-market real estate agents, current local sales data, bank history for devaluation of similar property, Sheriff's valuations and buy/sell contracts. If a real estate agent is used to market and sell the property, values are discounted 10% for selling costs. Additional discounts may be applied if research from the above sources indicates a discount is appropriate given devaluation of similar property from the time of the initial valuation.

Cash Surrender Value of Life Insurance—Fair value for life insurance cash surrender value is based on cash surrender values indicated by the insurance companies.

Other Real Estate—Other real estate (“ORE”) properties are adjusted to fair value upon transfer of the loans to other real estate. Subsequently, other real estate properties are carried at the net realizable value. Exceptions to obtaining initial appraisals are properties where a buy/sell agreement exists for the loan value or greater, or where a Sheriff’s valuation has been received for properties liquidated through a Sheriff sale. Fair value is based upon independent market prices, appraised values of the collateral or management’s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the ORE as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and adjusts the appraisal value by taking an additional discount for market conditions and there is no observable market prices, the Company records the ORE asset as nonrecurring Level 3.

Assets Held For Sale—Assets held for sale are carried at the lower of carrying value or fair value. Fair value is based upon appraised values.

Derivative Financial Instruments—The fair value of derivatives are determined by an independent valuation firm and are estimated using prices of financial instruments with similar characteristics. As a result, they are classified within Level 2 of the fair value hierarchy.

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Deposits—The fair value of demand deposits, savings accounts, NOW accounts, and money market deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The estimated fair value does not include customer related intangibles.

Securities Sold Under Agreements to Repurchase—The fair value approximates the carrying value of securities sold under agreements to repurchase due to their short-term nature.

Short-term Federal Home Loan Bank Advances —The fair value approximates the carrying value of short-term FHLB advances due to their short-term nature.

Long-term Federal Home Loan Bank Advances—The fair value of long-term FHLB advances is estimated using a discounted cash flow analysis that applies interest rates currently being offered on similar types of borrowings with similar terms.

Junior Subordinated Debentures—For junior subordinated debentures that bear interest on a floating basis, the carrying amount approximates fair value. For junior subordinated debentures that bear interest on a fixed rate basis, the fair value is estimated using a discounted cash flow analysis that applies interest rates currently being offered on similar types of borrowings.

Commitments to Extend Credit, Standby Letters of Credit and Credit Card Guarantees—Because commitments to extend credit and standby letters of credit are generally short-term and made using variable rates, the carrying value and estimated fair value associated with these instruments are immaterial.

Assets Recorded at Fair Value

The table below presents information about certain assets and liabilities measured at fair value on a recurring basis (in thousands):

Description	Assets / Liabilities Fair Value Measured Measurements at Fair at June 30, 2018 Value at		
	June 30, 2018	Level 1 Level 2	Level 3
Available-for-sale securities:			
Obligations of state and political subdivisions	\$ 19,809	\$-\$19,809	\$ —
GSE mortgage-backed securities	52,518	—52,518	—
Collateralized mortgage obligations: residential	208,714	—208,714	—
Collateralized mortgage obligations: commercial	2,101	—2,101	—
Corporate debt securities	25,795	—25,795	—
Total available-for-sale securities	\$ 308,937	\$-\$308,937	\$ —
Derivative assets	\$ 1,477	\$-\$1,477	\$ —
	Assets / Liabilities Measured at Fair	Fair Value Measurements at December 31, 2017	

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Description	Value at			
	December 31, 2017	Level 1	Level 2	Level 3
Available-for-sale securities:				
Obligations of state and political subdivisions	\$ 22,809	\$—	\$22,809	\$ —
GSE mortgage-backed securities	59,124	—	59,124	—
Collateralized mortgage obligations: residential	198,155	—	198,155	—
Collateralized mortgage obligations: commercial	2,240	—	2,240	—
Mutual funds	2,061	2,061	—	—
Corporate debt securities	24,802	—	24,802	—
Total available-for-sale securities	\$ 309,191	\$2,061	\$307,130	\$ —
Derivative assets	\$ 1,078	\$—	\$1,078	\$ —

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The Company records impaired loans at fair value, measured at the fair value of the collateral for collateral-dependent loans. Impaired loans are considered level 3 assets when measured using appraisals from third parties, discounted for selling costs and other collateral-based discounts. Other real estate properties are considered level 3 assets when measured using appraisals from third parties, discounted for selling costs, information from comparable sales and marketability of the property. Assets held for sale are considered level 2 assets when measured using appraisals from third parties. The following tables present the Company's financial assets that are measured at fair values on a nonrecurring basis (in thousands):

Description	Assets / Liabilities	Fair Value Measurements		
	Measured at Fair Value at June 30, 2018	Level 1	Level 2	Level 3
Impaired loans	\$ 14,880	\$ —	—	—\$ 14,880
Other real estate	1,365	—	—	1,365
Assets held for sale	3,995	—	3,995	—

Description	Assets / Liabilities	Fair Value Measurements		
	Measured at Fair Value at December 31, 2017	Level 1	Level 2	Level 3
Impaired loans	\$ 10,227	\$ —	—	—\$ 10,227
Loans held for sale	15,737	—	15,737	—
Other real estate	2,001	—	—	2,001
Assets held for sale	3,572	—	3,572	—

The following table shows the significant unobservable inputs used in the fair value measurement of Level 3 assets:

Description	Fair Value at June 30, 2018	Technique	Unobservable Inputs
	Impaired loans	\$ 14,880	Third party appraisals
Other real estate	1,365	Third party appraisals	Collateral discounts and estimated costs to sell

Description	Fair Value at December 31, 2017	Technique	Unobservable Inputs
	Impaired loans	\$ 10,227	Third party appraisals
Other real estate	2,001	Third party appraisals	Collateral discounts and estimated costs to sell

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The carrying amounts and estimated fair values of the Company's financial instruments are as follows at June 30, 2018 and December 31, 2017 (in thousands):

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	Carrying Value	Fair Value Measurements at June 30, 2018 Using:		
		Level 1	Level 2	Level 3
Financial assets:				
Cash and due from banks, interest-bearing deposits in banks and federal funds sold	\$278,776	\$278,776	\$ —	—
Available-for-sale securities	308,937		308,937	
Securities held-to-maturity	67,777	—	66,758	—
Other investments	14,927	14,927	—	—
Loans, net	1,034,449	—	—	1,038,460
Cash surrender value of life insurance	15,002	—	15,002	—
Financial liabilities:				
Non-interest-bearing deposits	419,517	—	419,517	—
Interest-bearing deposits	1,103,503	—	901,846	171,757
Securities sold under agreements to repurchase	14,886	14,886	—	—
Short-term Federal Home Loan Bank advances	27,500	27,500	—	—
Long-term Federal Home Loan Bank advances	10,011	—	9,991	—
Junior subordinated debentures	22,167	—	22,167	—

	Carrying Value	Fair Value Measurements at December 31, 2017 Using:		
		Level 1	Level 2	Level 3
Financial assets:				
Cash and due from banks, interest-bearing deposits in banks and federal funds sold	\$152,964	\$152,964	\$ —	—
Available-for-sale securities	309,191	2,061	307,130	
Securities held-to-maturity	81,052	—	80,920	—
Other investments	12,214	12,214	—	—
Loans, net	1,156,538	—	—	1,160,614
Cash surrender value of life insurance	14,896	—	14,896	—
Financial liabilities:				
Non-interest-bearing deposits	416,547	—	416,547	—
Interest-bearing deposits	1,063,142	—	881,139	179,910
Securities sold under agreements to repurchase	67,133	67,133	—	—
Short-term Federal Home Loan Bank advances	40,000	40,000	—	—
Long-term Federal Home Loan Bank advances	10,021	—	10,011	—
Junior subordinated debentures	22,167	—	22,167	—

9. Subsequent Events

On August 1, 2018, the Bank received an \$8.5 million payoff of a significant non-accruing classified energy relationship. Assuming this payoff had occurred on June 30, 2018, pro forma Classified Assets to Bank Capital would have been reduced to 47.9% from 52.9% and energy loans as a percentage of total loans would have decreased from 14.5% to 1.38%.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation.

MidSouth Bancorp, Inc. (the “Company”) is a bank holding company headquartered in Lafayette, Louisiana that conducts substantially all of its business through its wholly owned subsidiary bank, MidSouth Bank, N.A. (the “Bank”). We offer complete banking services to commercial and retail customers in Louisiana and south and central Texas with 42 locations and are connected to a worldwide ATM

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network that provides customers with access to more than 55,000 surcharge-free ATMs. We are community oriented and focus primarily on offering commercial and consumer loan and deposit services to individuals, small businesses, and middle market businesses.

The following discussion and analysis identifies significant factors that have affected our financial position and operating results during the periods included in the financial statements accompanying this report. We encourage you to read this discussion in conjunction with our consolidated financial statements and the notes thereto presented herein and with the financial statements, the notes thereto, and related Management's Discussion and Analysis of Financial Condition and Results of Operation in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Forward-Looking Statements

Certain statements included in this Report, other than statements of historical fact, are forward-looking statements (as such term is defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and the regulations thereunder), which are intended to be covered by the safe harbors created thereby. Forward-looking statements include, but are not limited to certain statements under the captions "Business," "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "would," "could," "should," "guidance," "continue," "project," "forecast," "confident," and similar expressions are typically used to identify forward-looking statements. These statements are based on assumptions and assessments made by management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. Any forward-looking statements are not guarantees of our future performance and are subject to risks and uncertainties and may be affected by various factors that may cause actual results, developments and business decisions to differ materially from those in the forward-looking statements. Some of the factors that may cause actual results, developments and business decisions to differ materially from those contemplated by such forward-looking statements include the factors discussed under the caption "Risk Factors" in this Report and in our 2017 Annual Report on form 10-K and under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Report and the following:

- changes in interest rates and market prices that could affect the net interest margin, asset valuation, and expense levels;
- changes in local economic and business conditions in the markets we serve, including, without limitation, changes related to the oil and gas industries that could adversely affect customers and their ability to repay borrowings under agreed upon terms, adversely affect the value of the underlying collateral related to their borrowings, and reduce demand for loans;
- increases in competitive pressure in the banking and financial services industries;
- increased competition for deposits and loans which could affect compositions, rates and terms;
- changes in the levels of prepayments received on loans and investment securities that adversely affect the yield and value of the earning assets;
- our ability to successfully implement and manage our recently announced strategic initiatives;
- costs and expenses associated with our strategic initiatives and regulatory remediation efforts and possible changes in the size and components of the expected costs and charges associated with our strategic initiatives and regulatory remediation efforts;
- our ability to realize the anticipated benefits and cost savings from our strategic initiatives within the anticipated time frame, if at all;

the ability of the Company to comply with the terms of the formal agreement with the Office of the Comptroller of the Currency;

- credit losses due to loan concentration, particularly our energy lending and commercial real estate portfolios;
- a deviation in actual experience from the underlying assumptions used to determine and establish our allowance for loan losses ("ALL"), which could result in greater than expected loan losses;
- the adequacy of the level of our ALL and the amount of loan loss provisions required in future periods including the impact of implementation of the new CECL (current expected credit loss) methodology;
- future examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, impose additional enforcement actions or conditions on our operations, require additional regulatory remediation efforts or require us to increase our allowance for loan losses or write-down assets;
- changes in the availability of funds resulting from reduced liquidity or increased costs;
- the timing and impact of future acquisitions or divestitures, the success or failure of integrating acquired operations, and the ability to capitalize on growth opportunities upon entering new markets;
- the ability to acquire, operate, and maintain effective and efficient operating systems;
- increased asset levels and changes in the composition of assets that would impact capital levels and regulatory capital ratios;
- loss of critical personnel and the challenge of hiring qualified personnel at reasonable compensation levels;

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legislative and regulatory changes, including the impact of regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and other changes in banking, securities and tax laws and regulations and their application by our regulators, changes in the scope and cost of FDIC insurance and other coverage; regulations and restrictions resulting from our participation in government-sponsored programs such as the U.S. Treasury's Small Business Lending Fund, including potential retroactive changes in such programs; changes in accounting principles, policies, and guidelines applicable to financial holding companies and banking; increases in cybersecurity risk, including potential business disruptions or financial losses; acts of war, terrorism, cyber intrusion, weather, or other catastrophic events beyond our control; and the ability to manage the risks involved in the foregoing

We can give no assurance that any of the events anticipated by the forward-looking statements will occur or, if any of them does, what impact they will have on our results of operations and financial condition. We disclaim any intent or obligation to publicly update or revise any forward-looking statements, regardless of whether new information becomes available, future developments occur or otherwise.

Critical Accounting Policies

Certain critical accounting policies affect the more significant judgments and estimates used in the preparation of the consolidated financial statements. Our significant accounting policies are described in the notes to the consolidated financial statements included in this report. The accounting principles we follow and the methods of applying these principles conform to accounting principles generally accepted in the United States of America ("GAAP") and general banking practices. Our most critical accounting policy relates to the determination of the allowance for loan losses, which reflects the estimated losses resulting from the inability of its borrowers to make loan payments. The determination of the adequacy of the allowance involves significant judgment and complexity and is based on many factors. If the financial condition of our borrowers were to deteriorate, resulting in an impairment of their ability to make payments, the estimates would be updated and additional provisions for loan losses may be required. See Asset Quality – Nonperforming Assets and Allowance for Loan Losses and Note 1 and Note 3 of the footnotes to the consolidated financial statements.

Another of our critical accounting policies relates to the valuation of goodwill, intangible assets and other purchase accounting adjustments. We account for acquisitions in accordance with ASC Topic No. 805, which requires the use of the purchase method of accounting. Under this method, we are required to record assets acquired and liabilities assumed at their fair value, including intangible assets. Determination of fair value involves estimates based on internal valuations of discounted cash flow analyses performed, third party valuations, or other valuation techniques that involve subjective assumptions. Additionally, the term of the useful lives and appropriate amortization periods of intangible assets is subjective. Resulting goodwill from an acquisition under the purchase method of accounting represents the excess of the purchase price over the fair value of net assets acquired. Goodwill is not amortized, but is evaluated for impairment annually or more frequently if deemed necessary. If the fair value of an asset exceeds the carrying amount of the asset, no charge to goodwill is made. If the carrying amount exceeds the fair value of the asset, goodwill will be adjusted through a charge to earnings. Given the instability of the economic environment, it is reasonably possible that the methodology of the assessment of potential loan losses and goodwill impairment could change in the near-term or could result in impairment going forward.

A third critical accounting policy relates to deferred tax assets and liabilities. We record deferred tax assets and deferred tax liabilities for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Future tax benefits, such as net operating loss carry forwards, are recognized to the extent that realization of such benefits is more likely than not. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which the assets and liabilities are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a

change in tax rates is recognized in income tax expense in the period that includes the enactment date. In the event the future tax consequences of differences between the financial reporting bases and the tax bases of our assets and liabilities results in deferred tax assets, an evaluation of the probability of being able to realize the future benefits indicated by such assets is required. A valuation allowance is provided when it is more likely than not that a portion or the full amount of the deferred tax asset will not be realized. In assessing the ability to realize the deferred tax assets, management considers the scheduled reversals of deferred tax liabilities, projected future taxable income, and tax planning strategies. A deferred tax liability is not recognized for portions of the allowance for loan losses for income tax purposes in excess of the financial statement balance. Such a deferred tax liability will only be recognized when it becomes apparent that those temporary differences will reverse in the foreseeable future. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% more likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

Results of Operations

For the Three Months Ended June 30, 2018 and 2017

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Net loss available to common shareholders totaled \$1.5 million, or \$0.09 per share, for the three months ended June 30, 2018, compared to a net loss available to common shareholders of \$6.2 million, or \$0.51 per share, for the three months ended June 30, 2017. The second quarter of 2018 included non-operating expenses totaling \$5.3 million of regulatory remediation costs and the second quarter of 2017 included non-operating expenses of \$2.4 million consisting of \$1.3 million for severance and \$1.0 million for costs associated with branch closures. Excluding these non-operating expenses, diluted earnings for the second quarter of 2018 were \$0.16 per diluted share, compared to a loss of \$0.38 per diluted share for the second quarter of 2017.

Fully taxable-equivalent ("FTE") net interest income was \$17.0 million for the second quarter of 2018, a \$1.4 million decrease compared to \$18.4 million for the second quarter of 2017. Our annualized net interest margin, on a FTE basis, decreased 20 basis points in prior year quarterly comparison, from 4.18% for the second quarter of 2017 to 3.98% for the second quarter of 2018. Excluding the impact of purchase accounting adjustments, the FTE margin decreased 14 basis points, from 4.09% to 3.95% for the three months ended June 30, 2017 and 2018, respectively.

Net interest income decreased \$1.3 million in quarterly comparison, resulting from a \$1.0 million decrease in interest income and a \$302,000 increase in interest expense.

Excluding non-operating expenses of \$5.3 million for the second quarter of 2018 and \$2.4 million for the second quarter of 2017, noninterest expenses decreased \$298,000 in quarterly comparison and consisted primarily of a \$194,000 decrease in salaries and employee benefits costs and a \$235,000 decrease in occupancy expense, which were partially offset by a \$164,000 increase in legal and professional fees. The provision for loan losses decreased \$12.1 million in quarterly comparison. The provision decrease is primarily due to payoffs and charge offs of large energy nonaccrual loans and a release of general energy reserves. A \$237,000 income tax benefit was reported for the second quarter of 2018, compared to a \$3.2 million income tax benefit that was reported in the second quarter of 2017.

Dividends on preferred stock totaled \$810,000 for the three months ended June 30, 2018 and \$811,000 for the three months ended June 30, 2017. Dividends on the Series B Preferred Stock were \$720,000 for the second quarter of 2018, unchanged from \$720,000 for the second quarter of 2017. Dividends on the Series C Preferred Stock issued with the December 28, 2012 acquisition of PSB Financial Corporation ("PSB") totaled \$90,000 for the three months ended June 30, 2018 and \$91,000 for the three months ended June 30, 2017.

For the Six Months Ended June 30, 2018 and 2017

We reported a net loss available to common shareholders of \$1.9 million, or \$0.09 per diluted share, for the six months ended June 30, 2018, compared to net loss available to common shareholders of \$4.5 million, or \$0.39 per diluted share, for the six months ended June 30, 2017. The first six months of 2018 included non-operating expenses totaling \$10.4 million which consisted of \$9.2 million of regulatory remediation costs, a \$883,000 loss on the transfer of loans held for sale, \$100,000 on fees related to the bulk loan sale, and a \$145,000 one-time charge related to discontinued branch projects. Excluding these non-operating expenses, the operating earnings per share for the first six months of 2018 was \$0.37.

FTE net interest income was \$34.4 million for the six months ended June 30, 2018, a \$2.3 million decrease compared to \$36.7 million for the six months ended June 30, 2017. Our annualized net interest margin, on a FTE basis, was 4.07% for the six months ended June 30, 2018, compared to 4.18% for the same period in 2017. Excluding the impact of purchase accounting adjustments, the FTE margin decreased 5 basis points, from 4.10% to 4.05% for the six months ended June 30, 2017 and 2018, respectively.

Noninterest income decreased \$556,000 in year-over-year comparison and consisted primarily of a \$605,000 decrease in service charges on deposit accounts, and a \$152,000 decrease in mortgage lending income which were partially

offset by a \$192,000 increase in ATM/ debit card income.

Excluding non-operating expenses of \$10.4 million for the six months ended June 30, 2018 and \$2.4 million for the six months ended June 30, 2017, noninterest expenses decreased \$690,000 in year-over-year comparison and consisted primarily of a \$1.2 million decrease in salaries and benefits costs, a \$211,000 decrease in ATM/ debit card expense, and a \$814,000 decrease in occupancy expense, which were partially offset by an increase of \$1.5 million in legal and professional fees. The provision for loan losses decreased \$14.9 million in year-over-year comparison, from \$15.3 million for the six months ended June 30, 2017 to \$440,000 for the six months ended June 30, 2018, primarily due to an \$11.2 million reduction of charge-offs for the comparable period. A \$271,000 income tax benefit was reported for the first six months of 2018, compared to income tax benefit of \$2.6 million for the first six months of 2017.

Net Interest Income

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Our primary source of earnings is net interest income, which is the difference between interest earned on loans and investments and interest paid on deposits and other interest-bearing liabilities. Changes in the volume and mix of earning assets and interest-bearing liabilities combined with changes in market rates of interest greatly affect net interest income. Our net interest margin on a taxable equivalent basis, which is net interest income as a percentage of average earning assets, was 3.98% and 4.18% for the three months ended June 30, 2018 and 2017, respectively. Tables 1 and 2 below analyze the changes in net interest income in the three months ended June 30, 2018 and 2017.

FTE net interest income decreased \$1.4 million in prior year quarterly comparison. Interest income on loans decreased \$1.4 million due to a decrease in the average balance of loans of \$145 million in prior year quarterly comparison. The average yield on loans increased 20 basis points in prior year quarterly comparison, from 5.35% to 5.55%.

Investment securities totaled \$376.7 million, or 20.3% of total assets at June 30, 2018, versus \$367.2 million, or 19.8% of total assets at March 31, 2018. The investment portfolio had an effective duration of 3.53 years and a net unrealized loss of \$9.3 million at June 30, 2018. FTE interest income on investments decreased \$544,000 in prior year quarterly comparison. The average volume of investment securities decreased \$60.1 million in prior year quarterly comparison, and the average tax equivalent yield on investment securities decreased 15 basis points, from 2.69% to 2.54%.

The average yield on all earning assets decreased 12 basis points in prior year quarterly comparison, from 4.52% for the second quarter of 2017 to 4.40% for the second quarter of 2018.

Net interest income decreased \$1.3 million in quarterly comparison, resulting from a \$1.0 million decrease in interest income and a \$302,000 increase in interest expense. Increases in interest reflect a \$437,000 increase in interest expense on deposits and a \$29,000 increase in interest expense on FHLB advances, which were partially offset by a \$211,000 decrease in interest expense on repurchase agreements.

As a result of these changes in volume and yield on earning assets and interest-bearing liabilities, the FTE net interest margin decreased 20 basis points, from 4.18% for the second quarter of 2017 to 3.98% for the second quarter of 2018. Excluding purchase accounting adjustments on loans, deposits and FHLB borrowings, the FTE margin decreased 14 basis points, from 4.09% for the second quarter of 2017 to 3.95% for the second quarter of 2018.

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Table 1
Consolidated Average Balances, Interest and Rates
(in thousands)

	Three Months Ended June 30,							
	2018		2017		2017			
	Average Volume	Interest	Average Yield/Rate	Average Volume	Interest	Average Yield/Rate		
Assets								
Investment securities ¹								
Taxable	\$340,080	\$2,093	2.46 %	\$387,441	\$2,416	2.49 %		
Tax exempt ²	43,858	348	3.18 %	56,622	570	4.03 %		
Total investment securities	383,938	2,442	2.54 %	444,063	2,986	2.69 %		
Federal funds sold	5,008	21	1.63 %	3,573	9	1.00 %		
Time and interest bearing deposits in other banks	201,281	912		55,331	150			
Other investments	14,924	92	1.79 %	11,493	78	1.07 %		
Total loans ³	1,109,371	15,344	2.45 %	1,254,402	16,731	2.71 %		
Total earning assets	1,714,522	18,810	5.55 %	1,768,862	19,954	5.35 %		
Allowance for loan losses	(25,025)		4.40%	(22,819)		4.52%		
Nonearning assets	171,409			180,365				
Total assets	\$1,860,906			\$1,926,408				
Liabilities and shareholders' equity								
Total interest bearing deposits	\$1,087,746	\$1,410	0.52 %	\$1,125,482	\$973	0.35 %		
Securities sold under repurchase agreements	26,230	25	0.39 %	90,807	236	1.04 %		
Short-term FHLB advances	27,500	75	1.08 %	—	—	— %		
Long-term FHLB advances	10,014	45	1.79 %	25,260	91	1.43 %		
Junior subordinated debentures	22,167	259	4.63 %	22,167	212	3.78 %		
Total interest bearing liabilities	1,173,657	1,814	0.62 %	1,263,716	1,512	0.48 %		
Demand deposits	426,575			426,017				
Other liabilities	9,396			7,804				
Shareholders' equity	251,278			228,871				
Total liabilities and shareholders' equity	\$1,860,906			\$1,926,408				
Net interest income and net interest spread		\$16,996	3.78 %		\$18,442	4.04 %		
Net interest margin			3.98 %			4.18 %		

- Securities classified as available-for-sale are included in average balances. Interest income figures reflect interest earned on such securities.
- Interest income of \$71,000 for 2018 and \$196,000 for 2017 is added to interest earned on tax-exempt obligations to reflect tax equivalent yields using a tax rate of 21% and 35%, respectively.
- Interest income includes loan fees of \$1,065,000 for 2018 and \$853,000 for 2017. Nonaccrual loans are included in average balances and income on such loans is recognized on a cash basis.

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Table 2
Consolidated Average Balances, Interest and Rates
(in thousands)

	Six Months Ended June 30,					
	2018			2017		
	Average Volume	Interest	Average Yield/Rate	Average Volume	Interest	Average Yield/Rate
Assets						
Investment securities ¹						
Taxable	\$336,221	\$4,140	2.50 %	\$384,788	\$4,743	2.47 %
Tax exempt ²	47,186	746	3.20 %	58,609	1,191	4.06 %
Total investment securities	383,407	4,886	2.58 %	443,397	5,934	2.68 %
Federal funds sold	4,993	39	1.57 %	3,572	15	0.84 %
Time and interest bearing deposits in other banks	167,299	1,426	1.72 %	48,595	235	0.96 %
Other investments	14,853	179	2.44 %	11,424	162	2.84 %
Total loans ³	1,134,382	31,359	5.57 %	1,264,253	33,353	5.32 %
Total earning assets	1,704,934	37,889	4.48 %	1,771,241	39,699	4.52 %
Allowance for loan losses	(25,747)			(23,416)		
Nonearning assets	181,303			181,628		
Total assets	\$1,860,490			\$1,929,453		
Liabilities and shareholders' equity						
Total interest bearing deposits	\$1,079,660	\$2,647	0.49 %	\$1,140,361	\$1,908	0.34 %
Securities sold under repurchase agreements	33,134	66	0.40 %	91,684	470	1.03 %
Short-term FHLB advances	28,108	159	—	—	—	—
Long-term FHLB advances	10,016	90	1.80 %	25,315	179	1.41 %
Junior subordinated debentures	22,167	479	4.30 %	22,167	420	3.77 %
Total interest bearing liabilities	1,173,085	3,441	0.59 %	1,279,527	2,977	0.47 %
Demand deposits	425,505			419,933		
Other liabilities	8,687			7,574		
Shareholders' equity	253,213			222,419		