

SOUTHERN FIRST BANCSHARES INC

Form 10-Q

July 31, 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 000-27719**

**Southern First Bancshares, Inc.**

(Exact name of registrant as specified in its charter)

**South Carolina**

(State or other jurisdiction of incorporation or organization)

**58-2459561**

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

**100 Verdae Boulevard, Suite 100**

**Greenville, S.C.**

(Address of principal executive offices)

**29606**

(Zip Code)

**864-679-9000**

(Registrant's telephone number, including area code)

**Not Applicable**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 (§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, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller Reporting Company

Emerging growth company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 7,425,672 shares of common stock, par value \$0.01 per share, were issued and outstanding as of July 26, 2018.

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY**  
**June 30, 2018 Form 10-Q**

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**PART I. CONSOLIDATED FINANCIAL INFORMATION****Item 1. CONSOLIDATED FINANCIAL STATEMENTS****SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS**

| (dollars in thousands, except share data)   | <b>June 30,</b><br><b>2018</b><br>(Unaudited) | <b>December 31,</b><br><b>2017</b><br>(Audited) |
|---|---|---|
| <b>ASSETS</b>   |   |   |
| Cash and cash equivalents:  |   |   |
| Cash and due from banks   | \$ 17,198                                     | 17,171  |
| Federal funds sold  | 62,854  | 49,148  |
| Interest-bearing deposits with banks  | 29,301  | 25,846  |
| Total cash and cash equivalents   | 109,353                                       | 92,165  |
| Investment securities:  |   |   |
| Investment securities available for sale  | 70,067  | 67,603  |
| Other investments   | 3,059   | 4,462   |
| Total investment securities   | 73,126  | 72,065  |
| Mortgage loans held for sale  | 8,075   | 11,790  |
| Loans   | 1,533,447                                     | 1,387,070                                       |
| Less allowance for loan losses  | (16,100)                                      | (15,523)  |
| Loans, net  | 1,517,347                                     | 1,371,547                                       |
| Bank owned life insurance   | 33,573  | 33,132  |
| Property and equipment, net   | 32,720  | 32,234  |
| Deferred income taxes   | 6,069   | 3,782   |
| Other assets  | 7,521   | 7,910   |
| Total assets  | \$ 1,787,784                                  | 1,624,625                                       |
| <b>LIABILITIES</b>  |   |   |
| Deposits  | \$ 1,567,982                                  | 1,381,123                                       |
| Federal Home Loan Bank advances and other borrowings  | 28,600  | 67,200  |
| Junior subordinated debentures  | 13,403  | 13,403  |
| Other liabilities   | 16,943  | 13,213  |
| Total liabilities   | 1,626,928                                     | 1,474,939                                       |
| <b>SHAREHOLDERS' EQUITY</b>   |   |   |
| Preferred stock, par value \$.01 per share, 10,000,000 shares authorized, no shares issued and outstanding  | -   | -   |
| Common stock, par value \$.01 per share, 10,000,000 shares authorized, 7,425,672 and 7,347,851 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively | 74  | 73  |
| Nonvested restricted stock  | (853)   | (502)   |
| Additional paid-in capital  | 101,691                                       | 99,986  |
| Accumulated other comprehensive loss  | (1,365)                                       | (456)   |
| Retained earnings   | 61,309  | 50,585  |
| Total shareholders' equity  | 160,856                                       | 149,686   |
| Total liabilities and shareholders' equity  | \$ 1,787,784                                  | 1,624,625                                       |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited)

|   | For the three months |           | For the six months |           |
|---|----------------------|-----------|--------------------|-----------|
|   | ended June 30,       |           | ended June 30,     |           |
| (dollars in thousands, except share data)           | 2018                 | 2017      | 2018               | 2017      |
| <b>Interest income</b>                              |                      |           |                    |           |
| Loans   | \$ 17,591            | 14,280    | 34,154             | 27,806    |
| Investment securities                               | 430                  | 390       | 798                | 766       |
| Federal funds sold                                  | 514                  | 261       | 761                | 318       |
| Total interest income                               | 18,535               | 14,931    | 35,713             | 28,890    |
| <b>Interest expense</b>                             |                      |           |                    |           |
| Deposits  | 3,524                | 1,739     | 6,263              | 2,989     |
| Borrowings  | 399                  | 840       | 797                | 1,942     |
| Total interest expense                              | 3,923                | 2,579     | 7,060              | 4,931     |
| Net interest income                                 | 14,612               | 12,352    | 28,653             | 23,959    |
| Provision for loan losses                           | 400                  | 500       | 900                | 1,000     |
| Net interest income after provision for loan losses | 14,212               | 11,852    | 27,753             | 22,959    |
| <b>Noninterest income</b>                           |                      |           |                    |           |
| Mortgage banking income                             | 1,629                | 1,603     | 2,957              | 2,660     |
| Service fees on deposit accounts                    | 256                  | 284       | 512                | 561       |
| ATM and debit card income                           | 371                  | 290       | 705                | 552       |
| Income from bank owned life insurance               | 220                  | 183       | 441                | 366       |
| Other income  | 295                  | 202       | 577                | 475       |
| Total noninterest income                            | 2,771                | 2,562     | 5,192              | 4,614     |
| <b>Noninterest expenses</b>                         |                      |           |                    |           |
| Compensation and benefits                           | 6,365                | 5,524     | 12,208             | 10,798    |
| Occupancy   | 1,276                | 1,033     | 2,413              | 1,999     |
| Outside service and data processing costs           | 824                  | 823       | 1,560              | 1,568     |
| Insurance   | 297                  | 297       | 610                | 587       |
| Professional fees                                   | 457                  | 382       | 933                | 695       |
| Marketing   | 229                  | 196       | 438                | 407       |
| Other   | 531                  | 507       | 1,022              | 1,069     |
| Total noninterest expenses                          | 9,979                | 8,762     | 19,184             | 17,123    |
| Income before income tax expense                    | 7,004                | 5,652     | 13,761             | 10,450    |
| <b>Income tax expense</b>                           | 1,494                | 2,048     | 3,037              | 3,734     |
| <b>Net income available to common shareholders</b>  | \$ 5,510             | 3,604     | 10,724             | 6,716     |
| <b>Earnings per common share</b>                    |                      |           |                    |           |
| Basic   | \$ 0.75              | 0.52      | 1.46               | 1.00      |
| Diluted   | \$ 0.71              | 0.49      | 1.39               | 0.95      |
| <b>Weighted average common shares outstanding</b>   |                      |           |                    |           |
| Basic   | 7,370,709            | 6,986,948 | 7,353,867          | 6,713,608 |
| Diluted   | 7,751,146            | 7,366,208 | 7,739,082          | 7,099,381 |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(Unaudited)**

| (dollars in thousands)   | For the three months<br>ended June 30, |       | For the six months<br>ended June 30, |       |
|--|--|-------|--------------------------------------|-------|
|  | 2018                                   | 2017  | 2018                                 | 2017  |
| Net income   | \$ 5,510                               | 3,604 | 10,724                               | 6,716 |
| Other comprehensive income (loss):   |  |       |                                      |       |
| Unrealized gain (loss) on securities available for sale:   |  |       |                                      |       |
| Unrealized holding gain (loss) arising during the period, pretax   | (234)                                  | 258   | (1,150)                              | 496   |
| Tax (expense) benefit  | 51                                     | (89)  | 240                                  | (170) |
| Unrealized holding gain (loss) arising during the period, pretax   | -                                      | (2)   | 1                                    | (2)   |
| Tax expense  | -                                      | -     | -                                    | -     |
| Other comprehensive income (loss)  | (183)                                  | 167   | (909)                                | 324   |
| Comprehensive income   | \$ 5,327                               | 3,771 | 9,815                                | 7,040 |
| See notes to consolidated financial statements that are an integral part of these consolidated statements. |  |       |                                      |       |

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2018 AND 2017**  
**(Unaudited)**

|   | Common stock     |              | Preferred stock | Nonvested restricted stock | Additional paid-in capital | Accumulated other comprehensive income (loss) | Retained earnings | Total            |                   |
|---|------------------|--------------|-----------------|----------------------------|----------------------------|---|-------------------|------------------|-------------------|
| (dollars in thousands, except share data)                 | Shares           | Amount       | Shares          | Amount                     |                            |   |                   |                  |                   |
| <b>December 31, 2016</b>                                  | <b>6,463,789</b> | <b>65</b>    | -               | -                          | <b>(600)</b>               | <b>73,371</b>                                 | <b>(504)</b>      | <b>37,540</b>    | <b>109,872</b>    |
| Net income  | -                | -            | -               | -                          | -                          | -   | 6,716             | 6,716            |                   |
| Net issuance of common stock                              | 805,000          | -            | -               | -                          | 24,750                     | -   | -                 | 24,758           |                   |
| Proceeds from exercise of stock options                   | 42,267           | 8            | -               | -                          | 416                        | -   | -                 | 416              |                   |
| Issuance of restricted stock                              | 3,125            | -            | -               | -                          | (146)                      | -   | -                 | -                |                   |
| Amortization of deferred compensation on restricted stock | -                | -            | -               | -                          | 159                        | -   | -                 | 159              |                   |
| Compensation expense related to stock options, net of tax | -                | -            | -               | -                          | 491                        | -   | -                 | 491              |                   |
| Other comprehensive income                                | -                | -            | -               | -                          | -                          | 324   | -                 | 324              |                   |
| <b>June 30, 2017</b>                                      | <b>7,314,181</b> | <b>\$ 73</b> | -               | <b>\$-</b>                 | <b>\$ (587)</b>            | <b>\$ 99,174</b>                              | <b>\$ (180 )</b>  | <b>\$ 44,256</b> | <b>\$ 142,736</b> |
| <b>December 31, 2017</b>                                  | <b>7,347,851</b> | <b>73</b>    | -               | -                          | <b>(502)</b>               | <b>99,986</b>                                 | <b>(456)</b>      | <b>50,585</b>    | <b>149,686</b>    |
| Net income  | -                | -            | -               | -                          | -                          | -   | 10,724            | 10,724           |                   |
| Proceeds from exercise of stock options                   | 66,321           | 1            | -               | -                          | 637                        | -   | -                 | 638              |                   |
| Issuance of restricted stock                              | 11,500           | -            | -               | -                          | (501)                      | -   | -                 | -                |                   |
| Amortization of deferred compensation on restricted stock | -                | -            | -               | -                          | 150                        | -   | -                 | 150              |                   |
| Compensation expense related to stock options, net of tax | -                | -            | -               | -                          | 567                        | -   | -                 | 567              |                   |
| Other comprehensive income                                | -                | -            | -               | -                          | -                          | (909)   | -                 | (909)            |                   |
| <b>June 30, 2018</b>                                      | <b>7,425,672</b> | <b>\$ 74</b> | -               | <b>\$-</b>                 | <b>\$ (853)</b>            | <b>\$ 101,691</b>                             | <b>\$ (1,365)</b> | <b>\$ 61,309</b> | <b>\$ 160,856</b> |

See notes to consolidated financial statements that are an integral part of these consolidated statements.

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

|  | <b>For the six months ended June 30,</b> |                  |
|--|--|------------------|
|  | <b>2018</b>                              | <b>2017</b>      |
| (dollars in thousands)   |  |                  |
| <b>Operating activities</b>  |  |                  |
| Net income   | \$ 10,724                                | \$ 6,716         |
| Adjustments to reconcile net income to cash provided by (used for) operating activities:                   |  |                  |
| Provision for loan losses  | 900                                      | 1,000            |
| Depreciation and other amortization  | 850                                      | 669              |
| Accretion and amortization of securities discounts and premium, net  | 220                                      | 267              |
| (Gain) loss on sale of investment securities available for sale  | 1  | (2)              |
| Gain on sale of real estate owned  | (7)                                      | (12)             |
| (Gain) loss on disposal of fixed assets  | (8)                                      | 50               |
| Write-down of real estate owned  | -  | 7                |
| Compensation expense related to stock options and grants   | 717                                      | 650              |
| Gain on sale of loans held for sale  | (2,620)                                  | (2,854)          |
| Loans originated and held for sale   | (109,193)                                | (94,159)         |
| Proceeds from sale of loans held for sale  | 115,528                                  | 93,334           |
| Increase in cash surrender value of bank owned life insurance  | (441)                                    | (366)            |
| Increase in deferred tax asset   | (2,045)                                  | (392)            |
| Decrease in other assets, net  | 264                                      | 109              |
| Increase in other liabilities  | 3,730                                    | 694              |
| Net cash provided by operating activities  | 18,620                                   | 5,711            |
| <b>Investing activities</b>  |  |                  |
| Increase (decrease) in cash realized from:   |  |                  |
| Origination of loans, net  | (146,700)                                | (136,760)        |
| Purchase of property and equipment   | (1,328)                                  | (4,043)          |
| Purchase of investment securities:   |  |                  |
| Available for sale   | (13,904)                                 | (20,675)         |
| Other  | (2,596)                                  | (1,811)          |
| Payments and maturities, calls and repayments of investment securities:                                    |  |                  |
| Available for sale   | 4,227                                    | 4,002            |
| Other  | 3,999                                    | 3,522            |
| Proceeds from sale of investment securities available for sale   | 5,841                                    | -                |
| Proceeds from sale of real estate owned  | 132                                      | 380              |
| Net cash used for investing activities   | (150,329)                                | (155,385)        |
| <b>Financing activities</b>  |  |                  |
| Increase (decrease) in cash realized from:   |  |                  |
| Increase in deposits, net  | 186,859                                  | 206,760          |
| Decrease in Federal Home Loan Bank advances and other borrowings   | (38,600)                                 | (42,000)         |
| Proceeds from issuance of common stock   | -  | 24,758           |
| Proceeds from the exercise of stock options and warrants   | 638                                      | 416              |
| Net cash provided by financing activities  | 148,897                                  | 189,934          |
| Net increase in cash and cash equivalents  | 17,188                                   | 40,260           |
| <b>Cash and cash equivalents at beginning of the period</b>  | <b>92,165</b>                            | <b>46,552</b>    |
| <b>Cash and cash equivalents at end of the period</b>  | <b>\$ 109,353</b>                        | <b>\$ 86,812</b> |
| <b>Supplemental information</b>  |  |                  |
| <b>Cash paid for</b>   |  |                  |
| Interest   | \$ 6,764                                 | \$ 4,891         |
| Income taxes   | 1,960                                    | 3,410            |
| <b>Schedule of non-cash transactions</b>   |  |                  |
| Real estate acquired in settlement of loans  | -  | 164              |
| Unrealized gain (loss) on securities, net of income taxes  | (909)                                    | 324              |
| See notes to consolidated financial statements that are an integral part of these consolidated statements. |  |                  |

**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 – Nature of Business and Basis of Presentation**

*Business Activity*

**Southern First Bancshares, Inc.** (the "Company") is a South Carolina corporation that owns all of the capital stock of Southern First Bank (the "Bank") and all of the stock of Greenville First Statutory Trust I and II (collectively, the "Trusts"). The Trusts are special purpose non-consolidated entities organized for the sole purpose of issuing trust preferred securities. The Bank's primary federal regulator is the Federal Deposit Insurance Corporation (the "FDIC"). The Bank is also regulated and examined by the South Carolina Board of Financial Institutions. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the FDIC, and providing commercial, consumer and mortgage loans to the general public.

*Basis of Presentation*

The accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017 as filed with the Securities and Exchange Commission on February 28, 2018. The consolidated financial statements include the accounts of the Company and the Bank. In accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 810, "Consolidation," the financial statements related to the Trusts have not been consolidated.

*Business Segments*

In determining proper segment definition, the Company considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated, relative to a resource allocation and performance assessment. The Company accounts for intersegment revenues and expenses as if the revenue/expense transactions were generated to third parties, that is, at current market prices. Please refer to "Note 9 – Reportable Segments" for further information on the reporting for the Company's three business segments.

*Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, real estate acquired in the settlement of loans, fair value of financial instruments, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

*Reclassifications*

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis and had no effect on shareholders' equity or net income.

*Subsequent Events*

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.



*Revenue from Contracts with Customers*

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Our accounting policies will not change materially since the principles of revenue recognition from the Accounting Standards Update are largely consistent with existing guidance and current practices applied by our business. The following is a discussion of revenues within the scope of the new guidance:

*Service fees on deposit accounts* - The Company earns fees from its deposit clients for various transaction-based, account maintenance, and overdraft or non-sufficient funds ("NSF") services. Transaction-based fees, which include services such as stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the client's request. Account maintenance fees, which relate primarily to monthly maintenance and account management, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft and NSF fees are recognized at the point in time that the overdraft occurs or the NSF item is presented. Service charges on deposits are withdrawn from the client's account balance.

*ATM and debit card income* - The Company earns interchange fees from debit cardholder transactions conducted through the payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

*Income Taxes*

On December 22, 2017, the United States enacted tax reform legislation commonly known as the Tax Cuts and Jobs Act (the "Tax Act"), resulting in significant modifications to existing law. Authoritative guidance and interpretation by regulatory bodies is ongoing, and as such, the accounting for the effects of the Tax Act is not final and the full impact of the new regulation is still being evaluated. The accounting is expected to be complete when the 2017 U.S. corporate income tax return is filed later in 2018.

*Adoption of New Accounting Standards*

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company's revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains/losses on the sale of other real estate owned, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

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In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). The guidance affects the accounting for equity investments, financial liabilities under the fair value option and the presentation and disclosure requirements of financial instruments. ASU 2016-01 was effective for the Company on January 1, 2018 and resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 7 – Fair Value Accounting for further information regarding the valuation of these loans.

In February 2018, the FASB Issued (ASU 2018-02), Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, which requires companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act. The Company has opted to early adopt this pronouncement by retrospective application to each period (or periods) in which the effect of the change in the tax rate under the Tax Act is recognized. The impact of the reclassification from other comprehensive income to retained earnings did not have a material effect on the Company's financial statements.

### *Newly Issued, But Not Yet Effective Accounting Standards*

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). The FASB issued this ASU to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet by lessees for those leases classified as operating leases under current U.S. GAAP and disclosing key information about leasing arrangements. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early application of this ASU is permitted for all entities. Adoption of ASU 2016-02 is not expected to have a material impact on the Company's consolidated financial statements. The Company leases certain properties under operating leases that will result in the recognition of lease assets and lease liabilities on the Company's balance sheet under the ASU. At June 30, 2018, the Company had contractual future minimum lease commitments of approximately \$14.6 million, before considering renewal options that are generally present.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). Among other things, ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to form their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, ASU 2016-13 amends the accounting for credit losses on debt securities and purchased financial assets with credit deterioration. The amendments in ASU 2016-13 are effective for fiscal years beginning after December 31, 2019, and interim periods within those years for public business entities that are SEC filers. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018, however, the Company does not currently plan to early adopt the ASU. We are evaluating the impact of the ASU on our consolidated financial statements. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

In March 2017, the FASB amended the requirement in the Receivables-Nonrefundable Fees and Other Costs Topic of the Accounting Standards Codification related to the amortization period for certain purchased callable debt securities held at a premium. The amendments shorten the amortization period for the premium to the earliest call date. The amendments will be effective for the Company for interim and annual periods beginning after December 15, 2018. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2018, the FASB amended the Financial Instruments Topic of the Accounting Standards Codification. The amendments clarify certain aspects of the guidance issued in ASU 2016-01. The amendments will be effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. The Company does not expect these amendments to have a material effect on its financial statements.

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Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

**NOTE 2 – Investment Securities**

The amortized costs and fair value of investment securities are as follows:

|  | June 30, 2018     |                  |        |               |
|--|-------------------|------------------|--------|---------------|
| (dollars in thousands)                         | Amortized<br>Cost | Gross Unrealized |        | Fair<br>Value |
|  |                   | Gains            | Losses |               |
| <b>Available for sale</b>                      |                   |                  |        |               |
| US government agencies                         | \$ 8,987          | 1                | 274    | 8,714         |
| SBA securities                                 | 3,904             | -                | 135    | 3,769         |
| State and political subdivisions               | 8,530             | 49               | 107    | 8,472         |
| Asset-backed securities                        | 6,703             | 3                | 15     | 6,691         |
| Mortgage-backed securities                     |                   |                  |        |               |
| FHLMC  | 8,401             | -                | 327    | 8,074         |
| FNMA   | 32,089            | 2                | 780    | 31,311        |
| GNMA   | 3,181             | 1                | 146    | 3,036         |
| Total mortgage-backed securities               | 43,671            | 3                | 1,253  | 42,421        |
| Total investment securities available for sale | \$ 71,795         | 56               | 1,784  | 70,067        |

|  | December 31, 2017 |                  |        |               |
|--|-------------------|------------------|--------|---------------|
| (dollars in thousands)                         | Amortized<br>Cost | Gross Unrealized |        | Fair<br>Value |
|  |                   | Gains            | Losses |               |
| <b>Available for sale</b>                      |                   |                  |        |               |
| US government agencies                         | \$ 8,749          | 1                | 97     | 8,653         |
| SBA securities                                 | 4,087             | -                | 24     | 4,063         |
| State and political subdivisions               | 11,242            | 179              | 25     | 11,396        |
| Mortgage-backed securities                     |                   |                  |        |               |
| FHLMC  | 9,102             | -                | 149    | 8,953         |
| FNMA   | 29,383            | 3                | 386    | 29,000        |
| GNMA   | 5,618             | 2                | 82     | 5,538         |
| Total mortgage-backed securities               | 44,103            | 5                | 617    | 43,491        |
| Total investment securities available for sale | \$ 68,181         | 185              | 763    | 67,603        |

During the first six months of 2018, there were \$5.8 million of investment securities sold, resulting in a loss on sale of \$1,000.

During the first six months of 2017, there were \$415,000 of investment securities either sold or called, subsequently resulting in a gain on sale of \$2,000.

Contractual maturities and yields on the Company's investment securities at June 30, 2018 and December 31, 2017 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

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| (dollars in thousands)           | June 30, 2018      |              |                   |              |                   |              |                |              |               |              |
|----------------------------------|--------------------|--------------|-------------------|--------------|-------------------|--------------|----------------|--------------|---------------|--------------|
|                                  | Less than one year |              | One to five years |              | Five to ten years |              | Over ten years |              | Total         |              |
|                                  | Amount             | Yield        | Amount            | Yield        | Amount            | Yield        | Amount         | Yield        | Amount        | Yield        |
| <b>Available for sale</b>        |                    |              |                   |              |                   |              |                |              |               |              |
| US government agencies           | \$ -               | -            | 2,641             | 2.12%        | 6,073             | 2.74%        | -              | -            | 8,714         | 2.55%        |
| SBA securities                   | -                  | -            | -                 | -            | -                 | -            | 3,769          | 2.60%        | 3,769         | 2.60%        |
| State and political subdivisions | -                  | -            | 514               | 2.14%        | 4,514             | 3.11%        | 3,444          | 2.83%        | 8,472         | 2.94%        |
| Asset-backed securities          | -                  | -            | -                 | -            | -                 | -            | 6,691          | 2.89%        | 6,691         | 2.89%        |
| Mortgage-backed securities       | 115                | 0.31%        | 790               | 1.94%        | 12,101            | 1.86%        | 29,415         | 2.53%        | 42,421        | 2.40%        |
| <b>Total</b>                     | <b>\$ 115</b>      | <b>0.31%</b> | <b>3,945</b>      | <b>2.09%</b> | <b>22,688</b>     | <b>2.34%</b> | <b>43,319</b>  | <b>2.61%</b> | <b>70,067</b> | <b>2.49%</b> |

| (dollars in thousands)           | December 31, 2017  |              |                   |              |                   |              |                |              |               |              |
|----------------------------------|--------------------|--------------|-------------------|--------------|-------------------|--------------|----------------|--------------|---------------|--------------|
|                                  | Less than one year |              | One to five years |              | Five to ten years |              | Over ten years |              | Total         |              |
|                                  | Amount             | Yield        | Amount            | Yield        | Amount            | Yield        | Amount         | Yield        | Amount        | Yield        |
| <b>Available for sale</b>        |                    |              |                   |              |                   |              |                |              |               |              |
| US government agencies           | \$ 995             | 1.15%        | 1,503             | 2.04%        | 6,155             | 2.40%        | -              | -            | 8,653         | 2.20%        |
| SBA securities                   | -                  | -            | -                 | -            | -                 | -            | 4,063          | 2.45%        | 4,063         | 2.45%        |
| State and political subdivisions | -                  | -            | 1,163             | 1.96%        | 7,162             | 2.84%        | 3,071          | 2.76%        | 11,396        | 2.73%        |
| Mortgage-backed securities       | 432                | 0.99%        | -                 | -            | 11,328            | 1.84%        | 31,731         | 2.06%        | 43,491        | 1.99%        |
| <b>Total</b>                     | <b>\$ 1,427</b>    | <b>1.10%</b> | <b>2,666</b>      | <b>1.59%</b> | <b>24,645</b>     | <b>2.27%</b> | <b>38,865</b>  | <b>2.15%</b> | <b>67,603</b> | <b>2.17%</b> |

The tables below summarize gross unrealized losses on investment securities and the fair market value of the related securities at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

| (dollars in thousands)           | June 30, 2018 |                     |                   |           |                     |                   |           |                  |                   |
|----------------------------------|---------------|---------------------|-------------------|-----------|---------------------|-------------------|-----------|------------------|-------------------|
|                                  | #             | Less than 12 months |                   | #         | 12 months or longer |                   | #         | Total            |                   |
|                                  |               | Fair value          | Unrealized losses |           | Fair value          | Unrealized losses |           | Fair value       | Unrealized losses |
| <b>Available for sale</b>        |               |                     |                   |           |                     |                   |           |                  |                   |
| US government agencies           | 6             | \$ 5,336            | \$ 118            | 3         | \$ 2,878            | \$ 156            | 9         | \$ 8,214         | \$ 274            |
| SBA securities                   | 1             | 2,759               | 106               | 1         | 1,010               | 29                | 2         | 3,769            | 135               |
| State and political subdivisions | 7             | 4,747               | 71                | 2         | 769                 | 36                | 9         | 5,516            | 107               |
| Asset-backed securities          | 3             | 4,851               | 15                | -         | -                   | -                 | 3         | 4,851            | 15                |
| Mortgage-backed securities       |               |                     |                   |           |                     |                   |           |                  |                   |
| FHLMC                            | 3             | 2,610               | 90                | 7         | 5,464               | 237               | 10        | 8,074            | 327               |
| FNMA                             | 12            | 14,882              | 297               | 16        | 16,386              | 483               | 28        | 31,268           | 780               |
| GNMA                             | 1             | 1,223               | 59                | 2         | 1,792               | 87                | 3         | 3,015            | 146               |
| <b>Total</b>                     | <b>33</b>     | <b>\$ 36,408</b>    | <b>\$ 756</b>     | <b>31</b> | <b>\$ 28,299</b>    | <b>\$ 1,028</b>   | <b>64</b> | <b>\$ 64,707</b> | <b>\$ 1,784</b>   |

| (dollars in thousands)           | December 31, 2017 |                     |                   |    |                     |                   |    |            |                   |
|----------------------------------|-------------------|---------------------|-------------------|----|---------------------|-------------------|----|------------|-------------------|
|                                  | #                 | Less than 12 months |                   | #  | 12 months or longer |                   | #  | Total      |                   |
|                                  |                   | Fair value          | Unrealized losses |    | Fair value          | Unrealized losses |    | Fair value | Unrealized losses |
| <b>Available for sale</b>        |                   |                     |                   |    |                     |                   |    |            |                   |
| US government agencies           | 5                 | \$ 4,184            | \$ 22             | 4  | \$ 3,968            | \$ 75             | 9  | \$ 8,152   | \$ 97             |
| SBA securities                   | 1                 | 2,936               | 13                | 1  | 1,127               | 11                | 2  | 4,063      | 24                |
| State and political subdivisions | 3                 | 1,214               | 9                 | 2  | 792                 | 16                | 5  | 2,006      | 25                |
| Mortgage-backed securities       |                   |                     |                   |    |                     |                   |    |            |                   |
| FHLMC                            | 3                 | 2,897               | 26                | 7  | 6,056               | 123               | 10 | 8,953      | 149               |
| FNMA                             | 11                | 14,345              | 135               | 13 | 14,597              | 251               | 24 | 28,942     | 386               |
| GNMA                             | 2                 | 2,270               | 40                | 1  | 971                 | 42                | 3  | 3,241      | 82                |

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|       |    |    |        |    |     |    |    |        |    |     |    |    |        |    |     |
|-------|----|----|--------|----|-----|----|----|--------|----|-----|----|----|--------|----|-----|
| Total | 25 | \$ | 27,846 | \$ | 245 | 28 | \$ | 27,511 | \$ | 518 | 53 | \$ | 55,357 | \$ | 763 |
| 12    |    |    |        |    |     |    |    |        |    |     |    |    |        |    |     |

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At June 30, 2018, the Company had 33 individual investments with a fair market value of \$36.4 million that were in an unrealized loss position for less than 12 months and 31 individual investments with a fair market value of \$28.3 million that were in an unrealized loss position for 12 months or longer. The unrealized losses were primarily attributable to changes in interest rates, rather than deterioration in credit quality. The individual securities are each investment grade securities. The Company considers the length of time and extent to which the fair value of available-for-sale debt securities have been less than cost to conclude that such securities are not other-than-temporarily impaired. The Company also considers other factors such as the financial condition of the issuer, including credit ratings and specific events affecting the operations of the issuer, volatility of the security, underlying assets that collateralize the debt security, and other industry and macroeconomic conditions.

As the Company has no intent to sell securities with unrealized losses and it is not more-likely-than-not that the Company will be required to sell these securities before recovery of amortized cost, the Company has concluded that these securities are not impaired on an other-than-temporary basis.

Other investments are comprised of the following and are recorded at cost which approximates fair value.

| (dollars in thousands)                   | June 30,<br>2018 | December<br>31, 2017 |
|--|------------------|----------------------|
| Federal Home Loan Bank stock             | \$ 2,524         | 3,754                |
| Investment in Trust Preferred securities | 403              | 403                  |
| Other investments                        | 132              | 305                  |
| Total other investments                  | \$ 3,059         | 4,462                |

The Company has evaluated the Federal Home Loan Bank ("FHLB") stock for impairment and determined that the investment in the FHLB stock is not other than temporarily impaired as of June 30, 2018 and ultimate recoverability of the par value of this investment is probable. All of the FHLB stock is used to collateralize advances with the FHLB.

At June 30, 2018, \$4.2 million of securities were pledged as collateral for repurchase agreements from brokers and no securities were pledged to secure client deposits. At December 31, 2017, \$7.7 million of securities were pledged as collateral for repurchase agreements from brokers.

### NOTE 3 – Mortgage Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are reported as loans held for sale and carried at fair value under the fair value option with changes in fair value recognized in current period earnings. At the date of funding of the mortgage loan held for sale, the funded amount of the loan, the related derivative asset or liability of the associated interest rate lock commitment, less direct loan costs becomes the initial recorded investment in the loan held for sale. Such amount approximates the fair value of the loan. At June 30, 2018, mortgage loans held for sale totaled \$8.1 million compared to \$11.8 million at December 31, 2017.

Mortgage loans held for sale are considered de-recognized, or sold, when the Company surrenders control over the financial assets. Control is considered to have been surrendered when the transferred assets have been isolated from the Company, beyond the reach of the Company and its creditors; the purchaser obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and the Company does not maintain effective control over the transferred assets through an agreement that both entitles and obligates the Company to repurchase or redeem the transferred assets before their maturity or the ability to unilaterally cause the holder to return specific assets.

Gains and losses from the sale of mortgage loans are recognized based upon the difference between the sales proceeds and carrying value of the related loans upon sale and are recorded in mortgage banking income in the statement of income. Mortgage banking income also includes the gains and losses associated with the loans held for sale and the gains and losses from derivatives.

Mortgage loans sold by the Company to investors and which were believed to have met investor and agency underwriting guidelines at the time of sale may be subject to repurchase or indemnification in the event of specific default by the borrower or subsequent discovery that underwriting standards were not met. The Company may, upon mutual agreement, agree to repurchase the loans or indemnify the investor against future losses on such loans. In such cases, the Company bears any subsequent credit loss on the loans.

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The Company establishes mortgage repurchase reserves related to various representations and warranties that reflect management's estimate of losses based on a combination of factors. The Company establishes a reserve at the time loans are sold and quarterly updates the reserve estimate during the estimated loan life.

**NOTE 4 – Loans and Allowance for Loan Losses**

The following table summarizes the composition of our loan portfolio. Total gross loans are recorded net of deferred loan fees and costs, which totaled \$2.7 million as of June 30, 2018 and \$2.3 million as of December 31, 2017.

| (dollars in thousands)                  | June 30, 2018 |            | December 31, 2017 |            |
|---|---------------|------------|-------------------|------------|
|   | Amount        | % of Total | Amount            | % of Total |
| <b>Commercial</b>                       |               |            |                   |            |
| Owner occupied RE                       | \$ 358,169    | 23.4%      | \$ 316,818        | 22.8%      |
| Non-owner occupied RE                   | 355,309       | 23.2%      | 312,798           | 22.6%      |
| Construction                            | 73,655        | 4.8%       | 51,179            | 3.7%       |
| Business                                | 238,402       | 15.5%      | 226,158           | 16.3%      |
| Total commercial loans                  | 1,025,535     | 66.9%      | 906,953           | 65.4%      |
| <b>Consumer</b>                         |               |            |                   |            |
| Real estate                             | 290,433       | 18.9%      | 273,050           | 19.7%      |
| Home equity                             | 156,630       | 10.2%      | 156,141           | 11.3%      |
| Construction                            | 38,400        | 2.5%       | 28,351            | 2.0%       |
| Other                                   | 22,449        | 1.5%       | 22,575            | 1.6%       |
| Total consumer loans                    | 507,912       | 33.1%      | 480,117           | 34.6%      |
| Total gross loans, net of deferred fees | 1,533,447     | 100.0%     | 1,387,070         | 100.0%     |
| Less—allowance for loan losses          | (16,100 )     |            | (15,523 )         |            |
| Total loans, net                        | \$ 1,517,347  |            | \$ 1,371,547      |            |

*Maturities and Sensitivity of Loans to Changes in Interest Rates*

The information in the following tables summarizes the loan maturity distribution by type and related interest rate characteristics based on the contractual maturities of individual loans, including loans which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below, because borrowers have the right to prepay obligations with or without prepayment penalties.

| (dollars in thousands)                  | June 30, 2018    |                                 |                  |            |
|---|------------------|---------------------------------|------------------|------------|
|   | One year or less | After one but within five years | After five years | Total      |
| <b>Commercial</b>                       |                  |                                 |                  |            |
| Owner occupied RE                       | \$ 27,294        | 163,994                         | 166,881          | 358,169    |
| Non-owner occupied RE                   | 37,270           | 182,889                         | 135,150          | 355,309    |
| Construction                            | 17,024           | 21,813                          | 34,818           | 73,655     |
| Business                                | 66,961           | 123,166                         | 48,275           | 238,402    |
| Total commercial loans                  | 148,549          | 491,862                         | 385,124          | 1,025,535  |
| <b>Consumer</b>                         |                  |                                 |                  |            |
| Real estate                             | 32,872           | 62,050                          | 195,511          | 290,433    |
| Home equity                             | 9,518            | 28,079                          | 119,033          | 156,630    |
| Construction                            | 21,089           | 882                             | 16,429           | 38,400     |
| Other                                   | 7,584            | 10,169                          | 4,696            | 22,449     |
| Total consumer loans                    | 71,063           | 101,180                         | 335,669          | 507,912    |
| Total gross loans, net of deferred fees | \$ 219,612       | 593,042                         | 720,793          | 1,533,447  |
| Loans maturing after one year with:     |                  |                                 |                  |            |
| Fixed interest rates                    |                  |                                 |                  | \$ 999,311 |
| Floating interest rates                 |                  |                                 |                  | 314,524    |

December 31, 2017

| (dollars in thousands)                 | One year<br>or less | After one<br>but within<br>five years | After five<br>years | Total      |
|--|---------------------|---------------------------------------|---------------------|------------|
| <b>Commercial</b>                      |                     |                                       |                     |            |
| Owner occupied RE                      | \$ 24,171           | 167,425                               | 125,222             | 316,818    |
| Non-owner occupied RE                  | 39,519              | 165,764                               | 107,515             | 312,798    |
| Construction                           | 13,086              | 12,796                                | 25,297              | 51,179     |
| Business                               | 73,588              | 107,584                               | 44,986              | 226,158    |
| Total commercial loans                 | 150,364             | 453,569                               | 303,020             | 906,953    |
| <b>Consumer</b>                        |                     |                                       |                     |            |
| Real estate                            | 30,172              | 61,809                                | 181,069             | 273,050    |
| Home equity                            | 13,331              | 25,807                                | 117,003             | 156,141    |
| Construction                           | 14,943              | 1,737                                 | 11,671              | 28,351     |
| Other                                  | 7,203               | 11,371                                | 4,001               | 22,575     |
| Total consumer                         | 65,649              | 100,724                               | 313,744             | 480,117    |
| Total gross loan, net of deferred fees | \$ 216,013          | 554,293                               | 616,764             | 1,387,070  |
| Loans maturing after one year with :   |                     |                                       |                     |            |
| Fixed interest rates                   |                     |                                       |                     | \$ 875,991 |
| Floating interest rates                |                     |                                       |                     | 295,066    |

**Portfolio Segment Methodology***Commercial*

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic reviews. The Company applies historic grade-specific loss factors to each loan class. In the development of statistically derived loan grade loss factors, the Company observes historical losses over 20 quarters for each loan grade. These loss estimates are adjusted as appropriate based on additional analysis of external loss data or other risks identified from current economic conditions and credit quality trends. The allowance also includes an amount for the estimated impairment on nonaccrual commercial loans and commercial loans modified in a troubled debt restructuring ("TDR"), whether on accrual or nonaccrual status.

*Consumer*

For consumer loans, the Company determines the allowance on a collective basis utilizing historical losses over 20 quarters to represent its best estimate of inherent loss. The Company pools loans, generally by loan class with similar risk characteristics. The allowance also includes an amount for the estimated impairment on nonaccrual consumer loans and consumer loans modified in a TDR, whether on accrual or nonaccrual status.

**Credit Quality Indicators***Commercial*

We manage a consistent process for assessing commercial loan credit quality by monitoring its loan grading trends and past due statistics. All loans are subject to individual risk assessment. Our risk categories include Pass, Special Mention, Substandard, and Doubtful, each of which is defined by our banking regulatory agencies. Delinquency statistics are also an important indicator of credit quality in the establishment of our allowance for credit losses.

We categorize our loans into risk categories based on relevant information about the ability of the borrower to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. A description of the general characteristics of the risk grades is as follows:

Pass—These loans range from minimal credit risk to average however still acceptable credit risk.



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Special mention—A special mention loan has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or the institution’s credit position at some future date.

Substandard—A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses, that may jeopardize the liquidation of the debt. A substandard loan is characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful—A doubtful loan has all of the weaknesses inherent in one classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of the currently existing facts, conditions and values, highly questionable and improbable.

The tables below provide a breakdown of outstanding commercial loans by risk category.

|                        | June 30, 2018        |                             |              |          |           |
|------------------------|----------------------|-----------------------------|--------------|----------|-----------|
|                        | Owner<br>occupied RE | Non-owner<br>occupied<br>RE | Construction | Business | Total     |
| (dollars in thousands) |                      |                             |              |          |           |
| Pass                   | \$ 354,276           | 349,819                     | 73,655       | 231,214  | 1,008,964 |
| Special mention        | 1,644                | 1,523                       | -            | 3,579    | 6,746     |
| Substandard            | 2,249                | 3,967                       | -            | 3,609    | 9,825     |
| Doubtful               | -                    | -                           | -            | -        | -         |
|                        | \$ 358,169           | 355,309                     | 73,655       | 238,402  | 1,025,535 |

|                 | December 31, 2017    |                             |              |          |         |
|-----------------|----------------------|-----------------------------|--------------|----------|---------|
|                 | Owner<br>occupied RE | Non-owner<br>occupied<br>RE | Construction | Business | Total   |
| Pass            | \$ 312,628           | 306,965                     | 51,179       | 215,729  | 886,501 |
| Special mention | 1,770                | 2,082                       | -            | 5,540    | 9,392   |
| Substandard     | 2,420                | 3,751                       | -            | 4,889    | 11,060  |
| Doubtful        | -                    | -                           | -            | -        | -       |
|                 | \$ 316,818           | 312,798                     | 51,179       | 226,158  | 906,953 |

The following tables provide past due information for outstanding commercial loans and include loans on nonaccrual status as well as accruing TDRs.

|                        | June 30, 2018        |                             |              |          |           |
|------------------------|----------------------|-----------------------------|--------------|----------|-----------|
|                        | Owner<br>occupied RE | Non-owner<br>occupied<br>RE | Construction | Business | Total     |
| (dollars in thousands) |                      |                             |              |          |           |
| Current                | \$ 357,261           | 354,718                     | 73,655       | 237,790  | 1,023,424 |
| 30-59 days past due    | 908                  | 398                         | -            | 519      | 1,825     |
| 60-89 days past due    | -                    | -                           | -            | -        | -         |
| Greater than 90 Days   | -                    | 193                         | -            | 93       | 286       |
|                        | \$ 358,169           | 355,309                     | 73,655       | 238,402  | 1,025,535 |

|                      | December 31, 2017       |                             |              |          |         |
|----------------------|-------------------------|-----------------------------|--------------|----------|---------|
|                      | Owner<br>occupied<br>RE | Non-owner<br>occupied<br>RE | Construction | Business | Total   |
| Current              | \$ 316,818              | 312,477                     | 51,179       | 224,861  | 905,335 |
| 30-59 days past due  | -                       | 129                         | -            | 416      | 545     |
| 60-89 days past due  | -                       | -                           | -            | -        | -       |
| Greater than 90 Days | -                       | 192                         | -            | 881      | 1,073   |
|                      | \$ 316,818              | 312,798                     | 51,179       | 226,158  | 906,953 |



as nonaccrual is recognized as a reduction in principal when received.

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Following is a summary of our nonperforming assets, including nonaccruing TDRs.

| (dollars in thousands)                             | June 30,<br>2018 | December<br>31, 2017 |
|--|------------------|----------------------|
| <b>Commercial</b>                                  |                  |                      |
| Owner occupied RE                                  | \$ -             | -                    |
| Non-owner occupied RE                              | 1,689            | 1,581                |
| Construction                                       | -                | -                    |
| Business   | 94               | 910                  |
| <b>Consumer</b>                                    |                  |                      |
| Real estate  | 1,174            | 992                  |
| Home equity  | 1,598            | 1,144                |
| Construction                                       | -                | -                    |
| Other  | -                | 1                    |
| Nonaccruing troubled debt restructurings           | 3,166            | 2,673                |
| Total nonaccrual loans, including nonaccruing TDRs | 7,721            | 7,301                |
| Other real estate owned                            | 117              | 242                  |
| Total nonperforming assets                         | \$7,838          | 7,543                |
| Nonperforming assets as a percentage of:           |                  |                      |
| Total assets                                       | 0.44%            | 0.46%                |
| Gross loans  | 0.51%            | 0.54%                |
| Total loans over 90 days past due                  | 1,122            | 2,027                |
| Loans over 90 days past due and still accruing     | -                | -                    |
| Accruing troubled debt restructurings              | \$7,397          | 5,145                |

**Impaired Loans**

The table below summarizes key information for impaired loans. The Company's impaired loans include loans on nonaccrual status and loans modified in a TDR, whether on accrual or nonaccrual status. These impaired loans may have estimated impairment which is included in the allowance for loan losses. The Company's commercial and consumer impaired loans are evaluated individually to determine the related allowance for loan losses.

| (dollars in thousands) | June 30, 2018                  |                   |  |   |
|------------------------|--------------------------------|-------------------|--|---|
|                        | Recorded investment            |                   |  |   |
|                        | Unpaid<br>Principal<br>Balance | Impaired<br>loans | Impaired loans<br>with related<br>allowance for<br>loan losses | Related<br>allowance for<br>loan losses |
| <b>Commercial</b>      |                                |                   |  |   |
| Owner occupied RE      | \$ 2,858                       | 2,793             | 454  | 74                                      |
| Non-owner occupied RE  | 7,304                          | 3,829             | 2,269  | 659                                     |
| Construction           | -                              | -                 | -  | -                                       |
| Business               | 4,076                          | 3,348             | 2,994  | 1,397                                   |
| Total commercial       | 14,238                         | 9,970             | 5,717  | 2,130                                   |
| <b>Consumer</b>        |                                |                   |  |   |
| Real estate            | 2,946                          | 2,867             | 2,203  | 1,226                                   |
| Home equity            | 2,750                          | 2,117             | 220  | 94                                      |
| Construction           | -                              | -                 | -  | -                                       |
| Other                  | 164                            | 164               | 164  | 20                                      |
| Total consumer         | 5,860                          | 5,148             | 2,587  | 1,340                                   |
| Total                  | \$ 20,098                      | 15,118            | 8,304  | 3,470                                   |

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|                        | December 31, 2017              |  |  |   |
|------------------------|--------------------------------|--|--|---|
|                        | Unpaid<br>Principal<br>Balance | Recorded investment<br>Impaired<br>loans | Impaired loans<br>with related<br>allowance for<br>loan losses | Related<br>allowance for<br>loan losses |
| (dollars in thousands) |                                |  |  |   |
| <b>Commercial</b>      |                                |  |  |   |
| Owner occupied RE      | \$ 2,281                       | 2,235                                    | 464  | 179                                     |
| Non-owner occupied RE  | 6,827                          | 3,665                                    | 2,646  | 750                                     |
| Construction           | -                              | -  | -  | -                                       |
| Business               | 3,735                          | 2,764                                    | 1,993  | 1,061                                   |
| Total commercial       | 12,843                         | 8,664                                    | 5,103  | 1,990                                   |
| <b>Consumer</b>        |                                |  |  |   |
| Real estate            | 2,062                          | 2,037                                    | 2,037  | 1,379                                   |
| Home equity            | 2,010                          | 1,575                                    | 680  | 286                                     |
| Construction           | -                              | -  | -  | -                                       |
| Other                  | 171                            | 170                                      | 170  | 22                                      |
| Total consumer         | 4,243                          | 3,782                                    | 2,887  | 1,687                                   |
| Total                  | \$ 17,086                      | 12,446                                   | 7,990  | 3,677                                   |

The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

|                        | Three months ended<br>June 30, 2018 |                                  | Three months ended<br>June 30, 2017 |                                  |
|------------------------|-------------------------------------|----------------------------------|-------------------------------------|----------------------------------|
|                        | Average<br>recorded<br>investment   | Recognized<br>interest<br>income | Average<br>recorded<br>investment   | Recognized<br>interest<br>income |
| (dollars in thousands) |                                     |                                  |                                     |                                  |
| <b>Commercial</b>      |                                     |                                  |                                     |                                  |
| Owner occupied RE      | \$ 2,800                            | 45                               | 2,195                               | 26                               |
| Non-owner occupied RE  | 3,878                               | 77                               | 3,620                               | 48                               |
| Construction           | -                                   | -                                | -                                   | -                                |
| Business               | 3,361                               | 57                               | 3,623                               | 54                               |
| Total commercial       | 10,039                              | 179                              | 9,438                               | 128                              |
| <b>Consumer</b>        |                                     |                                  |                                     |                                  |
| Real estate            | 2,892                               | 40                               | 1,635                               | 16                               |
| Home equity            | 2,135                               | 24                               | 197                                 | 1                                |
| Construction           | -                                   | -                                | -                                   | -                                |
| Other                  | 165                                 | 1                                | 180                                 | 1                                |
| Total consumer         | 5,192                               | 65                               | 2,012                               | 18                               |
| Total                  | \$ 15,231                           | 244                              | 11,450                              | 146                              |

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|                        | Six months ended<br>June 30, 2018 |                                  | Six months ended<br>June 30, 2017 |                                  | Year ended<br>December 31, 2017   |                                  |
|------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|                        | Average<br>recorded<br>investment | Recognized<br>interest<br>income | Average<br>recorded<br>investment | Recognized<br>interest<br>income | Average<br>recorded<br>investment | Recognized<br>interest<br>income |
|                        |                                   |                                  |                                   |                                  |                                   |                                  |
| (dollars in thousands) |                                   |                                  |                                   |                                  |                                   |                                  |
| <b>Commercial</b>      |                                   |                                  |                                   |                                  |                                   |                                  |
| Owner occupied RE      | \$ 2,804                          | 62                               | 2,204                             | 53                               | 2,255                             | 104                              |
| Non-owner occupied RE  | 3,920                             | 126                              | 3,721                             | 76                               | 4,144                             | 199                              |
| Construction           | -                                 | -                                | -                                 | -                                | -                                 | -                                |
| Business               | 3,380                             | 79                               | 3,635                             | 98                               | 2,823                             | 162                              |
| Total commercial       | 10,104                            | 267                              | 9,560                             | 227                              | 9,222                             | 465                              |
| <b>Consumer</b>        |                                   |                                  |                                   |                                  |                                   |                                  |
| Real estate            | 2,911                             | 81                               | 1,642                             | 33                               | 2,047                             | 69                               |
| Home equity            | 2,172                             | 51                               | 198                               | 2                                | 1,576                             | 97                               |
| Construction           | -                                 | -                                | -                                 | -                                | -                                 | -                                |
| Other                  | 167                               | 3                                | 181                               | 2                                | 174                               | 6                                |
| Total consumer         | 5,250                             | 135                              | 2,021                             | 37                               | 3,797                             | 172                              |
| Total                  | \$ 15,354                         | 402                              | 11,581                            | 264                              | 13,019                            | 637                              |

**Allowance for Loan Losses**

The allowance for loan loss is management's estimate of credit losses inherent in the loan portfolio. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company has an established process to determine the adequacy of the allowance for loan losses that assesses the losses inherent in the portfolio. While the Company attributes portions of the allowance to specific portfolio segments, the entire allowance is available to absorb credit losses inherent in the total loan portfolio. The Company's process involves procedures to appropriately consider the unique risk characteristics of the commercial and consumer loan portfolio segments. For each portfolio segment, impairment is measured individually for each impaired loan. The Company's allowance levels are influenced by loan volume, loan grade or delinquency status, historic loss experience and other economic conditions.

The following table summarizes the activity related to the allowance for loan losses by commercial and consumer portfolio segments:

|  | Three months ended June 30, 2018 |                             |              |          |                |                |              |       | Total   |
|--|----------------------------------|-----------------------------|--------------|----------|----------------|----------------|--------------|-------|---------|
|  | Commercial                       |                             |              |          | Consumer       |                |              |       |         |
|  | Owner<br>occupied<br>RE          | Non-owner<br>occupied<br>RE | Construction | Business | Real<br>Estate | Home<br>equity | Construction | Other |         |
| (dollars in thousands)                           |                                  |                             |              |          |                |                |              |       |         |
| <b>Balance, beginning of period</b>              | \$ 2,680                         | 3,366                       | 415          | 3,553    | 3,391          | 1,911          | 256          | 280   | 15,852  |
| Provision for loan losses                        | 19                               | 342                         | 129          | 280      | 54             | (438)          | 26           | (12)  | 40      |
| Loan charge-offs                                 | -                                | (234)                       | -            | -        | -              | (77)           | -            | -     | (31)    |
| Loan recoveries                                  | -                                | 107                         | -            | 16       | 1              | 35             | -            | -     | 159     |
| Net loan charge-offs                             | -                                | (127)                       | -            | 16       | 1              | (42)           | -            | -     | (152)   |
| <b>Balance, end of period</b>                    | \$ 2,699                         | 3,581                       | 544          | 3,849    | 3,446          | 1,431          | 282          | 268   | 16,100  |
| Net charge-offs to average loans (annualized)    |                                  |                             |              |          |                |                |              |       | 0.04%   |
| Allowance for loan losses to gross loans         |                                  |                             |              |          |                |                |              |       | 1.05%   |
| Allowance for loan losses to nonperforming loans |                                  |                             |              |          |                |                |              |       | 208.52% |

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| (dollars in thousands)                           | Three months ended June 30, 2017 |                    |          |        |             |              |              |       |        |   |
|--|----------------------------------|--------------------|----------|--------|-------------|--------------|--------------|-------|--------|---|
|  | Commercial                       |                    |          |        | Consumer    |              |              |       |        |   |
|  | Owner occupied                   | Non-owner occupied |          |        | Real Estate | Home equity  | Construction | Other | Total  |   |
| RE   | RE                               | Construction       | Business | Estate | equity      | Construction | Other        | Total |        |   |
| <b>Balance, beginning of period</b>              | \$ 3,052                         | 2,967              | 334      | 3,823  | 2,830       | 1,619        | 289          | 373   | 15,287 |   |
| Provision for loan losses                        | (88 )                            | 255                | 16       | 139    | 240         | (23 )        | 39           | (78 ) | 500    |   |
| Loan charge-offs                                 | -                                | (253 )             | -        | (120 ) | -           | -            | -            | -     | (373 ) |   |
| Loan recoveries                                  | -                                | 12                 | -        | 15     | (9 )        | 12           | -            | -     | 30     |   |
| Net loan charge-offs                             | -                                | (241 )             | -        | (105 ) | (9 )        | 12           | -            | -     | (343 ) |   |
| <b>Balance, end of period</b>                    | \$ 2,964                         | 2,981              | 350      | 3,857  | 3,061       | 1,608        | 328          | 295   | 15,444 |   |
| Net charge-offs to average loans (annualized)    |                                  |                    |          |        |             |              |              |       | 0.11   | % |
| Allowance for loan losses to gross loans         |                                  |                    |          |        |             |              |              |       | 1.19   | % |
| Allowance for loan losses to nonperforming loans |                                  |                    |          |        |             |              |              |       | 293.75 | % |

| (dollars in thousands)                        | Six months ended June 30, 2018 |                    |          |        |             |              |              |       |        |   |
|---|--------------------------------|--------------------|----------|--------|-------------|--------------|--------------|-------|--------|---|
|   | Commercial                     |                    |          |        | Consumer    |              |              |       |        |   |
|   | Owner occupied                 | Non-owner occupied |          |        | Real Estate | Home equity  | Construction | Other | Total  |   |
| RE  | RE                             | Construction       | Business | Estate | equity      | Construction | Other        | Total |        |   |
| <b>Balance, beginning of period</b>           | \$ 2,534                       | 3,230              | 325      | 3,848  | 3,495       | 1,600        | 210          | 281   | 15,523 |   |
| Provision for loan losses                     | 165                            | 478                | 219      | (14 )  | 25          | (64 )        | 72           | 19    | 900    |   |
| Loan charge-offs                              | -                              | (234 )             | -        | (119 ) | (77 )       | (140 )       | -            | (34 ) | (604 ) |   |
| Loan recoveries                               | -                              | 107                | -        | 134    | 3           | 35           | -            | 2     | 281    |   |
| Net loan charge-offs                          | -                              | (127 )             | -        | 15     | (74 )       | (105 )       | -            | (32 ) | (323 ) |   |
| <b>Balance, end of period</b>                 | \$ 2,699                       | 3,581              | 544      | 3,849  | 3,446       | 1,431        | 282          | 268   | 16,100 |   |
| Net charge-offs to average loans (annualized) |                                |                    |          |        |             |              |              |       | 0.04   | % |

| (dollars in thousands)                        | Six months ended June 30, 2017 |                    |          |        |             |              |              |       |        |   |
|---|--------------------------------|--------------------|----------|--------|-------------|--------------|--------------|-------|--------|---|
|   | Commercial                     |                    |          |        | Consumer    |              |              |       |        |   |
|   | Owner occupied                 | Non-owner occupied |          |        | Real Estate | Home equity  | Construction | Other | Total  |   |
| RE  | RE                             | Construction       | Business | Estate | equity      | Construction | Other        | Total |        |   |
| <b>Balance, beginning of period</b>           | \$ 2,843                       | 2,778              | 295      | 4,123  | 2,780       | 1,475        | 252          | 309   | 14,855 |   |
| Provision for loan losses                     | 121                            | 623                | 55       | (182 ) | 200         | 121          | 76           | (14 ) | 1,000  |   |
| Loan charge-offs                              | -                              | (433 )             | -        | (130 ) | -           | -            | -            | -     | (563 ) |   |
| Loan recoveries                               | -                              | 13                 | -        | 46     | 81          | 12           | -            | -     | 152    |   |
| Net loan charge-offs                          | -                              | (420 )             | -        | (84 )  | 81          | 12           | -            | -     | (411 ) |   |
| <b>Balance, end of period</b>                 | \$ 2,964                       | 2,981              | 350      | 3,857  | 3,061       | 1,608        | 328          | 295   | 15,444 |   |
| Net charge-offs to average loans (annualized) |                                |                    |          |        |             |              |              |       | 0.03   | % |

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The following table disaggregates the allowance for loan losses and recorded investment in loans by impairment methodology.

| (dollars in thousands) | Allowance for loan losses |          |        | June 30, 2018<br>Recorded investment in loans |          |           |
|------------------------|---------------------------|----------|--------|---|----------|-----------|
|                        | Commercial                | Consumer | Total  | Commercial                                    | Consumer | Total     |
| Individually evaluated | \$ 2,130                  | 1,340    | 3,470  | 9,970   | 5,148    | 15,118    |
| Collectively evaluated | 8,543                     | 4,087    | 12,630 | 1,015,565                                     | 502,764  | 1,518,329 |
| Total                  | \$ 10,673                 | 5,427    | 16,100 | 1,025,535                                     | 507,912  | 1,533,447 |

  

|                        | Allowance for loan losses |          |        | December 31, 2017<br>Recorded investment in loans |          |           |
|------------------------|---------------------------|----------|--------|---|----------|-----------|
|                        | Commercial                | Consumer | Total  | Commercial  | Consumer | Total     |
| Individually evaluated | \$ 1,990                  | 1,687    | 3,677  | 8,664   | 3,782    | 12,446    |
| Collectively evaluated | 7,947                     | 3,899    | 11,846 | 898,289   | 476,335  | 1,374,624 |
| Total                  | \$ 9,937                  | 5,586    | 15,523 | 906,953   | 480,117  | 1,387,070 |

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**NOTE 5 – Troubled Debt Restructurings**

At June 30, 2018, the Company had 28 loans totaling \$10.6 million compared to 21 loans totaling \$7.8 million at December 31, 2017, which were considered as TDRs. The Company considers a loan to be a TDR when the debtor experiences financial difficulties and the Company grants a concession to the debtor that it would not normally consider. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of the workout plan for individual loan relationships, the Company may restructure loan terms to assist borrowers facing financial challenges in the current economic environment. To date, the Company has restored four commercial loans previously classified as TDRs to accrual status.

The following table summarizes the concession at the time of modification and the recorded investment in the Company's TDRs before and after their modification.

| For the six months ended June 30, 2018 |                                    |                                    |                                  |                                |                             |   |   | Pre- | Post- |
|--|------------------------------------|------------------------------------|----------------------------------|--------------------------------|-----------------------------|---|---|------|-------|
|  | Renewals<br>deemed a<br>concession | Reduced<br>or deferred<br>payments | Converted<br>to interest<br>only | Maturity<br>date<br>extensions | Total<br>Number<br>of loans | modification<br>outstanding<br>recorded<br>investment | modification<br>outstanding<br>recorded<br>investment |      |       |
| (dollars in thousands)                 |                                    |                                    |                                  |                                |                             |   |   |      |       |
| <b>Commercial</b>                      |                                    |                                    |                                  |                                |                             |   |   |      |       |
| Owner occupied RE                      | 1                                  | -                                  | -                                | -                              | 1                           | \$ 506  | \$ 592  |      |       |
| Business                               | 4                                  | -                                  | -                                | -                              | 4                           | 1,207   | 1,532   |      |       |
| <b>Consumer</b>                        |                                    |                                    |                                  |                                |                             |   |   |      |       |
| Real estate                            | 2                                  | -                                  | -                                | -                              | 2                           | 549   | 669   |      |       |
| Home equity                            | -                                  | 1                                  | -                                | -                              | 1                           | 180   | 180   |      |       |
| Total loans                            | 7                                  | 1                                  | -                                | -                              | 8                           | \$ 2,442  | \$ 2,973  |      |       |

| For the six months ended June 30, 2017 |                                    |                                    |                                  |                                |                             |   |   | Pre- | Post- |
|--|------------------------------------|------------------------------------|----------------------------------|--------------------------------|-----------------------------|---|---|------|-------|
|  | Renewals<br>deemed a<br>concession | Reduced<br>or deferred<br>payments | Converted<br>to interest<br>only | Maturity<br>date<br>extensions | Total<br>Number<br>of loans | modification<br>outstanding<br>recorded<br>investment | modification<br>outstanding<br>recorded<br>investment |      |       |
| <b>Commercial</b>                      |                                    |                                    |                                  |                                |                             |   |   |      |       |
| Business                               | 1                                  | 1                                  | -                                | -                              | 2                           | \$ 378  | \$ 387  |      |       |
| Total loans                            | 1                                  | 1                                  | -                                | -                              | 2                           | \$ 378  | \$ 387  |      |       |

As of June 30, 2018 and 2017, there were no loans modified as TDRs for which there was a payment default (60 days past due) within 12 months of the restructuring date.

**NOTE 6 – Derivative Financial Instruments**

The Company utilizes derivative financial instruments primarily to hedge its exposure to changes in interest rates. All derivative financial instruments are recognized as either assets or liabilities and measured at fair value. The Company accounts for all of its derivatives as free-standing derivatives and does not designate any of these instruments for hedge accounting. Therefore, the gain or loss resulting from the change in the fair value of the derivative is recognized in the Company's statement of income during the period of change.

The Company enters into commitments to originate residential mortgage loans held for sale, at specified interest rates and within a specified period of time, with clients who have applied for a loan and meet certain credit and underwriting criteria (interest rate lock commitments). These interest rate lock commitments ("IRLCs") meet the definition of a derivative financial instrument and are reflected in the balance sheet at fair value with changes in fair value recognized in current period earnings. Unrealized gains and losses on the IRLCs are recorded as derivative assets and derivative liabilities, respectively, and are measured based on the value of the underlying mortgage loan, quoted mortgage-backed securities ("MBS") prices and an estimate of the probability that the mortgage loan will fund within the terms of the interest rate lock commitment, net of estimated commission expenses.

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The Company manages the interest rate and price risk associated with its outstanding IRLCs and mortgage loans held for sale by entering into derivative instruments such as forward sales of MBS. Management expects these derivatives will experience changes in fair value opposite to changes in fair value of the IRLCs and mortgage loans held for sale, thereby reducing earnings volatility. The Company takes into account various factors and strategies in determining the portion of the mortgage pipeline (IRLCs and mortgage loans held for sale) it wants to economically hedge.

The following table summarizes the Company's outstanding financial derivative instruments at June 30, 2018 and December 31, 2017.

|  | <b>June 30, 2018</b> |                               | <b>Fair Value</b>        |
|--|----------------------|-------------------------------|--------------------------|
| (dollars in thousands)                       | <b>Notional</b>      | <b>Balance Sheet Location</b> | <b>Asset/(Liability)</b> |
| Mortgage loan interest rate lock commitments | \$ 25,463            | Other assets                  | \$ 320                   |
| MBS forward sales commitments                | 16,500               | Other liabilities             | (60 )                    |
| Total derivative financial instruments       | \$ 41,963            |                               | \$ 260                   |
| <b>December 31, 2017</b>                     |                      |                               |                          |
|  | <b>Notional</b>      | <b>Balance Sheet Location</b> | <b>Fair Value</b>        |
|  |                      | <b>Asset/(Liability)</b>      |                          |
| Mortgage loan interest rate lock commitments | \$ 15,430            | Other assets                  | \$ 196                   |
| MBS forward sales commitments                | 10,750               | Other liabilities             | (28 )                    |
| Total derivative financial instruments       | \$ 26,180            |                               | \$ 168                   |

### **NOTE 7 – Fair Value Accounting**

FASB ASC 820, "Fair Value Measurement and Disclosures," defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

#### **Level 1 – Quoted market price in active markets**

Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include certain debt and equity securities that are traded in an active exchange market.

#### **Level 2 – Significant other observable inputs**

Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include fixed income securities and mortgage-backed securities that are held in the Company's available-for-sale portfolio and valued by a third-party pricing service, as well as certain impaired loans.

#### **Level 3 – Significant unobservable inputs**

Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. These methodologies may result in a significant portion of the fair value being derived from unobservable data.

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The methods of determining the fair value of assets and liabilities presented in this note are consistent with our methodologies disclosed in Note 13 of the Company's 2017 Form 10-K, except for the valuation of loans held for investment which was impacted by the adoption of ASU 2016-01. Prior to adopting the amendments included in the standard, the Company was allowed to measure fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk and market factors that sometimes exist in exit prices in dislocated markets. As of June 30, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion. This credit risk assumption is intended to approximate the fair value that a market participant would realize in a hypothetical orderly transaction. The Company's loan portfolio is initially fair valued using a segmented approach, using the eight categories as disclosed in Note 4 – Loans and Allowance for Loan Losses. Loans are considered a Level 2 and Level 3 classification.

*Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017.

| (dollars in thousands)  | Level 1 | Level 2 | Level 3 | June 30, 2018<br>Total     |
|---|---------|---------|---------|----------------------------|
| <b>Assets</b>   |         |         |         |                            |
| Securities available for sale                                 |         |         |         |                            |
| US government agencies  | \$ -    | 8,714   | -       | 8,714                      |
| SBA securities  | -       | 3,769   | -       | 3,769                      |
| State and political subdivisions                              | -       | 8,472   | -       | 8,472                      |
| Asset-backed securities                                       | -       | 6,691   | -       | 6,691                      |
| Mortgage-backed securities                                    | -       | 42,421  | -       | 42,421                     |
| Mortgage loans held for sale                                  | -       | 8,075   | -       | 8,075                      |
| Interest rate lock commitments                                | -       | 320     | -       | 320                        |
| Total assets measured at fair value on a recurring basis      | \$ -    | 78,462  | -       | 78,462                     |
| <b>Liabilities</b>  |         |         |         |                            |
| MBS forward sales commitments                                 | \$ -    | 60      | -       | 60                         |
| Total liabilities measured at fair value on a recurring basis | \$ -    | 60      | -       | 60                         |
|   | Level 1 | Level 2 | Level 3 | December 31, 2017<br>Total |
| <b>Assets</b>   |         |         |         |                            |
| Securities available for sale:                                |         |         |         |                            |
| US government agencies  | \$ -    | 8,653   | -       | 8,653                      |
| SBA securities  | -       | 4,063   | -       | 4,063                      |
| State and political subdivisions                              | -       | 11,396  | -       | 11,396                     |
| Mortgage-backed securities                                    | -       | 43,491  | -       | 43,491                     |
| Mortgage loans held for sale                                  | -       | 11,790  | -       | 11,790                     |
| Interest rate lock commitments                                | -       | 196     | -       | 196                        |
| Total assets measured at fair value on a recurring basis      | \$ -    | 79,589  | -       | 79,589                     |
| <b>Liabilities</b>  |         |         |         |                            |
| MBS forward sales commitments                                 | \$ -    | 28      | -       | 28                         |
| Total liabilities measured at fair value on a recurring basis | \$ -    | 28      | -       | 28                         |

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### *Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis*

The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2018 and December 31, 2017.

|  | <b>As of June 30, 2018</b> |                |                |               |
|--|----------------------------|----------------|----------------|---------------|
| (dollars in thousands)   | <b>Level 1</b>             | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b>  |
| <b>Assets</b>  |                            |                |                |               |
| Impaired loans   | \$ -                       | 2,920          | 8,728          | 11,648        |
| Other real estate owned  | -                          | 23             | 94             | 117           |
| <b>Total assets measured at fair value on a nonrecurring basis</b> | <b>\$ -</b>                | <b>2,943</b>   | <b>8,822</b>   | <b>11,765</b> |
| <br>   |                            |                |                |               |
| (dollars in thousands)   | <b>Level 1</b>             | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b>  |
| <b>Assets</b>  |                            |                |                |               |
| Impaired loans   | \$ -                       | 2,685          | 6,084          | 8,769         |
| Other real estate owned  | -                          | 148            | 94             | 242           |
| <b>Total assets measured at fair value on a nonrecurring basis</b> | <b>\$ -</b>                | <b>2,833</b>   | <b>6,178</b>   | <b>9,011</b>  |

The Company had no liabilities carried at fair value or measured at fair value on a nonrecurring basis.

### *Impaired Loans*

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan may be considered impaired and an allowance for loan losses may be 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 measures the impairment in accordance with FASB ASC 310, "Receivables." The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value 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. In accordance with FASB ASC 820, "Fair Value Measurement and Disclosures," impaired loans where an allowance is established based on the fair value of collateral 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 considers the impaired loan as nonrecurring Level 2. The Company's current loan and appraisal policies require the Company to obtain updated appraisals on an "as is" basis at renewal, or in the case of an impaired loan, on an annual basis, either through a new external appraisal or an appraisal evaluation. The Company reviews the third party appraisal for appropriateness and adjusts the value downward to consider selling and closing costs, which typically range from 7% - 10% of the appraised value. For non-real estate loans, fair value of the of the impaired loan's collateral may be determined using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the impaired loan as nonrecurring Level 3. The fair value of impaired loans may also be estimated using the present value of expected future cash flows to be realized on the loan, which is also considered a Level 3 valuation. These fair value estimates are subject to fluctuations in assumptions about the amount and timing of expected cash flows as well as the choice of discount rate used in the present value calculation.

### *Other Real Estate Owned ("OREO")*

OREO, consisting of properties obtained through foreclosure or in satisfaction of loans, is reported at the lower of cost or fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs (Level 2). At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and generally any subsequent adjustments to the value are recorded as a component of real estate owned activity. The unobservable inputs may vary depending on the individual assets and valuation approach. The Company reviews the third party appraisal for appropriateness and adjusts the value downward to consider selling and closing costs, which typically range from 7% to 10% of the appraised value. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company considers the OREO as nonrecurring Level 3.

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*Fair Value of Financial Instruments*

Financial instruments require disclosure of fair value information, whether or not recognized in the consolidated balance sheets, when it is practical to estimate the fair value. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual obligation which requires the exchange of cash. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock, premises and equipment and other assets and liabilities.

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

|                                |                 | June 30, 2018     |         |           |           |
|--------------------------------|-----------------|-------------------|---------|-----------|-----------|
| (dollars in thousands)         | Carrying Amount | Fair Value        | Level 1 | Level 2   | Level 3   |
| <b>Financial Assets:</b>       |                 |                   |         |           |           |
| Other investments, at cost     | \$ 3,059        | 3,059             | -       | -         | 3,059     |
| Loans <sup>1</sup>             | 1,502,229       | 1,483,215         | -       | -         | 1,483,215 |
| <b>Financial Liabilities:</b>  |                 |                   |         |           |           |
| Deposits                       | 1,567,982       | 1,430,788         | -       | 1,430,788 | -         |
| FHLB and other borrowings      | 28,600          | 28,792            | -       | 28,792    | -         |
| Junior subordinated debentures | 13,403          | 14,148            | -       | 14,148    | -         |
|                                |                 | December 31, 2017 |         |           |           |
| (dollars in thousands)         | Carrying Amount | Fair Value        | Level 1 | Level 2   | Level 3   |
| <b>Financial Assets:</b>       |                 |                   |         |           |           |
| Other investments, at cost     | \$ 4,462        | 4,462             | -       | -         | 4,462     |
| Loans <sup>1</sup>             | 1,359,101       | 1,363,915         | -       | -         | 1,363,915 |
| <b>Financial Liabilities:</b>  |                 |                   |         |           |           |
| Deposits                       | 1,381,123       | 1,269,462         | -       | 1,269,462 | -         |
| FHLB and other borrowings      | 67,200          | 67,890            | -       | 67,890    | -         |
| Junior subordinated debentures | 13,403          | 13,166            | -       | 13,166    | -         |

<sup>1</sup> Carrying amount is net of the allowance for loan losses and previously presented impaired loans. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

**NOTE 8 – Earnings Per Common Share**

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and six months ended June 30, 2018 and 2017. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options that were outstanding at June 30, 2018. The assumed conversion of stock options can create a difference between basic and dilutive net income per common share. At June 30, 2018 and 2017, there were 166,172 and 120,681 options, respectively, that were not considered in computing diluted earnings per common share because they were anti-dilutive.

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| (dollars in thousands, except share data)            | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | 2018               | June 30, 2017 | 2018             | June 30, 2017 |
| Numerator:   |                    |               |                  |               |
| Net income available to common shareholders          | \$ 5,510           | 3,604         | 10,724           | 6,716         |
| Denominator:   |                    |               |                  |               |
| Weighted-average common shares outstanding – basic   | 7,370,709          | 6,986,948     | 7,353,867        | 6,713,608     |
| Common stock equivalents                             | 380,437            | 379,260       | 385,215          | 385,773       |
| Weighted-average common shares outstanding – diluted | 7,751,146          | 7,366,208     | 7,739,082        | 7,099,381     |
| Earnings per common share:                           |                    |               |                  |               |
| Basic  | \$ 0.75            | 0.52          | 1.46             | 1.00          |
| Diluted  | \$ 0.71            | 0.49          | 1.39             | 0.95          |

**NOTE 9 – Reportable Segments**

The Company's reportable segments represent the distinct product lines the Company offers and are viewed separately for strategic planning purposes by management. The three segments include Commercial and Retail Banking, Mortgage Banking, and Corporate. The following schedule presents financial information for each reportable segment.

| (dollars in thousands)         | Three months ended            |                  |           |              |              | Three months ended            |                  |           |              |              |
|--------------------------------|-------------------------------|------------------|-----------|--------------|--------------|-------------------------------|------------------|-----------|--------------|--------------|
|                                | June 30, 2018                 |                  |           |              |              | June 30, 2017                 |                  |           |              |              |
|                                | Commercial and Retail Banking | Mortgage Banking | Corporate | Eliminations | Consolidated | Commercial and Retail Banking | Mortgage Banking | Corporate | Eliminations | Consolidated |
| Interest income                | \$ 18,437                     | 98               | 2         | (2)          | 18,535       | \$ 14,851                     | 80               | 6         | (6)          | 14,931       |
| Interest expense               | 3,762                         | -                | 163       | (2)          | 3,923        | 2,442                         | -                | 143       | (6)          | 2,579        |
| Net interest income (loss)     | 14,675                        | 98               | (161)     | -            | 14,612       | 12,409                        | 80               | (137)     | -            | 12,352       |
| Provision for loan losses      | 400                           | -                | -         | -            | 400          | 500                           | -                | -         | -            | 500          |
| Noninterest income             | 1,142                         | 1,629            | -         | -            | 2,771        | 959                           | 1,603            | -         | -            | 2,562        |
| Noninterest expense            | 8,754                         | 1,165            | 60        | -            | 9,979        | 7,667                         | 1,035            | 60        | -            | 8,762        |
| Net income (loss) before taxes | 6,663                         | 562              | (221)     | -            | 7,004        | 5,201                         | 648              | (197)     | -            | 5,652        |
| Income tax provision (benefit) | 1,422                         | 118              | (46)      | -            | 1,494        | 1,877                         | 240              | (69)      | -            | 2,048        |
| Net income (loss)              | \$ 5,241                      | 444              | (175)     | -            | 5,510        | \$ 3,324                      | 408              | (128)     | -            | 3,604        |
| Total assets                   | \$1,777,952                   | 9,404            | 174,331   | (173,903)    | 1,787,784    | \$1,527,837                   | 10,958           | 156,145   | (155,714)    | 1,539,226    |

| (dollars in thousands)         | Six months ended              |                  |           |              |              | Six months ended              |                  |           |              |              |
|--------------------------------|-------------------------------|------------------|-----------|--------------|--------------|-------------------------------|------------------|-----------|--------------|--------------|
|                                | June 30, 2018                 |                  |           |              |              | June 30, 2017                 |                  |           |              |              |
|                                | Commercial and Retail Banking | Mortgage Banking | Corporate | Eliminations | Consolidated | Commercial and Retail Banking | Mortgage Banking | Corporate | Eliminations | Consolidated |
| Interest income                | \$ 35,515                     | 198              | 4         | (4)          | 35,713       | \$ 28,744                     | 146              | 8         | (8)          | 28,890       |
| Interest expense               | 6,782                         | -                | 282       | (4)          | 7,060        | 4,665                         | -                | 274       | (8)          | 4,931        |
| Net interest income (loss)     | 28,733                        | 198              | (278)     | -            | 28,653       | 24,079                        | 146              | (266)     | -            | 23,959       |
| Provision for loan losses      | 900                           | -                | -         | -            | 900          | 1,000                         | -                | -         | -            | 1,000        |
| Noninterest income             | 2,235                         | 2,957            | -         | -            | 5,192        | 1,954                         | 2,660            | -         | -            | 4,614        |
| Noninterest expense            | 16,935                        | 2,129            | 120       | -            | 19,184       | 15,114                        | 1,883            | 126       | -            | 17,123       |
| Net income before taxes        | 13,133                        | 1,026            | (398)     | -            | 13,761       | 9,919                         | 923              | (392)     | -            | 10,450       |
| Income tax provision (benefit) | 2,906                         | 215              | (84)      | -            | 3,037        | 3,530                         | 342              | (138)     | -            | 3,734        |
| Net income (loss)              | \$ 10,227                     | 811              | (314)     | -            | 10,724       | \$ 6,389                      | 581              | (254)     | -            | 6,716        |
| Total assets                   | \$1,777,952                   | 9,404            | 174,331   | (173,903)    | 1,787,784    | \$1,527,837                   | 10,958           | 156,145   | (155,714)    | 1,539,226    |

**Commercial and retail banking.** The Company's primary business is to provide traditional deposit and lending products and services to its commercial and retail banking clients.

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Mortgage banking. The mortgage banking segment provides mortgage loan origination services for loans that will be sold in the secondary market to investors.

Corporate. Corporate is comprised primarily of compensation and benefits for certain members of management and interest on parent company debt.

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

*The following discussion reviews our results of operations for the three and six month periods ended June 30, 2018 as compared to the three and six month periods ended June 30, 2017 and assesses our financial condition as of June 30, 2018 as compared to December 31, 2017. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements and the related notes and the consolidated financial statements and the related notes for the year ended December 31, 2017 included in our Annual Report on Form 10-K for that period. Results for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results for the year ending December 31, 2018 or any future period.*

**CAUTIONARY WARNING REGARDING FORWARD-LOOKING STATEMENTS**

This report, including information included or incorporated by reference in this report, contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements may relate to our financial condition, results of operations, plans, objectives, or future performance. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those anticipated in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "could," "should," "will," "expect," "anticipate," "predict," "project," "potential," "believe," "continue," "assume," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties that could cause our actual results to differ from those anticipated in any forward-looking statements include, but are not limited to, the following:

Restrictions or conditions imposed by our regulators on our operations;

Increases in competitive pressure in the banking and financial services industries;

Changes in access to funding or increased regulatory requirements with regard to funding;

Changes in deposit flows;

Credit losses as a result of declining real estate values, increasing interest rates, increasing unemployment, changes in payment behavior or other factors;

Credit losses due to loan concentration;

Changes in the amount of our loan portfolio collateralized by real estate and weaknesses in the real estate market;

Our ability to successfully execute our business strategy;

Our ability to attract and retain key personnel;

The success and costs of our expansion into the Greensboro, North Carolina, Raleigh, North Carolina and Atlanta, Georgia markets;

Changes in the interest rate environment which could reduce anticipated or actual margins;

Changes in political conditions or the legislative or regulatory environment, including governmental initiatives affecting the financial services industry;

Changes in economic conditions resulting in, among other things, a deterioration in credit quality;

Changes occurring in business conditions and inflation;

Increased cybersecurity risk, including potential business disruptions or financial losses;



Changes in technology;

The adequacy of the level of our allowance for loan losses and the amount of loan loss provisions required in future periods;

Examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, require us to increase our allowance for loan losses or write-down assets;

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Changes in monetary and tax policies;

The rate of delinquencies and amounts of loans charged-off;

The rate of loan growth in recent years and the lack of seasoning of a portion of our loan portfolio;

Our ability to maintain appropriate levels of capital and to comply with our capital ratio requirements;

Adverse changes in asset quality and resulting credit risk-related losses and expenses;

Changes in accounting policies and practices; and

Other risks and uncertainties detailed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017, in Part II, Item 1A of this Quarterly Report on Form 10-Q, and from time to time in our other filings with the Securities and Exchange Commission (the "SEC").

If any of these risks or uncertainties materialize, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. For information with respect to additional factors that could cause actual results to differ from the expectations stated in the forward-looking statements, see "Risk Factors" under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017 and "Risk Factors" under Part II, Item 1A of this Quarterly Report on Form 10-Q. We urge investors to consider all of these factors carefully in evaluating the forward-looking statements contained in this Quarterly Report on Form 10-Q. We make these forward-looking statements as of the date of this document and we do not intend, and assume no obligation, to update the forward-looking statements or to update the reasons why actual results could differ from those expressed in, or implied or projected by, the forward-looking statements.

## OVERVIEW

Our business model continues to be client-focused, utilizing relationship teams to provide our clients with a specific banker contact and support team responsible for all of their banking needs. The purpose of this structure is to provide a consistent and superior level of professional service, and we believe it provides us with a distinct competitive advantage. We consider exceptional client service to be a critical part of our culture, which we refer to as "ClientFIRST."

At June 30, 2018, we had total assets of \$1.8 billion, a 10.0% increase from total assets of \$1.6 billion at December 31, 2017. The largest components of our total assets are loans, cash and cash equivalents and securities which were \$1.5 billion, \$109.4 million and \$73.1 million, respectively, at June 30, 2018. Comparatively, our loans, cash and cash equivalents and securities totaled \$1.4 billion, \$92.2 million and \$72.1 million, respectively, at December 31, 2017. Our liabilities and shareholders' equity at June 30, 2018 totaled \$1.6 billion and \$160.9 million, respectively, compared to liabilities of \$1.5 billion and shareholders' equity of \$149.7 million at December 31, 2017. The principal component of our liabilities is deposits which were \$1.6 billion and \$1.4 billion at June 30, 2018 and December 31, 2017, respectively.

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread. In addition to earning interest on our loans and investments, we earn income through fees and other charges to our clients.

Our net income to common shareholders was \$5.5 million and \$3.6 million for the three months ended June 30, 2018 and 2017, respectively, an increase of \$1.9 million, or 52.9%. Diluted earnings per share ("EPS") was \$0.71 for the second quarter of 2018 as compared to \$0.49 for the same period in 2017. The increase in net income resulted primarily from increases in net interest income and noninterest income partially offset due to an increase in noninterest expense. In addition, as a result of the Tax Act which was passed in December 2017, our effective rate declined from 36.2% for the second quarter of 2017 to 21.3% for the second quarter of 2018, which also contributed to the increase in net income during the second quarter of 2018.

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Our net income to common shareholders was \$10.7 million and \$6.7 million for the six months ended June 30, 2018 and 2017, respectively, an increase of \$4.0 million, or 59.7%. Diluted EPS was \$1.39 for the six months ended June 30, 2018 as compared to \$0.95 for the same period in 2017. The increase in net income resulted primarily from an increase in net interest income and noninterest income as well as a lower tax rate, and partially offset by an increase in noninterest expense.

Economic conditions, competition, and the monetary and fiscal policies of the Federal government significantly affect most financial institutions, including the Bank. Lending and deposit activities and fee income generation are influenced by levels of business spending and investment, consumer income, consumer spending and savings, capital market activities, and competition among financial institutions, as well as customer preferences, interest rate conditions and prevailing market rates on competing products in our market areas.

### RESULTS OF OPERATIONS

#### *Net Interest Income and Margin*

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. Our net interest income was \$14.6 million for the three month period ended June 30, 2018, an 18.3% increase over net interest income of \$12.4 million for the same period in 2017. In comparison, our average earning assets increased 17.7%, or \$252.9 million, during the second quarter of 2018 compared to the second quarter of 2017, while our average interest-bearing liabilities increased by \$186.8 million during the same period. Our net interest income was \$28.7 million for the six month period ended June 30, 2018, a 19.6% increase over net interest income of \$24.0 million for the same period in 2017. In comparison, our average earning assets increased 18.7%, or \$256.0 million, during the first six months of 2018 compared to the first six months of 2017, while our average interest-bearing liabilities increased by \$184.5 million during the same period. The increase in average earning assets in both the three and six month periods ended June 30, 2018 is primarily related to an increase in average loans and federal funds sold, while the increase in average interest-bearing liabilities is primarily a result of an increase in interest-bearing deposits, partially offset by a decrease in our FHLB advances and other borrowings.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances, Income and Expenses, Yields and Rates" table reflects the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and six month periods ended June 30, 2018 and 2017. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts.

The following tables set forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the same periods, we had no securities purchased with agreements to resell. All investments owned have an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

## Average Balances, Income and Expenses, Yields and Rates

| (dollars in thousands)                           | For the Three Months Ended June 30, |                    |                                       |                    |                    |                                       |
|--|-------------------------------------|--------------------|---------------------------------------|--------------------|--------------------|---------------------------------------|
|  | Average<br>Balance                  | Income/<br>Expense | 2018<br>Yield/<br>Rate <sup>(1)</sup> | Average<br>Balance | Income/<br>Expense | 2017<br>Yield/<br>Rate <sup>(1)</sup> |
| <b>Interest-earning assets</b>                   |                                     |                    |                                       |                    |                    |                                       |
| Federal funds sold                               | \$ 113,238                          | \$ 514             | 1.82%                                 | \$ 95,214          | \$ 261             | 1.10%                                 |
| Investment securities, taxable                   | 62,780                              | 390                | 2.49%                                 | 53,296             | 269                | 2.02%                                 |
| Investment securities, nontaxable <sup>(2)</sup> | 5,661                               | 52                 | 3.68%                                 | 19,879             | 195                | 3.94%                                 |
| Loans <sup>(3)</sup>                             | 1,499,625                           | 17,591             | 4.70%                                 | 1,260,007          | 14,280             | 4.55%                                 |
| Total interest-earning assets                    | 1,681,304                           | 18,547             | 4.42%                                 | 1,428,396          | 15,005             | 4.21%                                 |
| Noninterest-earning assets                       | 75,851                              |                    |                                       | 66,916             |                    |                                       |
| Total assets                                     | \$ 1,757,155                        |                    |                                       | \$ 1,495,312       |                    |                                       |
| <b>Interest-bearing liabilities</b>              |                                     |                    |                                       |                    |                    |                                       |
| NOW accounts                                     | \$ 235,235                          | 102                | 0.17%                                 | \$ 225,577         | 106                | 0.19%                                 |
| Savings & money market                           | 671,065                             | 2,099              | 1.25%                                 | 446,890            | 821                | 0.74%                                 |
| Time deposits                                    | 329,325                             | 1,323              | 1.61%                                 | 329,497            | 812                | 0.99%                                 |
| Total interest-bearing deposits                  | 1,235,625                           | 3,524              | 1.14%                                 | 1,001,964          | 1,739              | 0.70%                                 |
| FHLB advances and other borrowings               | 28,600                              | 239                | 3.35%                                 | 75,469             | 729                | 3.87%                                 |
| Junior subordinated debentures                   | 13,403                              | 160                | 4.79%                                 | 13,403             | 111                | 3.32%                                 |
| Total interest-bearing liabilities               | 1,277,628                           | 3,923              | 1.23%                                 | 1,090,836          | 2,579              | 0.95%                                 |
| Noninterest-bearing liabilities                  | 321,952                             |                    |                                       | 272,096            |                    |                                       |
| Shareholders' equity                             | 157,575                             |                    |                                       | 132,380            |                    |                                       |
| Total liabilities and shareholders' equity       | \$ 1,757,155                        |                    |                                       | \$ 1,495,312       |                    |                                       |
| Net interest spread                              |                                     |                    | 3.19%                                 |                    |                    | 3.26%                                 |
| Net interest income (tax equivalent) / margin    |                                     | \$ 14,624          | 3.49%                                 |                    | \$ 12,426          | 3.49%                                 |
| Less: tax-equivalent adjustment <sup>(2)</sup>   |                                     | 12                 |                                       |                    | 74                 |                                       |
| Net interest income                              |                                     | \$ 14,612          |                                       |                    | \$ 12,352          |                                       |

(1) Annualized for the three month period.

The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable (2) basis.

(3) Includes mortgage loans held for sale.

Our net interest margin, on a tax-equivalent basis, was 3.49% for both the three months ended June 30, 2018 and 2017. While our net interest margin remained consistent from the prior year, our average interest-earning assets grew by \$252.9 million during the second quarter of 2018 as compared to the same period in 2017, with the average yield on these assets increasing by 21 basis points. In addition, our average interest-bearing liabilities grew by \$186.8 million during the 2018 period while the rate on these liabilities increased 28 basis points to 1.23% for the three months ended June 30, 2018.

The \$252.9 million increase in average interest-earning assets for the three months ended June 30, 2018, as compared to the same quarter in 2017, primarily related to a \$239.6 million increase in our average loan balances. In addition, the yield on our average loans increased 15 basis points during the second quarter of 2018 as compared to the same period of 2017, contributing to the 21 basis point increase in our average interest earning assets during the second quarter of 2018. The higher yield on our loan portfolio was due to loans being originated or renewed at market rates which are higher than those in the past.

In addition, our average interest-bearing liabilities increased by \$186.8 million during the second quarter of 2018 as compared to the second quarter of 2017, while the cost of our interest-bearing liabilities increased by 28 basis points during the same period. The increased cost during the 2018 period resulted primarily from a \$233.7 million increase in our interest-bearing deposits at an average rate of 1.14%, a 44 basis point increase from the average rate in the second quarter of 2017. This increase was partially offset by a \$46.9 million decrease in FHLB advances and other borrowings at an average rate of 3.35%, a 52 basis point decrease from the second quarter of 2017.

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Our net interest spread was 3.19% for the three months ended June 30, 2018 compared to 3.26% for the same period in 2017. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. The seven basis point decrease in our net interest spread was driven by the 28 basis point increase in the cost of our interest-bearing liabilities, partially offset by the 21 basis point increase in yield on our interest-earning assets for the 2018 period. We anticipate continued pressure on our net interest spread and net interest margin in future periods based on the possibility of additional Federal Reserve interest rate increases and a competitive rate environment.

| (dollars in thousands)                           |                    |                    |                                       | For the Six Months Ended June 30, |                    |                                       |
|--|--------------------|--------------------|---------------------------------------|-----------------------------------|--------------------|---------------------------------------|
|  | Average<br>Balance | Income/<br>Expense | 2018<br>Yield/<br>Rate <sup>(1)</sup> | Average<br>Balance                | Income/<br>Expense | 2017<br>Yield/<br>Rate <sup>(1)</sup> |
| <b>Interest-earning assets</b>                   |                    |                    |                                       |                                   |                    |                                       |
| Federal funds sold                               | \$ 87,632          | \$ 761             | 1.75%                                 | \$ 62,545                         | \$ 318             | 1.03%                                 |
| Investment securities, taxable                   | 60,413             | 711                | 2.37%                                 | 51,740                            | 523                | 2.04%                                 |
| Investment securities, nontaxable <sup>(2)</sup> | 6,354              | 113                | 3.59%                                 | 19,748                            | 392                | 4.00%                                 |
| Loans <sup>(3)</sup>                             | 1,472,137          | 34,154             | 4.68%                                 | 1,236,544                         | 27,806             | 4.53%                                 |
| Total interest-earning assets                    | 1,626,536          | 35,739             | 4.43%                                 | 1,370,577                         | 29,039             | 4.27%                                 |
| Noninterest-earning assets                       | 75,272             |                    |                                       | 66,086                            |                    |                                       |
| Total assets                                     | \$ 1,701,808       |                    |                                       | \$ 1,436,663                      |                    |                                       |
| <b>Interest-bearing liabilities</b>              |                    |                    |                                       |                                   |                    |                                       |
| NOW accounts                                     | \$ 237,020         | 193                | 0.16%                                 | \$ 222,677                        | 205                | 0.19%                                 |
| Savings & money market                           | 633,361            | 3,677              | 1.17%                                 | 417,217                           | 1,373              | 0.66%                                 |
| Time deposits                                    | 322,374            | 2,393              | 1.50%                                 | 301,012                           | 1,411              | 0.95%                                 |
| Total interest-bearing deposits                  | 1,192,755          | 6,263              | 1.06%                                 | 940,906                           | 2,989              | 0.64%                                 |
| FHLB advances and other borrowings               | 31,925             | 521                | 3.29%                                 | 99,274                            | 1,727              | 3.51%                                 |
| Junior subordinated debentures                   | 13,403             | 276                | 4.15%                                 | 13,403                            | 215                | 3.23%                                 |
| Total interest-bearing liabilities               | 1,238,083          | 7,060              | 1.15%                                 | 1,053,583                         | 4,931              | 0.94%                                 |
| Noninterest-bearing liabilities                  | 308,737            |                    |                                       | 260,851                           |                    |                                       |
| Shareholders' equity                             | 154,988            |                    |                                       | 122,229                           |                    |                                       |
| Total liabilities and shareholders' equity       | \$ 1,701,808       |                    |                                       | \$ 1,436,663                      |                    |                                       |
| Net interest spread                              |                    |                    | 3.28%                                 |                                   |                    | 3.33%                                 |
| Net interest income (tax equivalent) / margin    |                    | \$ 28,679          | 3.56%                                 |                                   | \$ 24,108          | 3.55%                                 |
| Less: tax-equivalent adjustment <sup>(2)</sup>   |                    | 26                 |                                       |                                   | 149                |                                       |
| Net interest income                              |                    | \$ 28,653          |                                       |                                   | \$ 23,959          |                                       |

(1) Annualized for the six month period.

The tax-equivalent adjustment to net interest income adjusts the yield for assets earning tax-exempt income to a comparable yield on a taxable (2) basis.

(3) Includes mortgage loans held for sale.

Our net interest margin, on a tax-equivalent basis, was 3.56% for the six months ended June 30, 2018 compared to 3.55% for the first six months of 2017. While our net interest margin increased only one basis point as compared to the same period in 2017, our average interest-earning assets grew by \$256.0 million during the same period, with the average yield on these assets increasing by 16 basis points. In addition, our average interest-bearing liabilities grew by \$184.5 million during the 2018 period while the rate on these liabilities increased 21 basis points for the six months ended June 30, 2018.

Our average interest-earning assets increased by \$256.0 million as compared to the six months ended June 30, 2017 related primarily to a \$235.6 million increase in our average loan balances for the 2018 period. The 16 basis point increase in yield on our interest-earning assets was driven by a 15 basis point increase in our loan yield due primarily to loans being originated or renewed at market rates which are higher than those in the past.

In addition, our average interest-bearing liabilities increased by \$184.5 million during the six months ended June 30, 2018 as compared to the first six months of 2017, while the cost of our interest-bearing liabilities increased 21 basis points during the same period. The increased cost during the first six months of 2018 was driven by a \$251.8 million increase in our average interest-bearing deposits at an average rate of 1.06%, a 42 basis point increase from the average rate for the first six months of 2017, partially offset by a \$67.3 million decrease in FHLB advances and other borrowings at an average rate of 3.29%, or 22 basis points lower than the first six months of 2017.

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Our net interest spread was 3.28% for the six months ended June 30, 2018 compared to 3.33% for the same period in 2017. The five basis point decrease in our net interest spread for the 2018 period was driven by the 21 basis point increase in cost on our interest-bearing liabilities, partially offset by the 16 basis point increase in yield on our interest-earning assets. We anticipate continued pressure on our net interest spread and net interest margin in future periods based on the possibility of additional Federal Reserve interest rate increases and a competitive rate environment.

### *Rate/Volume Analysis*

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following table sets forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

|                        | <b>June 30, 2018 vs. 2017</b>     |             |               |              | <b>Three Months Ended<br/>June 30, 2017 vs. 2016</b> |             |               |              |
|------------------------|-----------------------------------|-------------|---------------|--------------|--|-------------|---------------|--------------|
|                        | <b>Increase (Decrease) Due to</b> |             |               |              | <b>Increase (Decrease) Due to</b>                    |             |               |              |
|                        | <b>Rate/</b>                      |             |               |              | <b>Rate/</b>   |             |               |              |
| (dollars in thousands) | <b>Volume</b>                     | <b>Rate</b> | <b>Volume</b> | <b>Total</b> | <b>Volume</b>  | <b>Rate</b> | <b>Volume</b> | <b>Total</b> |
| Interest income        |                                   |             |               |              |  |             |               |              |
| Loans                  | \$ 2,716                          | 500         | 95            | 3,311        | \$ 2,326   | (38)        | (7)           | 2,281        |
| Investment securities  | (25)                              | 70          | (5)           | 40           | (72)   | 5           | (1)           | (68)         |
| Federal funds sold     | 49                                | 171         | 33            | 253          | 89   | 43          | 83            | 215          |
| Total interest income  | 2,740                             | 741         | 123           | 3,604        | 2,343  | 10          | 75            | 2,428        |
| Interest expense       |                                   |             |               |              |  |             |               |              |