

SOUTHERN FIRST BANCSHARES INC  
Form 10-Q  
April 26, 2017

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**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 March 31, 2017  
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

Non-accelerated filer

(Do not check if a smaller reporting company)

Accelerated filer

Smaller Reporting Company

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Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

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: 6,480,164 shares of common stock, par value \$0.01 per share, were issued and outstanding as of April 17, 2017.

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***SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY***

March 31, 2017 Form 10-Q

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**Table of Contents****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)  | March 31,<br>2017<br>(Unaudited) | December 31,<br>2016<br>(Audited) |
|--|----------------------------------|-----------------------------------|
| <b>ASSETS</b>  |                                  |                                   |
| Cash and cash equivalents:   |                                  |                                   |
| Cash and due from banks  | \$ 14,339                        | 11,574                            |
| Federal funds sold   | 86,466                           | 24,039                            |
| Interest-bearing deposits with banks   | 20,427                           | 10,939                            |
| Total cash and cash equivalents  | 121,232                          | 46,552                            |
| Investment securities:   |                                  |                                   |
| Investment securities available for sale   | 62,836                           | 64,480                            |
| Other investments  | 5,523                            | 5,742                             |
| Total investment securities  | 68,359                           | 70,222                            |
| Mortgage loans held for sale   | 7,452                            | 7,801                             |
| Loans  | 1,218,680                        | 1,163,644                         |
| Less allowance for loan losses   | (15,287)                         | (14,855)                          |
| Loans, net   | 1,203,393                        | 1,148,789                         |
| Bank owned life insurance  | 25,654                           | 25,471                            |
| Property and equipment, net  | 29,990                           | 28,362                            |
| Deferred income taxes  | 5,029                            | 6,825                             |
| Other assets   | 6,829                            | 6,886                             |
| Total assets   | \$ 1,467,938                     | 1,340,908                         |
| <b>LIABILITIES</b>   |                                  |                                   |
| Deposits   | \$ 1,211,274                     | 1,091,151                         |
| Federal Home Loan Bank advances and other borrowings   | 117,700                          | 115,200                           |
| Junior subordinated debentures   | 13,403                           | 13,403                            |
| Other liabilities  | 11,995                           | 11,282                            |
| Total liabilities  | 1,354,372                        | 1,231,036                         |
| <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, 6,480,164 and 6,463,789 shares issued and outstanding at March 31, 2017 and December 31, 2016, respectively | 65                               | 65                                |
| Nonvested restricted stock   | (669)                            | (600)                             |
| Additional paid-in capital   | 73,865                           | 73,371                            |
| Accumulated other comprehensive income (loss)  | (347)                            | (504)                             |
| Retained earnings  | 40,652                           | 37,540                            |
| Total shareholders equity  | 113,566                          | 109,872                           |
| Total liabilities and shareholders equity  | \$ 1,467,938                     | 1,340,908                         |

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

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

|   | For the three months<br>ended March 31, |           |
|---|---|-----------|
|   | 2017                                    | 2016      |
| (dollars in thousands, except share data)           |   |           |
| <b>Interest income</b>                              |   |           |
| Loans   | 13,526                                  | 11,795    |
| Investment securities                               | 376                                     | 489       |
| Federal funds sold                                  | 57                                      | 45        |
| Total interest income                               | 13,959                                  | 12,329    |
| <b>Interest expense</b>                             |   |           |
| Deposits  | 1,249                                   | 988       |
| Borrowings  | 1,103                                   | 1,034     |
| Total interest expense                              | 2,352                                   | 2,022     |
| Net interest income                                 | 11,607                                  | 10,307    |
| Provision for loan losses                           | 500                                     | 625       |
| Net interest income after provision for loan losses | 11,107                                  | 9,682     |
| <b>Noninterest income</b>                           |   |           |
| Mortgage banking income                             | 1,057                                   | 1,447     |
| Service fees on deposit accounts                    | 278                                     | 220       |
| Income from bank owned life insurance               | 183                                     | 186       |
| Gain on sale of investment securities               | -                                       | 307       |
| Other income  | 533                                     | 399       |
| Total noninterest income                            | 2,051                                   | 2,559     |
| <b>Noninterest expenses</b>                         |   |           |
| Compensation and benefits                           | 5,273                                   | 4,551     |
| Occupancy   | 967                                     | 870       |
| Real estate owned expenses                          | 13                                      | 285       |
| Outside service and data processing costs           | 745                                     | 598       |
| Insurance   | 289                                     | 233       |
| Professional fees                                   | 313                                     | 254       |
| Marketing   | 210                                     | 231       |
| Other   | 550                                     | 495       |
| Total noninterest expenses                          | 8,360                                   | 7,517     |
| Income before income tax expense                    | 4,798                                   | 4,724     |
| <b>Income tax expense</b>                           | 1,686                                   | 1,718     |
| <b>Net income available to common shareholders</b>  | 3,112                                   | 3,006     |
| <b>Earnings per common share</b>                    |   |           |
| Basic   | 0.48                                    | 0.48      |
| Diluted   | 0.46                                    | 0.45      |
| <b>Weighted average common shares outstanding</b>   |   |           |
| Basic   | 6,437,231                               | 6,272,847 |
| Diluted   | 6,829,590                               | 6,663,432 |

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

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

| (dollars in thousands)   | 2017  | For the three months<br>ended March 31,<br>2016 |
|--|-------|---|
| Net income   | 3,112 | 3,006   |
| Other comprehensive income (loss):                               |       |   |
| Unrealized gain (loss) on securities available for sale:         |       |   |
| Unrealized holding gain (loss) arising during the period, pretax | 238   | 1,092   |
| Tax (expense) benefit  | (81)  | (371)   |
| Reclassification of realized gain                                | -     | (307)   |
| Tax expense  | -     | 104   |
| Other comprehensive income (loss)                                | 157   | 518   |
| Comprehensive income   | 3,269 | 3,524   |

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

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**SOUTHERN FIRST BANCSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2017 AND 2016  
(Unaudited)**

|   | Common stock     |              | Preferred stock |        | Nonvested<br>restricted | Additional<br>paid-in | Accumulated<br>comprehensive |
|---|------------------|--------------|-----------------|--------|-------------------------|-----------------------|------------------------------|
|   | Shares           | Amount       | Shares          | Amount | stock                   | capital               | income                       |
| (dollars in thousands, except share data)                 |                  |              |                 |        |                         |                       |                              |
| <b>December 31, 2015</b>                                  | <b>6,289,038</b> | <b>63</b>    | -               | -      | (360)                   | <b>70,037</b>         |                              |
| Net income  | -                | -            | -               | -      | -                       | -                     | -                            |
| Proceeds from exercise of stock options                   | 37,950           | -            | -               | -      | -                       | 285                   | -                            |
| Issuance of restricted stock                              | 17,000           | -            | -               | -      | (391)                   | 391                   | -                            |
| Amortization of deferred compensation on restricted stock | -                | -            | -               | -      | 70                      | -                     | -                            |
| Compensation expense related to stock options, net of tax | -                | -            | -               | -      | -                       | 176                   | -                            |
| Other comprehensive income                                | -                | -            | -               | -      | -                       | -                     | -                            |
| <b>March 31, 2016</b>                                     | <b>6,343,988</b> | <b>\$ 63</b> | -               | \$ -   | <b>(681)</b>            | <b>\$ 70,889</b>      | \$ -                         |
| <b>December 31, 2016</b>                                  | <b>6,463,789</b> | <b>65</b>    | -               | -      | (600)                   | <b>73,371</b>         |                              |
| Net income  | -                | -            | -               | -      | -                       | -                     | -                            |
| Proceeds from exercise of stock options                   | 13,250           | -            | -               | -      | -                       | 112                   | -                            |
| Issuance of restricted stock                              | 3,125            | -            | -               | -      | (146)                   | 146                   | -                            |
| Amortization of deferred compensation on restricted stock | -                | -            | -               | -      | 77                      | -                     | -                            |
| Compensation expense related to stock options, net of tax | -                | -            | -               | -      | -                       | 236                   | -                            |
| Other comprehensive income                                | -                | -            | -               | -      | -                       | -                     | -                            |
| <b>March 31, 2017</b>                                     | <b>6,480,164</b> | <b>\$ 65</b> | -               | \$ -   | <b>(669)</b>            | <b>\$ 73,865</b>      | \$ -                         |

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

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

(Unaudited)

| (dollars in thousands)   | For the three months<br>ended March 31, |                  |
|--|---|------------------|
|  | 2017                                    | 2016             |
| <b>Operating activities</b>  |   |                  |
| Net income   | \$ 3,112                                | \$ 3,006         |
| Adjustments to reconcile net income to cash provided by (used for) operating activities: |   |                  |
| Provision for loan losses  | 500                                     | 625              |
| Depreciation and other amortization  | 309                                     | 315              |
| Accretion and amortization of securities discounts and premium, net                      | 132                                     | 120              |
| Gain on sale of investment securities available for sale                                 | -                                       | (307)            |
| Loss on sale of real estate owned  | -                                       | 51               |
| Write-down of real estate owned  | -                                       | 125              |
| Compensation expense related to stock options and grants                                 | 313                                     | 246              |
| Gain on sale of loans held for sale  | (1,001)                                 | (1,447)          |
| Loans originated and held for sale   | (36,570)                                | (52,034)         |
| Proceeds from sale of loans held for sale  | 37,920                                  | 44,183           |
| Increase in cash surrender value of bank owned life insurance                            | (183)                                   | (186)            |
| Decrease in deferred tax asset   | 1,714                                   | 369              |
| Decrease in other assets, net  | 87                                      | 62               |
| Increase in other liabilities  | 713                                     | 461              |
| Net cash provided by (used for) operating activities                                     | 7,046                                   | (4,411)          |
| <b>Investing activities</b>  |   |                  |
| Increase (decrease) in cash realized from:   |   |                  |
| Origination of loans, net  | (55,134)                                | (34,519)         |
| Purchase of property and equipment   | (1,937)                                 | (854)            |
| Purchase of investment securities:   |   |                  |
| Available for sale   | -                                       | -                |
| Other  | (1,386)                                 | (168)            |
| Payments and maturities, calls and repayments of investment securities:                  |   |                  |
| Available for sale   | 1,751                                   | 3,203            |
| Other  | 1,605                                   | -                |
| Proceeds from sale of investment securities available for sale                           | -                                       | 10,603           |
| Proceeds from sale of real estate owned  | -                                       | 260              |
| Net cash used for investing activities   | (55,101)                                | (21,475)         |
| <b>Financing activities</b>  |   |                  |
| Increase (decrease) in cash realized from:   |   |                  |
| Increase in deposits, net  | 120,123                                 | 17,508           |
| Increase in Federal Home Loan Bank advances and other borrowings, net                    | 2,500                                   | -                |
| Proceeds from the exercise of stock options and warrants                                 | 112                                     | 285              |
| Net cash provided by financing activities  | 122,735                                 | 17,793           |
| Net increase (decrease) in cash and cash equivalents                                     | 74,680                                  | (8,093)          |
| <b>Cash and cash equivalents at beginning of the period</b>                              | <b>46,552</b>                           | <b>62,866</b>    |
| <b>Cash and cash equivalents at end of the period</b>                                    | <b>\$ 121,232</b>                       | <b>\$ 54,773</b> |
| <b>Supplemental information</b>  |   |                  |
| <b>Cash paid for</b>   |   |                  |
| Interest   | \$ 2,339                                | \$ 1,767         |
| Income taxes   | -                                       | 1,350            |
| <b>Schedule of non-cash transactions</b>   |   |                  |
| Real estate acquired in settlement of loans  | -                                       | 245              |
| Unrealized gain (loss) on securities, net of income taxes                                | (157)                                   | (721)            |



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

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**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 month period ended March 31, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. 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, 2016 as filed with the Securities and Exchange Commission on March 3, 2017. 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.

*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.

*Business Segments*

The Company began reporting its activities as three business segments Commercial and Retail Banking, Mortgage Banking and Corporate in 2016. 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.

*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.



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

| (dollars in thousands)                         | Amortized<br>Cost | Gross Unrealized |        | March 31, 2017 |
|--|-------------------|------------------|--------|----------------|
|  |                   | Gains            | Losses | Fair<br>Value  |
| <b>Available for sale</b>                      |                   |                  |        |                |
| US government agencies                         | \$ 6,266          | 4                | 90     | 6,180          |
| SBA securities                                 | 1,436             | -                | 16     | 1,420          |
| State and political subdivisions               | 20,584            | 186              | 198    | 20,572         |
| Mortgage-backed securities                     | 35,076            | 14               | 426    | 34,664         |
| Total investment securities available for sale | \$ 63,362         | 204              | 730    | 62,836         |

  

| (dollars in thousands)                         | Amortized<br>Cost | Gross Unrealized |        | December 31, 2016 |
|--|-------------------|------------------|--------|-------------------|
|  |                   | Gains            | Losses | Fair<br>Value     |
| <b>Available for sale</b>                      |                   |                  |        |                   |
| US government agencies                         | \$ 6,271          | 1                | 113    | 6,159             |
| SBA securities                                 | 1,453             | -                | 16     | 1,437             |
| State and political subdivisions               | 20,625            | 141              | 292    | 20,474            |
| Mortgage-backed securities                     | 36,895            | 21               | 506    | 36,410            |
| Total investment securities available for sale | \$ 65,244         | 163              | 927    | 64,480            |

During the first quarter of 2017, there were no investment securities either sold or called. During the first quarter of 2016, approximately \$12.2 million of investment securities were either sold or called, subsequently resulting in a gain on sale of \$307,000.

Contractual maturities and yields on the Company's investment securities at March 31, 2017 and December 31, 2016 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.

| (dollars in thousands)           | March 31, 2017        |       |                   |       |                   |       |                |       |        |       |
|----------------------------------|-----------------------|-------|-------------------|-------|-------------------|-------|----------------|-------|--------|-------|
|                                  | Less than<br>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           | \$ -                  | -     | 2,014             | 1.61% | 4,166             | 2.27% | -              | -     | 6,180  | 2.06% |
| SBA securities                   | -                     | -     | -                 | -     | -                 | -     | 1,420          | 1.56% | 1,420  | 1.56% |
| State and political subdivisions | -                     | -     | 2,822             | 1.80% | 12,063            | 2.36% | 5,687          | 2.82% | 20,572 | 2.41% |
| Mortgage-backed securities       | -                     | -     | -                 | -     | 8,014             | 1.66% | 26,650         | 1.82% | 34,664 | 1.78% |
| Total                            | \$ -                  | -     | 4,836             | 1.72% | 24,243            | 2.11% | 33,757         | 1.98% | 62,836 | 2.01% |

  

| (dollars in thousands)           | December 31, 2016     |       |                   |       |                   |       |                |       |        |       |
|----------------------------------|-----------------------|-------|-------------------|-------|-------------------|-------|----------------|-------|--------|-------|
|                                  | Less than<br>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           | \$ -                  | -     | 997               | 1.15% | 5,162             | 2.23% | -              | -     | 6,159  | 2.06% |
| SBA securities                   | -                     | -     | -                 | -     | -                 | -     | 1,437          | 1.32% | 1,437  | 1.32% |
| State and political subdivisions | -                     | -     | 2,271             | 1.73% | 12,287            | 2.35% | 5,916          | 2.77% | 20,474 | 2.40% |
| Mortgage-backed securities       | -                     | -     | -                 | -     | 8,527             | 1.64% | 27,883         | 1.68% | 36,410 | 1.67% |
| Total                            | \$ -                  | -     | 3,268             | 1.55% | 25,976            | 2.10% | 35,236         | 1.85% | 64,480 | 1.93% |





investment is probable. All of the FHLB stock is used to collateralize advances with the FHLB.

At March 31, 2017, \$20.7 million of securities were pledged as collateral for repurchase agreements from brokers and no securities were pledged to secure client deposits. At December 31, 2016, \$21.0 million of securities were pledged as collateral for repurchase agreements from brokers, and approximately \$21.1 million of securities were pledged to secure client deposits.

**Table of Contents****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, which was adopted by the Company on April 1, 2016, 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 March 31, 2017, mortgage loans held for sale totaled \$7.5 million compared to \$7.8 million at December 31, 2016.

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 unrealized gains and losses associated with the loans held for sale and the realized and unrealized 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.

**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 \$2.1 million as of March 31, 2017 and \$2.0 million as of December 31, 2016.

| (dollars in thousands)                  | Amount       | March 31, 2017<br>% of Total | Amount       | December 31, 2016<br>% of Total |
|---|--------------|------------------------------|--------------|---------------------------------|
| <b>Commercial</b>                       |              |                              |              |                                 |
| Owner occupied RE                       | \$ 288,300   | 23.7%                        | \$ 285,938   | 24.6%                           |
| Non-owner occupied RE                   | 258,449      | 21.2%                        | 239,574      | 20.6%                           |
| Construction                            | 36,889       | 3.0%                         | 33,393       | 2.9%                            |
| Business                                | 208,590      | 17.1%                        | 202,552      | 17.4%                           |
| Total commercial loans                  | 792,228      | 65.0%                        | 761,457      | 65.5%                           |
| <b>Consumer</b>                         |              |                              |              |                                 |
| Real estate                             | 230,695      | 18.9%                        | 215,588      | 18.5%                           |
| Home equity                             | 143,673      | 11.8%                        | 137,105      | 11.8%                           |
| Construction                            | 31,535       | 2.6%                         | 31,922       | 2.7%                            |
| Other                                   | 20,549       | 1.7%                         | 17,572       | 1.5%                            |
| Total consumer loans                    | 426,452      | 35.0%                        | 402,187      | 34.5%                           |
| Total gross loans, net of deferred fees | 1,218,680    | 100.0%                       | 1,163,644    | 100.0%                          |
| Less allowance for loan losses          | (15,287)     |                              | (14,855)     |                                 |
| Total loans, net                        | \$ 1,203,393 |                              | \$ 1,148,789 |                                 |



**Table of Contents***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.

|   | March 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                       | \$ 22,336           | 149,371                               | 116,593             | 288,300    |
| Non-owner occupied RE                   | 33,669              | 140,116                               | 84,664              | 258,449    |
| Construction                            | 9,077               | 11,358                                | 16,454              | 36,889     |
| Business                                | 62,790              | 106,729                               | 39,071              | 208,590    |
| Total commercial loans                  | 127,872             | 407,574                               | 256,782             | 792,228    |
| <b>Consumer</b>                         |                     |                                       |                     |            |
| Real estate                             | 28,754              | 52,367                                | 149,574             | 230,695    |
| Home equity                             | 7,391               | 29,494                                | 106,788             | 143,673    |
| Construction                            | 15,762              | 606                                   | 15,167              | 31,535     |
| Other                                   | 6,600               | 9,629                                 | 4,320               | 20,549     |
| Total consumer loans                    | 58,507              | 92,096                                | 275,849             | 426,452    |
| Total gross loans, net of deferred fees | \$ 186,379          | 499,670                               | 532,631             | 1,218,680  |
| Loans maturing after one year with:     |                     |                                       |                     |            |
| Fixed interest rates                    |                     |                                       |                     | \$ 778,861 |
| Floating interest rates                 |                     |                                       |                     | 253,440    |

|  | December 31, 2016   |                                       |                     |            |
|--|---------------------|---------------------------------------|---------------------|------------|
| (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                      | \$ 26,062           | 145,419                               | 114,457             | 285,938    |
| Non-owner occupied RE                  | 34,685              | 142,261                               | 62,628              | 239,574    |
| Construction                           | 5,881               | 9,558                                 | 17,954              | 33,393     |
| Business                               | 66,361              | 99,255                                | 36,936              | 202,552    |
| Total commercial loans                 | 132,989             | 396,493                               | 231,975             | 761,457    |
| <b>Consumer</b>                        |                     |                                       |                     |            |
| Real estate                            | 26,342              | 49,832                                | 139,414             | 215,588    |
| Home equity                            | 7,142               | 29,041                                | 100,922             | 137,105    |
| Construction                           | 14,103              | 627                                   | 17,192              | 31,922     |
| Other                                  | 5,049               | 9,305                                 | 3,218               | 17,572     |
| Total consumer                         | 52,636              | 88,805                                | 260,746             | 402,187    |
| Total gross loan, net of deferred fees | \$ 185,625          | 485,298                               | 492,721             | 1,163,644  |
| Loans maturing after one year with:    |                     |                                       |                     |            |
| Fixed interest rates                   |                     |                                       |                     | \$ 733,892 |
| Floating interest rates                |                     |                                       |                     | 244,127    |

**Portfolio Segment Methodology***Commercial*

Commercial loans are assessed for estimated losses by grading each loan using various risk factors identified through periodic

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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.

**Table of Contents***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 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.

**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.

|                        | March 31, 2017 |             |              |          |         |
|------------------------|----------------|-------------|--------------|----------|---------|
|                        | Owner          | Non-owner   |              |          |         |
| (dollars in thousands) | occupied RE    | occupied RE | Construction | Business | Total   |
| Pass                   | \$ 282,726     | 253,421     | 36,889       | 198,953  | 771,989 |
| Special mention        | 3,164          | 976         | -            | 3,735    | 7,875   |
| Substandard            | 2,410          | 4,052       | -            | 5,902    | 12,364  |
| Doubtful               | -              | -           | -            | -        | -       |
|                        | \$ 288,300     | 258,449     | 36,889       | 208,590  | 792,228 |

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|                 | December 31, 2016    |                          |              |          |         |
|-----------------|----------------------|--------------------------|--------------|----------|---------|
|                 | Owner<br>occupied RE | Non-owner<br>occupied RE | Construction | Business | Total   |
| Pass            | \$ 282,055           | 234,957                  | 33,393       | 193,517  | 743,922 |
| Special mention | 1,097                | 975                      | -            | 2,489    | 4,561   |
| Substandard     | 2,786                | 3,642                    | -            | 6,546    | 12,974  |
| Doubtful        | -                    | -                        | -            | -        | -       |
|                 | \$ 285,938           | 239,574                  | 33,393       | 202,552  | 761,457 |

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

|                        | March 31, 2017       |                          |              |          |         |
|------------------------|----------------------|--------------------------|--------------|----------|---------|
| (dollars in thousands) | Owner<br>occupied RE | Non-owner<br>occupied RE | Construction | Business | Total   |
| Current                | \$ 288,035           | 256,991                  | 36,889       | 206,466  | 788,381 |
| 30-59 days past due    | -                    | 416                      | -            | 651      | 1,067   |
| 60-89 days past due    | 249                  | -                        | -            | 1,100    | 1,349   |
| Greater than 90 Days   | 16                   | 1,042                    | -            | 373      | 1,431   |
|                        | \$ 288,300           | 258,449                  | 36,889       | 208,590  | 792,228 |

|                      | December 31, 2016    |                          |              |          |         |
|----------------------|----------------------|--------------------------|--------------|----------|---------|
|                      | Owner<br>occupied RE | Non-owner<br>occupied RE | Construction | Business | Total   |
| Current              | \$ 284,700           | 238,346                  | 33,393       | 200,624  | 757,063 |
| 30-59 days past due  | 981                  | -                        | -            | 1,423    | 2,404   |
| 60-89 days past due  | 257                  | 56                       | -            | -        | 313     |
| Greater than 90 Days | -                    | 1,172                    | -            | 505      | 1,677   |
|                      | \$ 285,938           | 239,574                  | 33,393       | 202,552  | 761,457 |

As of March 31, 2017 and December 31, 2016, loans 30 days or more past due represented 0.45% and 0.55% of the Company's total loan portfolio, respectively. Commercial loans 30 days or more past due were 0.32% and 0.38% of the Company's total loan portfolio as of March 31, 2017 and December 31, 2016, respectively.

**Consumer**

The Company manages a consistent process for assessing consumer loan credit quality by monitoring its loan grading trends and past due statistics. All loans are subject to individual risk assessment. The Company's categories include Pass, Special Mention, Substandard, and Doubtful, which are defined above. Delinquency statistics are also an important indicator of credit quality in the establishment of the allowance for loan losses.

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

|                        | March 31, 2017 |             |              |        |         |
|------------------------|----------------|-------------|--------------|--------|---------|
| (dollars in thousands) | Real estate    | Home equity | Construction | Other  | Total   |
| Pass                   | \$ 226,785     | 140,439     | 31,535       | 20,428 | 419,187 |
| Special mention        | 860            | 2,184       | -            | 24     | 3,068   |
| Substandard            | 3,050          | 1,050       | -            | 97     | 4,197   |
| Doubtful               | -              | -           | -            | -      | -       |
| Loss                   | -              | -           | -            | -      | -       |
|                        | \$ 230,695     | 143,673     | 31,535       | 20,549 | 426,452 |



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|                 | December 31, 2016 |             |              |        |         |
|-----------------|-------------------|-------------|--------------|--------|---------|
|                 | Real estate       | Home equity | Construction | Other  | Total   |
| Pass            | \$ 211,563        | 134,124     | 31,922       | 17,485 | 395,094 |
| Special mention | 1,064             | 2,109       | -            | 16     | 3,189   |
| Substandard     | 2,961             | 872         | -            | 71     | 3,904   |
| Doubtful        | -                 | -           | -            | -      | -       |
| Loss            | -                 | -           | -            | -      | -       |
|                 | \$ 215,588        | 137,105     | 31,922       | 17,572 | 402,187 |

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

|                        | March 31, 2017 |             |              |        |         |
|------------------------|----------------|-------------|--------------|--------|---------|
| (dollars in thousands) | Real estate    | Home equity | Construction | Other  | Total   |
| Current                | \$ 229,729     | 143,078     | 31,535       | 20,510 | 424,852 |
| 30-59 days past due    | 413            | 209         | -            | 39     | 661     |
| 60-89 days past due    | 553            | 129         | -            | -      | 682     |
| Greater than 90 Days   | -              | 257         | -            | -      | 257     |
|                        | \$ 230,695     | 143,673     | 31,535       | 20,549 | 426,452 |

|                      | December 31, 2016 |             |              |        |         |
|----------------------|-------------------|-------------|--------------|--------|---------|
|                      | Real estate       | Home equity | Construction | Other  | Total   |
| Current              | \$ 214,228        | 136,638     | 31,922       | 17,427 | 400,215 |
| 30-59 days past due  | 1,041             | 210         | -            | 126    | 1,377   |
| 60-89 days past due  | 282               | -           | -            | 6      | 288     |
| Greater than 90 Days | 37                | 257         | -            | 13     | 307     |
|                      | \$ 215,588        | 137,105     | 31,922       | 17,572 | 402,187 |

As of March 31, 2017 and December 31, 2016, consumer loans 30 days or more past due were 0.13% and 0.17% of total loans, respectively.

**Nonperforming assets**

The following table shows the nonperforming assets and the related percentage of nonperforming assets to total assets and gross loans. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when the Company believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified 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)                             | March 31, 2017 | December 31, 2016 |
|--|----------------|-------------------|
| <b>Commercial</b>                                  |                |                   |
| Owner occupied RE                                  | \$ 266         | 276               |
| Non-owner occupied RE                              | 2,514          | 2,711             |
| Construction                                       | -              | -                 |
| Business   | 1,616          | 686               |
| <b>Consumer</b>                                    |                |                   |
| Real estate  | 541            | 550               |
| Home equity  | 257            | 256               |
| Construction                                       | -              | -                 |
| Other  | 5              | 13                |
| Nonaccruing troubled debt restructurings           | 979            | 990               |
| Total nonaccrual loans, including nonaccruing TDRs | 6,178          | 5,482             |
| Other real estate owned                            | 669            | 639               |
| Total nonperforming assets                         | \$ 6,847       | 6,121             |
| Nonperforming assets as a percentage of:           |                |                   |
| Total assets                                       | 0.47%          | 0.46%             |
| Gross loans  | 0.56%          | 0.53%             |
| Total loans over 90 days past due                  | 1,688          | 1,984             |
| Loans over 90 days past due and still accruing     | -              | -                 |
| Accruing troubled debt restructurings              | \$ 5,795       | 5,675             |

**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) | March 31, 2017           |                |   |                                   |
|------------------------|--------------------------|----------------|---|-----------------------------------|
|                        | Unpaid Principal Balance | Impaired loans | Recorded investment impaired loans with related allowance for loan losses | Related allowance for loan losses |
| <b>Commercial</b>      |                          |                |   |                                   |
| Owner occupied RE      | \$ 2,271                 | 2,220          | 2,220   | 420                               |
| Non-owner occupied RE  | 7,226                    | 3,823          | 1,503   | 410                               |
| Construction           | -                        | -              | -   | -                                 |
| Business               | 4,353                    | 3,665          | 2,943   | 1,160                             |
| Total commercial       | 13,850                   | 9,708          | 6,666   | 1,990                             |
| <b>Consumer</b>        |                          |                |   |                                   |
| Real estate            | 1,844                    | 1,828          | 1,642   | 605                               |
| Home equity            | 262                      | 257            | 123   | 61                                |
| Construction           | -                        | -              | -   | -                                 |
| Other                  | 181                      | 181            | 181   | 93                                |
| Total consumer         | 2,287                    | 2,266          | 1,946   | 759                               |
| Total                  | \$ 16,137                | 11,974         | 8,612   | 2,749                             |





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|                       |                                | December 31, 2016 |   |   |
|-----------------------|--------------------------------|-------------------|---|---|
|                       | Unpaid<br>Principal<br>Balance | Impaired<br>loans | Recorded investment<br>Impaired loans<br>with related<br>allowance for<br>loan losses | Related<br>allowance for<br>loan losses |
| <b>Commercial</b>     |                                |                   |   |   |
| Owner occupied RE     | \$ 2,284                       | 2,243             | 2,224   | 263                                     |
| Non-owner occupied RE | 7,238                          | 4,031             | 1,638   | 457                                     |
| Construction          | -                              | -                 | -   | -                                       |
| Business              | 3,699                          | 2,593             | 1,610   | 1,154                                   |
| Total commercial      | 13,221                         | 8,867             | 5,472   | 1,874                                   |
| <b>Consumer</b>       |                                |                   |   |   |
| Real estate           | 1,853                          | 1,843             | 1,843   | 682                                     |
| Home equity           | 207                            | 257               | -   | -                                       |
| Construction          | -                              | -                 | -   | -                                       |
| Other                 | 261                            | 190               | 177   | 88                                      |
| Total consumer        | 2,321                          | 2,290             | 2,020   | 770                                     |
| Total                 | \$ 15,542                      | 11,157            | 7,492   | 2,644                                   |

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.

| (dollars in thousands) | Three months ended<br>March 31, 2017 |                                  | Three months ended<br>March 31, 2016 |                                  | Year ended<br>December 31, 2016   |                                  |
|------------------------|--------------------------------------|----------------------------------|--------------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|                        | 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 |
| <b>Commercial</b>      |                                      |                                  |                                      |                                  |                                   |                                  |
| Owner occupied RE      | \$ 2,232                             | 28                               | \$ 615                               | 7                                | 2,263                             | 112                              |
| Non-owner occupied RE  | 3,927                                | 29                               | 5,731                                | 48                               | 4,106                             | 200                              |
| Construction           | -                                    | -                                | 1,778                                | 30                               | -                                 | -                                |
| Business               | 3,675                                | 40                               | 2,760                                | 30                               | 2,873                             | 135                              |
| Total commercial       | 9,834                                | 97                               | 10,884                               | 115                              | 9,242                             | 447                              |
| <b>Consumer</b>        |                                      |                                  |                                      |                                  |                                   |                                  |
| Real estate            | 1,836                                | 16                               | 1,119                                | 9                                | 1,854                             | 81                               |
| Home equity            | 256                                  | 1                                | 195                                  | 2                                | 257                               | 2                                |
| Construction           | -                                    | -                                | -                                    | -                                | -                                 | -                                |
| Other                  | 182                                  | -                                | 257                                  | -                                | 203                               | 6                                |
| Total consumer         | 2,274                                | 17                               | 1,571                                | 11                               | 2,314                             | 89                               |
| Total                  | \$ 12,108                            | 114                              | \$ 12,455                            | 126                              | 11,556                            | 536                              |

**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.



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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:

| (dollars in thousands)                           | Commercial        |                       |              |          |             |             |              |       |        | Consumer |
|--|-------------------|-----------------------|--------------|----------|-------------|-------------|--------------|-------|--------|----------|
|  | Owner occupied RE | Non-owner occupied RE | Construction | Business | Real Estate | Home 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                        | 209               | 369                   | 39           | (321)    | (40)        | 143         | 37           | 64    | 500    |          |
| Loan charge-offs                                 | -                 | (181)                 | -            | (9)      | -           | -           | -            | -     | (190)  |          |
| Loan recoveries                                  | -                 | 1                     | -            | 30       | 90          | 1           | -            | -     | 122    |          |
| Net loan charge-offs                             | -                 | (180)                 | -            | 21       | 90          | 1           | -            | -     | (68)   |          |
| <b>Balance, end of period</b>                    | \$ 3,052          | 2,967                 | 334          | 3,823    | 2,830       | 1,619       | 289          | 373   | 15,287 |          |
| Net charge-offs to average loans (annualized)    |                   |                       |              |          |             |             |              |       |        | 0.02%    |
| Allowance for loan losses to gross loans         |                   |                       |              |          |             |             |              |       |        | 1.25%    |
| Allowance for loan losses to nonperforming loans |                   |                       |              |          |             |             |              |       |        | 247.43%  |

| (dollars in thousands)                           | Commercial        |                       |              |          |             |             |              |       |        | Consumer |
|--|-------------------|-----------------------|--------------|----------|-------------|-------------|--------------|-------|--------|----------|
|  | Owner occupied RE | Non-owner occupied RE | Construction | Business | Real Estate | Home equity | Construction | Other | Total  |          |
|  |                   |                       |              |          |             |             |              |       |        |          |
| <b>Balance, beginning of period</b>              | \$ 2,347          | 3,187                 | 338          | 3,800    | 2,070       | 1,202       | 313          | 372   | 13,629 |          |
| Provision for loan losses                        | 151               | 122                   | 104          | (158)    | 248         | 61          | 38           | 59    | 625    |          |
| Loan charge-offs                                 | (5)               | (75)                  | -            | (36)     | (187)       | -           | -            | (91)  | (394)  |          |
| Loan recoveries                                  | -                 | 2                     | -            | 33       | -           | -           | -            | 3     | 38     |          |
| Net loan charge-offs                             | (5)               | (73)                  | -            | (3)      | (187)       | -           | -            | (88)  | (356)  |          |
| <b>Balance, end of period</b>                    | \$ 2,493          | 3,236                 | 442          | 3,639    | 2,131       | 1,263       | 351          | 343   | 13,898 |          |
| Net charge-offs to average loans (annualized)    |                   |                       |              |          |             |             |              |       |        | 0.14%    |
| Allowance for loan losses to gross loans         |                   |                       |              |          |             |             |              |       |        | 1.34%    |
| Allowance for loan losses to nonperforming loans |                   |                       |              |          |             |             |              |       |        | 224.56%  |

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

| (dollars in thousands) | Allowance for loan losses |              |               | Recorded investment in loans |                |                  |
|------------------------|---------------------------|--------------|---------------|------------------------------|----------------|------------------|
|                        | Commercial                | Consumer     | Total         | Commercial                   | Consumer       | Total            |
| Individually evaluated | \$ 1,990                  | 759          | 2,749         | 9,708                        | 2,266          | 11,974           |
| Collectively evaluated | 8,230                     | 4,308        | 12,538        | 782,520                      | 424,186        | 1,206,706        |
| <b>Total</b>           | <b>\$ 10,220</b>          | <b>5,067</b> | <b>15,287</b> | <b>792,228</b>               | <b>426,452</b> | <b>1,218,680</b> |

| (dollars in thousands) | Allowance for loan losses |          |       | Recorded investment in loans |          |        |
|------------------------|---------------------------|----------|-------|------------------------------|----------|--------|
|                        | Commercial                | Consumer | Total | Commercial                   | Consumer | Total  |
| Individually evaluated | \$ 1,874                  | 770      | 2,644 | 8,867                        | 2,290    | 11,157 |

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|                        |    |        |       |        |         |         |           |
|------------------------|----|--------|-------|--------|---------|---------|-----------|
| Collectively evaluated |    | 8,165  | 4,046 | 12,211 | 752,590 | 399,897 | 1,152,487 |
| Total                  | \$ | 10,039 | 4,816 | 14,855 | 761,457 | 402,187 | 1,163,644 |

**Table of Contents****NOTE 5 Troubled Debt Restructurings**

At March 31, 2017, the Company had 18 loans totaling \$6.8 million compared to 17 loans totaling \$6.7 million at December 31, 2016, 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 three 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 during the three months ended March 31, 2017. There were no loans modified and considered a TDR during the three months ended March 31, 2016.

| (dollars in thousands) | Renewals<br>deemed a<br>concession | Reduced<br>or deferred<br>payments | Converted<br>to interest<br>only | Maturity<br>date<br>extensions | For the three months ended March 31, 2017 |  |   |
|------------------------|------------------------------------|------------------------------------|----------------------------------|--------------------------------|---|--|---|
|                        |                                    |                                    |                                  |                                | Total<br>Number<br>of loans               | Pre-<br>modification<br>recorded<br>investment | Post-<br>modification<br>recorded<br>investment |
| <b>Commercial</b>      |                                    |                                    |                                  |                                |   |  |   |
| Business               | 1                                  | -                                  | -                                | -                              | 1   | \$ 149   | \$ 149  |
| Total loans            | 1                                  | -                                  | -                                | -                              | 1   | \$ 149   | \$ 149  |

As of March 31, 2017, there was one loan with a recorded investment of \$187,000 modified as a TDR for which there was a payment default (60 days past due) within 12 months of the restructuring date. There were no such loans as of March 31, 2016.

**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.

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.

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The following table summarizes the Company's outstanding financial derivative instruments at March 31, 2017 and December 31, 2016.

| (dollars in thousands)                       | Notional  | Balance Sheet Location | March 31, 2017<br>Fair Value<br>Asset/(Liability) |
|--|-----------|------------------------|---|
| Mortgage loan interest rate lock commitments | \$ 29,583 | Other assets           | \$ 455  |
| MBS forward sales commitments                | 18,000    | Other assets           | (140)   |
| Total derivative financial instruments       | \$ 47,583 |                        | \$ 315  |

| (dollars in thousands)                       | Notional  | Balance Sheet Location | December 31, 2016<br>Fair Value<br>Asset/(Liability) |
|--|-----------|------------------------|--|
| Mortgage loan interest rate lock commitments | \$ 17,986 | Other assets           | \$ 256   |
| MBS forward sales commitments                | 14,250    | Other assets           | (3)  |
| Total derivative financial instruments       | \$ 32,236 |                        | \$ 253   |

**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.

Following is a description of valuation methodologies used for assets recorded at fair value.

*Investment Securities*

Securities available for sale are valued on a recurring basis at quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange or U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities and debentures issued by government sponsored entities, municipal bonds and corporate debt securities. In certain cases where there is limited activity or less transparency around inputs to valuations, securities are classified as Level 3 within the valuation hierarchy. Securities held to maturity are valued at quoted market prices or dealer quotes similar to securities available for sale. The carrying value of Other Investments, such as FHLB stock, approximates fair value based on their redemption provisions.



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### *Mortgage Loans Held for Sale*

Loans held for sale include mortgage loans which are saleable into the secondary mortgage markets and their fair values are estimated using observable quoted market or contracted prices or market price equivalents, which would be used by other market participants. These saleable loans are considered Level 2.

### *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. At March 31, 2017, a significant portion of the impaired loans were evaluated based on the fair value of the collateral. 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 Bank 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. 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. 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.

### *Derivative Financial Instruments*

The Company estimates the fair value of IRLCs based on the value of the underlying mortgage loan, quoted MBS prices and an estimate of the probability that the mortgage loan will fund within the terms of the IRLC, net of commission expenses (Level 2). The Company estimates the fair value of forward sales commitments based on quoted MBS prices (Level 2).



**Table of Contents***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 March 31, 2017 and December 31, 2016.

| (dollars in thousands)  | Level 1 | Level 2 | Level 3 | March 31, 2017<br>Total |
|---|---------|---------|---------|-------------------------|
| <b>Assets</b>   |         |         |         |                         |
| Securities available for sale                                 |         |         |         |                         |
| US government agencies  | \$ -    | 6,180   | -       | 6,180                   |
| SBA securities  | -       | 1,420   | -       | 1,420                   |
| State and political subdivisions                              | -       | 20,572  | -       | 20,572                  |
| Mortgage-backed securities                                    | -       | 34,664  | -       | 34,664                  |
| Mortgage loans held for sale                                  | -       | 7,452   | -       | 7,452                   |
| Interest rate lock commitments                                | -       | 455     | -       | 455                     |
| Total assets measured at fair value on a recurring basis      | \$ -    | 70,743  | -       | 70,743                  |
| <b>Liabilities</b>  |         |         |         |                         |
| MBS forward sales commitments                                 | \$ -    | 140     | -       | 140                     |
| Total liabilities measured at fair value on a recurring basis | \$ -    | 140     | -       | 140                     |

| (dollars in thousands)  | Level 1 | Level 2 | Level 3 | December 31, 2016<br>Total |
|---|---------|---------|---------|----------------------------|
| <b>Assets</b>   |         |         |         |                            |
| Securities available for sale:                                |         |         |         |                            |
| US government agencies  | \$ -    | 6,159   | -       | 6,159                      |
| SBA securities  | -       | 1,437   | -       | 1,437                      |
| State and political subdivisions                              | -       | 20,474  | -       | 20,474                     |
| Mortgage-backed securities                                    | -       | 36,410  | -       | 36,410                     |
| Mortgage loans held for sale                                  | -       | 7,801   | -       | 7,801                      |
| Interest rate lock commitments                                | -       | 256     | -       | 256                        |
| Total assets measured at fair value on a recurring basis      | \$ -    | 72,537  | -       | 72,537                     |
| <b>Liabilities</b>  |         |         |         |                            |
| MBS forward sales commitments                                 | \$ -    | 3       | -       | 3                          |
| Total liabilities measured at fair value on a recurring basis | \$ -    | 3       | -       | 3                          |

The Company has no liabilities carried at fair value or measured at fair value on a recurring basis as of March 31, 2017 and December 31, 2016.

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

The Company is predominantly an asset based lender with real estate serving as collateral on more than 80% of loans as of March 31, 2017. Loans which are deemed to be impaired are valued net of the allowance for loan losses, and other real estate owned is valued at the lower of cost or net realizable value of the underlying real estate collateral. Such market values are generally obtained using independent appraisals, which the Company considers to be level 2 inputs. The tables below present the recorded amount of assets and liabilities measured at fair value on a nonrecurring basis as of March 31, 2017 and December 31, 2016.

| (dollars in thousands) | Level 1 | Level 2 | Level 3 | As of March 31, 2017<br>Total |
|------------------------|---------|---------|---------|-------------------------------|
| <b>Assets</b>          |         |         |         |                               |

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|   |    |   |       |       |       |
|---|----|---|-------|-------|-------|
| Impaired loans  | \$ | - | 3,855 | 5,370 | 9,225 |
| Other real estate owned                                     |    | - | 556   | 113   | 669   |
| Total assets measured at fair value on a nonrecurring basis | \$ | - | 4,411 | 5,483 | 9,894 |

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|   | As of December 31, 2016 |         |         |       |
|---|-------------------------|---------|---------|-------|
|   | Level 1                 | Level 2 | Level 3 | Total |
| <b>Assets</b>   |                         |         |         |       |
| Impaired loans  | \$ -                    | 4,075   | 4,438   | 8,513 |
| Other real estate owned                                     | -                       | 526     | 113     | 639   |
| Total assets measured at fair value on a nonrecurring basis | \$ -                    | 4,601   | 4,551   | 9,152 |

The Company has no liabilities carried at fair value or measured at fair value on a nonrecurring basis as of March 31, 2017 and December 31, 2016.

For Level 3 assets and liabilities measured at fair value on a recurring or nonrecurring basis as of March 31, 2017, the significant unobservable inputs used in the fair value measurements were as follows:

|                         | Valuation Technique                       | Significant Unobservable Inputs  | Range of Inputs |
|-------------------------|---|--|-----------------|
| Impaired loans          | Appraised Value/<br>Discounted Cash Flows | Discounts to appraisals or cash flows for estimated holding and/or selling costs or age of appraisal | 0-25%           |
| Other real estate owned | Appraised Value/<br>Comparable Sales      | Discounts to appraisals for estimated holding or selling costs                                       | 0-25%           |

*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 following is a description of valuation methodologies used to estimate fair value for certain other financial instruments.

Fair value approximates carrying value for the following financial instruments due to the short-term nature of the instrument: cash and due from banks, federal funds sold, federal funds purchased, and securities sold under agreement to repurchase.

**Deposits** Fair value for demand deposit accounts and interest-bearing accounts with no fixed maturity date is equal to the carrying value. The fair value of certificate of deposit accounts are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

**FHLB Advances and Other Borrowings** Fair value for FHLB advances and other borrowings are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

**Junior subordinated debentures** Fair value for junior subordinated debentures are estimated by discounting cash flows from expected maturities using current interest rates on similar instruments.

The Company has used management's best estimate of fair value based on the above assumptions. Thus, the fair values presented may not be the amounts that could be realized in an immediate sale or settlement of the instrument. In addition, any income taxes or other expenses, which would be incurred in an actual sale or settlement, are not taken into consideration in the fair value presented.



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The estimated fair values of the Company's financial instruments at March 31, 2017 and December 31, 2016 are as follows:

| (dollars in thousands)         | March 31, 2017    |            | Level 1 | Level 2   | Level 3   |
|--------------------------------|-------------------|------------|---------|-----------|-----------|
|                                | Carrying Amount   | Fair Value |         |           |           |
| <b>Financial Assets:</b>       |                   |            |         |           |           |
| Other investments, at cost     | \$5,523           | 5,523      | -       | -         | 5,523     |
| Loans, net                     | 1,203,393         | 1,203,710  | -       | 3,855     | 1,199,855 |
| <b>Financial Liabilities:</b>  |                   |            |         |           |           |
| Deposits                       | 1,211,274         | 1,127,398  | -       | 1,127,398 | -         |
| FHLB and other borrowings      | 117,700           | 118,357    | -       | 118,357   | -         |
| Junior subordinated debentures | 13,403            | 12,289     | -       | 12,289    | -         |
| <b>December 31, 2016</b>       |                   |            |         |           |           |
| (dollars in thousands)         | December 31, 2016 |            | Level 1 | Level 2   | Level 3   |
|                                | Carrying Amount   | Fair Value |         |           |           |
| <b>Financial Assets:</b>       |                   |            |         |           |           |
| Other investments, at cost     | \$5,742           | 5,742      | -       | -         | 5,742     |
| Loans, net                     | 1,148,789         | 1,149,527  | -       | 4,075     | 1,145,452 |
| <b>Financial Liabilities:</b>  |                   |            |         |           |           |
| Deposits                       | 1,091,151         | 1,004,923  | -       | 1,004,923 | -         |
| FHLB and other borrowings      | 115,200           | 115,825    | -       | 115,825   | -         |
| Junior subordinated debentures | 13,403            | 12,026     | -       | 12,026    | -         |

**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 month periods ended March 31, 2017 and 2016. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options that were outstanding at March 31, 2017. The assumed conversion of stock options can create a difference between basic and dilutive net income per common share. At March 31, 2017 and 2016, there were 94,070 and 97,500 options, respectively, that were not considered in computing diluted earnings per common share because they were anti-dilutive.

| (dollars in thousands, except share data)          | Three months ended |           |
|--|--------------------|-----------|
|  | 2017               | 2016      |
| <b>Numerator:</b>                                  |                    |           |
| Net income available to common shareholders        | \$ 3,112           | 3,006     |
| <b>Denominator:</b>                                |                    |           |
| Weighted-average common shares outstanding basic   | 6,437,231          | 6,272,847 |
| Common stock equivalents                           | 392,359            | 390,585   |
| Weighted-average common shares outstanding diluted | 6,829,590          | 6,663,432 |
| <b>Earnings per common share:</b>                  |                    |           |
| Basic  | \$ 0.48            | 0.48      |
| Diluted  | \$ 0.46            | 0.45      |

**Table of Contents****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 March 31, 2017 |          |         |           |              |              |
|--------------------------------|-----------------------------------|----------|---------|-----------|--------------|--------------|
|                                | Commercial<br>and Retail          | Mortgage |         | Corporate | Eliminations | Consolidated |
|                                | Banking                           | Banking  | -       | -         | -            | -            |
| Interest income                | \$ 13,893                         | 66       | 2       | (2)       | 13,959       |              |
| Interest expense               | 2,223                             | -        | 131     | (2)       | 2,352        |              |
| Net interest income (loss)     | 11,670                            | 66       | (129)   | -         | 11,607       |              |
| Provision for loan losses      | 500                               | -        | -       | -         | 500          |              |
| Noninterest income             | 994                               | 1,057    | -       | -         | 2,051        |              |
| Noninterest expense            | 7,446                             | 848      | 66      | -         | 8,360        |              |
| Net income (loss) before taxes | 4,718                             | 275      | (195)   | -         | 4,798        |              |
| Income tax (provision) benefit | (1,653)                           | (102)    | 69      | -         | (1,686)      |              |
| Net income (loss)              | \$ 3,065                          | 173      | (126)   | -         | 3,112        |              |
| Total assets                   | \$ 1,459,695                      | 7,808    | 136,996 | (136,561) | 1,467,938    |              |

**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.

**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.

**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 month period ended March 31, 2017 as compared to the three month period ended March 31, 2016 and assesses our financial condition as of March 31, 2017 as compared to December 31, 2016. 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, 2016 included in our Annual Report on Form 10-K for that period. Results for the three month period ended March 31, 2017 are not necessarily indicative of the results for the year ending December 31, 2017 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 and Section 21E of the Securities Exchange Act of 1934. 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 "es" 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, those described under Item 1A- Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2016, as well as the following:

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Restrictions or conditions imposed by our regulators on our operations;

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

Our ability to identify and retain individuals with experience and relationships in the markets in which we intend to expand, including our newly announced Raleigh, North Carolina and Atlanta Georgia markets;

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The time and costs of evaluating new markets, hiring or retaining experienced local management, and opening new offices and the time lags between these activities and the generation of sufficient assets and deposits to support the costs of the expansion;

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 attract and retain key personnel;

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;

Cybersecurity breaches, 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;

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, 2016, 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 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, 2016 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.

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### **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 March 31, 2017, we had total assets of \$1.47 billion, a 9.5% increase from total assets of \$1.34 billion at December 31, 2016. The largest components of our total assets are net loans and securities which were \$1.20 billion and \$68.4 million, respectively, at March 31, 2017. Comparatively, our net loans and securities totaled \$1.15 billion and \$70.2 million, respectively, at December 31, 2016. Our liabilities and shareholders' equity at March 31, 2017 totaled \$1.35 billion and \$113.6 million, respectively, compared to liabilities of \$1.23 billion and shareholders' equity of \$109.9 million at December 31, 2016. The principal component of our liabilities is deposits which were \$1.21 billion and \$1.09 billion at March 31, 2017 and December 31, 2016, 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 \$3.1 million and \$3.0 million for the three months ended March 31, 2017 and 2016, respectively, an increase of \$106 thousand, or 3.5%. Diluted earnings per share (EPS) was \$0.46, for the first quarter of 2017 as compared to \$0.45 for the same period in 2016. The increase in net income resulted primarily from increases in net interest income, partially offset by a decrease in noninterest income and 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 \$11.6 million for the three month period ended March 31, 2017, a 12.6% increase over net interest income of \$10.3 million for the same period in 2016. In comparison, our average earning assets increased 14.3%, or \$163.9 million, during the first quarter of 2017 compared to the first quarter of 2016, while our interest-bearing liabilities increased by \$96.7 million during the same period. The increase in average earning assets is primarily related to an increase in average loans partially offset by a decrease in investment securities, while the increase in average interest-bearing liabilities is primarily a result of an increase in interest-bearing deposits.

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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 month periods ended March 31, 2017 and 2016. 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 March 31, |                |                                |                 |                |                                |
|--|--------------------------------------|----------------|--------------------------------|-----------------|----------------|--------------------------------|
|  | Average Balance                      | Income/Expense | 2017 Yield/Rate <sup>(1)</sup> | Average Balance | Income/Expense | 2016 Yield/Rate <sup>(1)</sup> |
| <b>Interest-earning assets</b>                   |                                      |                |                                |                 |                |                                |
| Federal funds sold                               | \$ 29,514                            | \$ 57          | 0.78%                          | \$ 28,090       | \$ 45          | 0.64%                          |
| Investment securities, taxable                   | 50,168                               | 255            | 2.06%                          | 67,206          | 355            | 2.12%                          |
| Investment securities, nontaxable <sup>(2)</sup> | 19,614                               | 195            | 4.04%                          | 20,103          | 216            | 4.32%                          |
| Loans <sup>(3)</sup>                             | 1,212,820                            | 13,526         | 4.52%                          | 1,032,793       | 11,795         | 4.59%                          |
| Total interest-earning assets                    | 1,312,116                            | 14,033         | 4.34%                          | 1,148,192       | 12,411         | 4.35%                          |
| Noninterest-earning assets                       | 65,246                               |                |                                | 59,309          |                |                                |
| Total assets                                     | \$ 1,377,362                         |                |                                | \$ 1,207,501    |                |                                |
| <b>Interest-bearing liabilities</b>              |                                      |                |                                |                 |                |                                |
| NOW accounts                                     | \$ 219,743                           | 98             | 0.18%                          | \$ 189,848      | 83             | 0.18%                          |
| Savings & money market                           | 387,213                              | 552            | 0.58%                          | 326,323         | 343            | 0.42%                          |
| Time deposits                                    | 272,214                              | 599            | 0.89%                          | 274,422         | 562            | 0.82%                          |
| Total interest-bearing deposits                  | 879,170                              | 1,249          | 0.58%                          | 790,593         | 988            | 0.50%                          |
| FHLB advances and other borrowings               | 123,345                              | 999            | 3.28%                          | 115,200         | 940            | 3.28%                          |
| Junior subordinated debentures                   | 13,403                               | 104            | 3.15%                          | 13,403          | 94             | 2.82%                          |
| Total interest-bearing liabilities               | 1,015,918                            | 2,352          | 0.94%                          | 919,196         | 2,022          | 0.88%                          |
| Noninterest-bearing liabilities                  | 249,478                              |                |                                | 191,340         |                |                                |
| Shareholders' equity                             | 111,966                              |                |                                | 96,965          |                |                                |
| Total liabilities and shareholders' equity       | \$ 1,377,362                         |                |                                | \$ 1,207,501    |                |                                |
| Net interest spread                              |                                      |                | 3.40%                          |                 |                | 3.47%                          |
| Net interest income (tax equivalent) / margin    |                                      | \$ 11,681      | 3.61%                          |                 | \$ 10,389      | 3.64%                          |
| Less: tax-equivalent adjustment <sup>(2)</sup>   |                                      | 74             |                                |                 | 82             |                                |
| Net interest income                              |                                      | \$ 11,607      |                                |                 | \$ 10,307      |                                |

(1) Annualized for the three month period.

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

(3) Includes mortgage loans held for sale.

Our net interest margin, on a tax-equivalent basis, was 3.61% for the three months ended March 31, 2017 compared to 3.64% for the first quarter of 2016. The three basis point decline in net interest margin was driven by the lower yield on our interest-earning assets combined with the increased rate on our interest-bearing liabilities compared to the prior year. While our average interest-earning assets grew by \$163.9 million during the first three months of 2017 as compared to the same period in 2016, the average yield on these assets declined by one basis point. In addition, our average interest-bearing liabilities grew by \$96.7 million during the 2017 period while the rate on these liabilities increased six basis points to 0.94% for the three months ended March 31,

2017.

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The \$163.9 million increase in average interest-earning assets for the three months ended March 31, 2017 as compared to the same quarter in 2016, primarily related to an \$180.0 million increase in our average loan balances partially offset by a decrease in investment securities of \$17.5 million during the 2017 period. However, the one basis point decrease in yield on these assets was driven by a seven basis point decrease in our loan yield. The lower yield on our loan portfolio was due to loans being originated or renewed at market rates which are lower than those in the past.

In addition, our average interest-bearing liabilities increased by \$96.7 million during the first quarter of 2017 as compared to the first quarter of 2016, while the cost of our interest-bearing liabilities increased by six basis points during the same period. The increased rate during the 2017 period resulted primarily from a \$88.6 million increase in our interest-bearing deposits at an average rate of 0.58% which is eight basis points higher than that in the first quarter of 2016. In addition, the cost of our other interest-bearing liabilities, of which 63% are at variable rates tied to Libor, increased in relation to current market rates and trends.

Our net interest spread was 3.40% for the three months ended March 31, 2017 compared to 3.47% for the same period in 2016. 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 one basis point reduction in yield on our interest-earning assets and the six basis point increase in rate on our interest-bearing liabilities, resulted in a seven basis point decrease in our net interest spread for the 2017 period.

*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.

| (dollars in thousands)             | March 31, 2017 vs. 2016<br>Increase (Decrease) Due to |       |        |       | Three Months Ended<br>March 31, 2016 vs. 2015<br>Increase (Decrease) Due to |       |        |       |
|------------------------------------|---|-------|--------|-------|---|-------|--------|-------|
|                                    | Volume  | Rate  | Volume | Total | Volume  | Rate  | Volume | Total |
| Interest income                    |   |       |        |       |   |       |        |       |
| Loans                              | \$ 1,930  | (169) | (30)   | 1,731 | \$ 1,497  | (89)  | (13)   | 1,395 |
| Investment securities              | (101)   | (15)  | 3      | (113) | 191   | (52)  | (26)   | 113   |
| Federal funds sold                 | 2   | 9     | 1      | 12    | (4)   | 30    | (6)    | 20    |
| Total interest income              | 1,831   | (175) | (26)   | 1,630 | 1,684   | (111) | (45)   | 1,528 |
| Interest expense                   |   |       |        |       |   |       |        |       |
| Deposits                           | 143   | 103   | 15     | 261   | 145   | 63    | 12     | 220   |
| FHLB advances and other borrowings | 58  | 1     | -      | 59    | (68)  | 135   | (10)   | 57    |
| Junior subordinated debt           | -   | 10    | -      | 10    | -   | 14    | -      | 14    |
| Total interest expense             | 201   | 114   | 15     | 330   | 77  | 212   | 2      | 291   |
| Net interest income                | \$ 1,630  | (289) | (41)   | 1,300 | \$ 1,607  | (323) | (47)   | 1,237 |

Net interest income, the largest component of our income, was \$11.6 million for the three-month period ended March 31, 2017 and \$10.3 million for the three months ended March 31, 2016, a \$1.3 million, or 12.6%, increase during the first quarter of 2017. The increase in net interest income is due to a \$1.6 million increase in interest income, partially offset by a \$330,000 increase in interest expense. During the first quarter of 2017, the primary driver of the increase in net interest income was the \$163.9 million increase in our average interest-earning assets as compared to the first quarter of 2016.

**Provision for Loan Losses**

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our consolidated statements of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under **Balance Sheet Review Allowance for Loan Losses** for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

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For the three months ended March 31, 2017 and 2016, we incurred a noncash expense related to the provision for loan losses of \$500,000 and \$625,000, respectively, which resulted in an allowance for loan losses of \$15.3 million, or 1.25% of gross loans, for the 2017 period. For the three months ended March 31, 2016, our provision for loan losses of \$625,000 resulted in an allowance for loan losses of \$13.9 million, or 1.34% of gross loans, for the 2016 period. During the past 12 months, our loan balances increased by \$179.8 million, while the amount of our nonperforming loans and classified loans declined. Factors such as these are also considered in determining the amount of loan loss provision necessary to maintain our allowance for loan losses at an adequate level.

*Noninterest Income*

The following table sets forth information related to our noninterest income.

|                                       | Three months ended |       |
|---------------------------------------|--------------------|-------|
|                                       | March 31,          |       |
| (dollars in thousands)                | 2017               | 2016  |
| Mortgage banking income               | 1,057              | 1,447 |
| Service fees on deposit accounts      | 278                | 220   |
| Income from bank owned life insurance | 183                | 186   |
| Gain on sale of investment securities | -                  | 307   |
| Other income                          | 533                | 399   |
| Total noninterest income              | 2,051              | 2,559 |

Noninterest income decreased \$508,000, or 19.9%, for the first quarter of 2017 as compared to the same period in 2016. The decrease in total noninterest income during the 2017 period resulted primarily from the following:

Mortgage banking income decreased by \$390,000, or 27.0%, driven by lower origination volume during the first quarter due to seasonality typical of the industry as well as an overall increase in the average market rate for new mortgage loan originations. We anticipate that our mortgage origination volume for 2017 may not be at the same levels experienced in the past.

A gain on sale of investment securities of \$307,000 was recognized in the first quarter of 2016 while there was no gain recognized during the current period.

Partially offsetting these decreases in noninterest income was a \$58,000 increase in service fees on deposit accounts, driven by increased service charges and non-sufficient funds ( NSF ) fee income, and a \$134,000 increase in other income due to increased loan fee income, which includes late charges and line of credit fees, and ATM and debit card exchange income.

In accordance with the requirement set forth under the Dodd-Frank Wall Street Reform and Consumer Protection Act, in June 2011, the Federal Reserve approved a final rule which caps an issuer's base interchange fee at 21 cents per transaction and allows an additional 5 basis point charge per transaction to help cover fraud losses. Although the rule does not apply to institutions with less than \$10 billion in assets, such as our Bank, there is concern that the price controls may harm community banks, which could be pressured by the marketplace to lower their own interchange rates. Our ATM/Debit card fee income is included in other noninterest income and was \$263,000 and \$201,000 for the three months ended March 31, 2017 and 2016, respectively, the majority of which related to interchange fee income.

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The following table sets forth information related to our noninterest expenses.

|                                     | Three months<br>ended<br>March 31, |              |
|-------------------------------------|------------------------------------|--------------|
| (dollars in thousands)              | 2017                               | 2016         |
| Compensation and benefits           | 5,273                              | 4,551        |
| Occupancy                           | 967                                | 870          |
| Real estate owned expenses          | 13                                 | 285          |
| Outside service and data processing | 745                                | 598          |
| Insurance                           | 289                                | 233          |
| Professional fees                   | 313                                | 254          |
| Marketing                           | 210                                | 231          |
| Other                               | 550                                | 495          |
| <b>Total noninterest expense</b>    | <b>8,360</b>                       | <b>7,517</b> |

Noninterest expense was \$8.4 million for the three months ended March 31, 2017, an \$843,000, or 11.2%, increase from noninterest expense of \$7.5 million for the three months ended March 31, 2016. Significant fluctuations in noninterest expenses resulted from the following:

Compensation and benefits expense increased \$722,000, or 15.9%, relating primarily to increases in base compensation, incentive compensation and benefits expenses. Base compensation increased by \$421,000 driven by the cost of ten additional employees, six of which were hired in conjunction with the opening of our new office in Raleigh, North Carolina, with the remainder being hired to support our mortgage department as well as to support loan and deposit growth. Incentive compensation increased by \$46,000 and benefits expense increased by \$250,000 during the 2017 period. The increase in incentive compensation related to the additional number of employees at March 31, 2017 while the increase in benefits expenses was driven by an increase in payroll taxes and group insurance costs for the 2017 period.

Occupancy expenses increased by \$97,000, or 11.1%, driven primarily by increased rent expense as well as additional property tax expenses on the properties we own.

Outside service and data processing costs increased by \$147,000, or 24.6%, driven by increased software licensing and maintenance costs as well as ATM/Debit card related expenses.

Professional fees increased by \$59,000, or 23.2%, due primarily to increased loan appraisal fees as well as other professional service fees related to our mortgage operations.

Other noninterest expenses increased by \$55,000, or 11.1%, driven by an increase in travel and entertainment, business meals, and office supplies expenses.

Partially offsetting the increases in noninterest expense was a decrease in real estate owned expenses of \$272,000, or 95.4%, due primarily to a loss on sale of property during the 2016 period.

Our efficiency ratio was 61.2% for the first quarter of 2017 compared to 58.4% for the same period in 2016. The efficiency ratio represents the percentage of one dollar of expense required to be incurred to earn a full dollar of revenue and is computed by dividing noninterest expense by the sum of net interest income and noninterest income. The increase during the 2017 period relates primarily to the increase in noninterest expenses combined with the decrease in noninterest income compared to the prior year.

We incurred income tax expense of \$1.7 million for the three months ended March 31, 2017 and 2016. Our effective tax rate was 35.1% and 36.4% for the three months ended March 31, 2017 and 2016, respectively. In the first quarter of 2017 we adopted the new FASB guidance which simplified several aspects of the accounting for share-based payment award transactions, including income tax consequences. As a result, our income tax expense was reduced by \$53,000 for the period ended March 31, 2017.

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**BALANCE SHEET REVIEW**

*Investment Securities*

At March 31, 2017, the \$68.4 million in our investment securities portfolio represented approximately 4.7% of our total assets. Our available for sale investment portfolio included US government agency securities, SBA securities, state and political subdivisions, and mortgage-backed securities with a fair value of \$62.8 million and an amortized cost of \$63.4 million resulting in an unrealized loss of \$526,000. At December 31, 2016, the \$70.2 million in our investment securities portfolio represented approximately 5.2% of our total assets. At December 31, 2016, we held investment securities available for sale with a fair value of \$64.5 million and an amortized cost of \$65.2 million for an unrealized loss of \$764,000.

*Loans*

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. Average loans for the three months ended March 31, 2017 and 2016 were \$1.21 billion and \$1.03 billion, respectively. Before the allowance for loan losses, total loans outstanding at March 31, 2017 and December 31, 2016 were \$1.22 billion and \$1.16 billion, respectively.

The principal component of our loan portfolio is loans secured by real estate mortgages. As of March 31, 2017, our loan portfolio included \$989.5 million, or 81.2%, of real estate loans. As of December 31, 2016, real estate loans made up 81.1% of our loan portfolio and totaled \$943.5 million. Most of our real estate loans are secured by residential or commercial property. We obtain a security interest in real estate, in addition to any other available collateral. This collateral is taken to increase the likelihood of the ultimate repayment of the loan. Generally, we limit the loan-to-value ratio on loans to coincide with the appropriate regulatory guidelines. We attempt to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral and business types. We do not generally originate traditional long term residential mortgages to hold in our loan portfolio, but we do issue traditional second mortgage residential real estate loans and home equity lines of credit. Home equity lines of credit totaled \$143.7 million as of March 31, 2017, of which approximately 41% were in a first lien position, while the remaining balance was second liens, compared to \$137.1 million as of December 31, 2016, with approximately 39% in first lien positions and the remaining balance in second liens. The average loan had a balance of approximately \$92,000 and a loan to value of 70% as of March 31, 2017, compared to an average loan balance of \$91,000 and a loan to value of approximately 73% as of December 31, 2016. Further, 0.4% and 0.3% of our total home equity lines of credit were over 30 days past due as of March 31, 2017 and December 31, 2016, respectively.

Following is a summary of our loan composition at March 31, 2017 and December 31, 2016. During the first three months of 2017, our loan portfolio increased by \$55.0 million, or 4.7%. Our commercial and consumer loan portfolios experienced similar growth during the three months ended March 31, 2017 with a 4.0% increase in commercial loans and an 6.0% increase in consumer loans during the period. Of the \$55.0 million in loan growth during the first three months of 2017, \$46.0 million of the increase was in loans secured by real estate, \$6.0 million in commercial business loans, and \$3.0 million in other consumer loans. Our consumer real estate portfolio includes high quality 1-4 family consumer real estate loans. Our average consumer real estate loan currently has a principal balance of \$352,000, a term of 10 years, and an average rate of 4.33% as of March 31, 2017, compared to \$341,000 a term of nine years, and an average rate of 4.34% as of December 31, 2016.



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| (dollars in thousands)                  | March 31, 2017 |            | December 31, 2016 |            |
|---|----------------|------------|-------------------|------------|
|   | Amount         | % of Total | Amount            | % of Total |
| <b>Commercial</b>                       |                |            |                   |            |
| Owner occupied RE                       | \$ 288,300     | 23.7%      | \$ 285,938        | 24.6%      |
| Non-owner occupied RE                   | 258,449        | 21.2%      | 239,574           | 20.6%      |
| Construction                            | 36,889         | 3.0%       | 33,393            | 2.9%       |
| Business                                | 208,590        | 17.1%      | 202,552           | 17.4%      |
| Total commercial loans                  | 792,228        | 65.0%      | 761,457           | 65.5%      |
| <b>Consumer</b>                         |                |            |                   |            |
| Real estate                             | 230,695        | 18.9%      | 215,588           | 18.5%      |
| Home equity                             | 143,673        | 11.8%      | 137,105           | 11.8%      |
| Construction                            | 31,535         | 2.6%       | 31,922            | 2.7%       |
| Other                                   | 20,549         | 1.7%       | 17,572            | 1.5%       |
| Total consumer loans                    | 426,452        | 35.0%      | 402,187           | 34.5%      |
| Total gross loans, net of deferred fees | 1,218,680      | 100.0%     | 1,163,644         | 100.0%     |
| Less allowance for loan losses          | (15,287)       |            | (14,855)          |            |
| Total loans, net                        | \$ 1,203,393   |            | \$ 1,148,789      |            |
| <i>Nonperforming assets</i>             |                |            |                   |            |

Nonperforming assets include real estate acquired through foreclosure or deed taken in lieu of foreclosure and loans on nonaccrual status. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the contractual principal or interest on the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as a reduction in principal when received. Our policy with respect to nonperforming loans requires the borrower to make a minimum of six consecutive payments in accordance with the loan terms and to show capacity to continue performing into the future before that loan can be placed back on accrual status. As of March 31, 2017 and December 31, 2016, we had no loans 90 days past due and still accruing.

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

| (dollars in thousands)                   | March 31, | December 31, 2016 |
|--|-----------|-------------------|
|  | 2017      |                   |
| Commercial                               | \$ 4,396  | 3,673             |
| Consumer                                 | 803       | 819               |
| Nonaccruing troubled debt restructurings | 979       | 990               |
| Total nonaccrual loans                   | 6,178     | 5,482             |
| Other real estate owned                  | 669       | 639               |
| Total nonperforming assets               | \$ 6,847  | 6,121             |

At March 31, 2017, nonperforming assets were \$6.8 million, or 0.47% of total assets and 0.56% of gross loans. Comparatively, nonperforming assets were \$6.1 million, or 0.46% of total assets and 0.53% of gross loans at December 31, 2016. Nonaccrual loans were \$6.2 million at March 31, 2017, a \$696,000 increase from December 31, 2016. During the first three months of 2017, three loans were put on nonaccrual status and three nonaccrual loans were either paid or charged-off. The amount of foregone interest income on the nonaccrual loans in the first three months of 2017 and 2016 was approximately \$112,000 and \$109,000, respectively.

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Nonperforming assets include other real estate owned which totaled \$669,000 at March 31, 2017, a \$30,000 increase from December 31, 2016. The balance at March 31, 2017 includes six commercial properties totaling \$348,000 and three residential properties totaling \$321,000. All of these properties are located in the Upstate of South Carolina. We believe that these properties are appropriately valued at the lower of cost or market as of March 31, 2017.

At March 31, 2017 and 2016, the allowance for loan losses represented 247.4% and 224.6% of the total amount of nonperforming loans, respectively. A significant portion, or 77%, of nonperforming loans at March 31, 2017 is secured by real estate. Our nonperforming loans have been written down to approximately 60% of their original nonperforming balance. We have evaluated the underlying collateral on these loans and believe that the collateral on these loans is sufficient to minimize future losses. Based on the level of coverage on nonperforming loans and analysis of our loan portfolio, we believe the allowance for loan losses of \$15.3 million as of March 31, 2017 to be adequate.

As a general practice, most of our loans are originated with relatively short maturities of less than 10 years. As a result, when a loan reaches its maturity we frequently renew the loan and thus extend its maturity using the same credit standards as those used when the loan was first originated. Due to these loan practices, we may, at times, renew loans which are classified as nonperforming after evaluating the loan's collateral value and financial strength of its guarantors. Nonperforming loans are renewed at terms generally consistent with the ultimate source of repayment and rarely at reduced rates. In these cases the Company will seek additional credit enhancements, such as additional collateral or additional guarantees to further protect the loan. When a loan is no longer performing in accordance with its stated terms, the Company will typically seek performance under the guarantee.

In addition, at March 31, 2017, 81.2% of our loans are collateralized by real estate and 77% of our impaired loans are secured by real estate. The Company utilizes third party appraisers to determine the fair value of collateral dependent loans. Our current loan and appraisal policies require the Company to obtain updated appraisals on an annual basis, either through a new external appraisal or an appraisal evaluation. Impaired loans are individually reviewed on a quarterly basis to determine the level of impairment. As of March 31, 2017, we do not have any impaired real estate loans carried at a value in excess of the appraised value. We typically charge-off a portion or create a specific reserve for impaired loans when we do not expect repayment to occur as agreed upon under the original terms of the loan agreement.

At March 31, 2017, impaired loans totaled \$12.0 million for which \$8.6 million of these loans have a reserve of approximately \$2.7 million allocated in the allowance. During the first three months of 2017, the average recorded investment in impaired loans was approximately \$12.1 million. Comparatively, impaired loans totaled \$11.2 million at December 31, 2016, and \$7.5 million of these loans had a reserve of approximately \$2.6 million allocated in the allowance. During 2016, the average recorded investment in impaired loans was approximately \$11.6 million.

We consider a loan to be a TDR when the debtor experiences financial difficulties and we provide concessions such that we will not collect all principal and interest in accordance with the original terms of the loan agreement. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment. As of March 31, 2017, we determined that we had loans totaling \$6.8 million that we considered TDRs. As of December 31, 2016, we had loans totaling \$6.7 million, that we considered TDRs.

### *Allowance for Loan Losses*

The allowance for loan losses was \$15.3 million and \$13.9 million at March 31, 2017 and 2016, respectively, or 1.25% of outstanding loans at March 31, 2017 and 1.34% of outstanding loans at March 31, 2016. At December 31, 2016, our allowance for loan losses was \$14.9 million, or 1.28% of outstanding loans, and we had net loans charged-off of \$1.1 million for the year ended December 31, 2016.

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During the three months ended March 31, 2017, we charged-off \$190,000 of loans and recorded \$122,000 of recoveries on loans previously charged-off, for net charge-offs of \$68,000, or 0.02% of average loans, annualized. Comparatively, we charged-off \$394,000 of loans and recorded \$38,000 of recoveries on loans previously charged-off, resulting in net charge-offs of \$356,000, or 0.14% of average loans, annualized, for the first three months of 2016.

Following is a summary of the activity in the allowance for loan losses.

| (dollars in thousands)              | Three months ended<br>March 31, |           | Year ended<br>December 31, |
|-------------------------------------|---------------------------------|-----------|----------------------------|
|                                     | 2017                            | 2016      | 2016                       |
| <b>Balance, beginning of period</b> | \$ 14,855                       | \$ 13,629 | 13,629                     |
| Provision                           | 500                             | 625       | 2,300                      |
| Loan charge-offs                    | (190)                           | (394)     | (1,648)                    |
| Loan recoveries                     | 122                             | 38        | 574                        |
| Net loan charge-offs                | (68)                            | (356)     | (1,074)                    |
| <b>Balance, end of period</b>       | \$ 15,287                       | \$ 13,898 | 14,855                     |

*Deposits and Other Interest-Bearing Liabilities*

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and structured repurchase agreements. In the past, we have chosen to obtain a portion of our certificates of deposits from areas outside of our market in order to obtain longer term deposits than are readily available in our local market. We have adopted guidelines regarding our use of brokered CDs that limit our brokered CDs to 25% of total deposits and dictate that our current interest rate risk profile determines the terms. In addition, we do not obtain time deposits of \$100,000 or more through the Internet. These guidelines allow us to take advantage of the attractive terms that wholesale funding can offer while mitigating the related inherent risk.

Our retail deposits represented \$1.11 billion, or 91.8% of total deposits at March 31, 2017, while our out-of-market, or brokered, deposits represented \$99.3 million, or 8.2% of our total deposits at March 31, 2017. At December 31, 2016, retail deposits represented \$1.03 billion, or 94.6% of our total deposits, and brokered CDs were \$59.1 million, representing 5.4% of our total deposits. Our loan-to-deposit ratio was 101% at March 31, 2017 and 107% at December 31, 2016.

The following is a detail of our deposit accounts:

| (dollars in thousands)                              | March 31,<br>2017 | December 31,<br>2016 |
|---|-------------------|----------------------|
| Non-interest bearing                                | \$ 253,320        | 235,538              |
| Interest bearing:                                   |                   |                      |
| NOW accounts  | 228,640           | 234,949              |
| Money market accounts                               | 391,923           | 345,117              |
| Savings   | 15,688            | 14,942               |
| Time, less than \$100,000                           | 49,367            | 48,638               |
| Time and out-of-market deposits, \$100,000 and over | 272,336           | 211,967              |
| Total deposits                                      | \$ 1,211,274      | 1,091,151            |

During the past 12 months, we continued our focus on increasing core deposits, which exclude out-of-market deposits and time deposits of \$250,000 or more, in order to provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$1.00 billion and \$937.5 million at March 31, 2017, and December 31, 2016, respectively.

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The following table shows the average balance amounts and the average rates paid on deposits.

| (dollars in thousands)               |              |              | Three months ended |                              |
|--------------------------------------|--------------|--------------|--------------------|------------------------------|
|                                      | Amount       | 2017<br>Rate | Amount             | March<br>31,<br>2016<br>Rate |
| Noninterest bearing demand deposits  | \$ 239,873   | -%           | \$ 182,340         | -%                           |
| Interest bearing demand deposits     | 219,743      | 0.18%        | 189,848            | 0.18%                        |
| Money market accounts                | 371,985      | 0.60%        | 315,033            | 0.44%                        |
| Savings accounts                     | 15,228       | 0.05%        | 11,290             | 0.05%                        |
| Time deposits less than \$100,000    | 48,013       | 0.68%        | 58,740             | 0.75%                        |
| Time deposits greater than \$100,000 | 224,201      | 0.94%        | 215,682            | 0.84%                        |
| Total deposits                       | \$ 1,119,043 | 0.45%        | \$ 972,933         | 0.41%                        |

During the twelve months ended March 31, 2017, our average transaction account balances increased by \$148.3 million, or 21.2%, from the three months ended March 31, 2016, while our average time deposit balances decreased by \$2.2 million during the same twelve-month period.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of \$100,000 or more at March 31, 2017 was as follows:

|                                | March 31,<br>2017 |
|--------------------------------|-------------------|
| (dollars in thousands)         |                   |
| Three months or less           | \$ 31,523         |
| Over three through six months  | 73,691            |
| Over six through twelve months | 108,456           |
| Over twelve months             | 58,666            |
| Total                          | \$ 272,336        |

Included in time deposits of \$100,000 or more at March 31, 2017 is \$89.4 million of wholesale CDs scheduled to mature within the next 12 months at a weighted average rate of 0.96%. Time deposits that meet or exceed the FDIC insurance limit of \$250,000 at March 31, 2017 and December 31, 2016 were \$210.2 million and \$153.7 million, respectively.

**LIQUIDITY AND CAPITAL RESOURCES**

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At March 31, 2017 and December 31, 2016, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to \$121.2 million and \$46.6 million, or 8.3% and 3.5% of total assets, respectively. Our investment securities at March 31, 2017 and December 31, 2016 amounted to \$68.4 million and \$70.2 million, or 4.7% and 5.2% of total assets, respectively. The increase in cash and cash equivalents is primarily attributable to our effort to increase the amount of on balance sheet liquidity as well as in anticipation of \$44.5 million of FHLB advances we have maturing in the second quarter of 2017. In addition, investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner; however, approximately 30% of these securities are pledged against outstanding debt. Therefore, the related debt would need to be repaid prior to the securities being sold in order for these securities to be converted to cash.



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Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, loan payoffs, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. We maintain three federal funds purchased lines of credit with correspondent banks totaling \$45.0 million for which there were no borrowings against the lines of credit at March 31, 2017.

We are also a member of the FHLB, from which applications for borrowings can be made. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from the FHLB. The unused borrowing capacity currently available from the FHLB at March 31, 2017 was \$137.5 million, based on the Bank's \$5.0 million investment in FHLB stock, as well as qualifying mortgages available to secure any future borrowings. However, we are able to pledge additional securities to the FHLB in order to increase our available borrowing capacity. In addition, at March 31, 2017 and December 31, 2016 we had \$175.3 million and \$130.1 million, respectively, of letters of credit outstanding with the FHLB to secure client deposits.

We also have a line of credit with another financial institution for \$10.0 million, of which the entire balance was outstanding at March 31, 2017. The line of credit bears interest at LIBOR plus 2.90% with a floor of 3.25% and a ceiling of 5.15%, and matures on June 6, 2017. Management intends to renew the line of credit at maturity.

We believe that our existing stable base of core deposits, borrowings from the FHLB, and short-term repurchase agreements will enable us to successfully meet our long-term liquidity needs. However, as short-term liquidity needs arise, we have the ability to sell a portion of our investment securities portfolio to meet those needs.

Total shareholders' equity was \$113.6 million at March 31, 2017 and \$109.9 million at December 31, 2016. The \$3.7 million increase from December 31, 2016 is primarily related to net income of \$3.1 million during the first three months of 2017, combined with a \$157,000 increase in accumulated other comprehensive income and \$112,000 from the exercise of stock options.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), equity to assets ratio (average equity divided by average assets), and tangible common equity ratio (total equity less preferred stock divided by total assets) annualized for the three months ended March 31, 2017 and the year ended December 31, 2016. Since our inception, we have not paid cash dividends.

|  | March 31, 2017 | December 31, 2016 |
|--|----------------|-------------------|
| Return on average assets               | 0.92%          | 1.04%             |
| Return on average equity               | 11.27%         | 12.73%            |
| Return on average common equity        | 11.27%         | 12.73%            |
| Average equity to average assets ratio | 8.13%          | 8.16%             |
| Tangible common equity to assets ratio | 7.74%          | 8.19%             |

At both the holding company and Bank level, we are subject to various regulatory capital requirements administered by the federal banking agencies. Under the capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. Our capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

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Regulatory capital rules released in July 2013 to implement capital standards referred to as Basel III and developed by an international body known as the Basel Committee on Banking Supervision, impose higher minimum capital requirements for bank holding companies and banks. The rules apply to all national and state banks and savings associations regardless of size and bank holding companies and savings and loan holding companies with more than \$1 billion in total consolidated assets. More stringent requirements are imposed on advanced approaches banking organizations—those organizations with \$250 billion or more in total consolidated assets, \$10 billion or more in total foreign exposures, or that have opted in to the Basel II capital regime. The requirements in the rule began to phase in on January 1, 2015, for us. The requirements in the rule will be fully phased in by January 1, 2019.

The rule includes certain new and higher risk-based capital and leverage requirements than those currently in place. Specifically, the following minimum capital requirements apply to us:

- a new common equity Tier 1 risk-based capital ratio of 4.5%;
- a Tier 1 risk-based capital ratio of 6% (increased from the former 4% requirement);
- a total risk-based capital ratio of 8% (unchanged from the former requirement); and
- a leverage ratio of 4% (also unchanged from the former requirement).

Under the rule, Tier 1 capital is redefined to include two components: Common Equity Tier 1 capital and additional Tier 1 capital. The new and highest form of capital, Common Equity Tier 1 capital, consists solely of common stock (plus related surplus), retained earnings, accumulated other comprehensive income, and limited amounts of minority interests that are in the form of common stock. Additional Tier 1 capital includes other perpetual instruments historically included in Tier 1 capital, such as noncumulative perpetual preferred stock. Tier 2 capital consists of instruments that currently qualify in Tier 2 capital plus instruments that the rule has disqualified from Tier 1 capital treatment. Cumulative perpetual preferred stock, formerly includable in Tier 1 capital, is now included only in Tier 2 capital. Accumulated other comprehensive income (AOCI) is presumptively included in Common Equity Tier 1 capital and often would operate to reduce this category of capital. The rule provided a one-time opportunity at the end of the first quarter of 2015 for covered banking organizations to opt out of much of this treatment of AOCI. We made this opt-out election and, as a result, will retain the pre-existing treatment for AOCI.

In addition, in order to avoid restrictions on capital distributions or discretionary bonus payments to executives, a covered banking organization must maintain a capital conservation buffer on top of its minimum risk-based capital requirements. This buffer must consist solely of Tier 1 Common Equity, but the buffer applies to all three measurements (Common Equity Tier 1, Tier 1 capital and total capital). The capital conservation buffer will be phased in incrementally over time, becoming fully effective on January 1, 2019, and will consist of an additional amount of common equity equal to 2.5% of risk-weighted assets. As of January 1, 2016, we are required to hold a capital conservation buffer of 0.625%, increasing by that amount each successive year until 2019.

In general, the rules have had the effect of increasing capital requirements by increasing the risk weights on certain assets, including high volatility commercial real estate, certain loans past due 90 days or more or in nonaccrual status, mortgage servicing rights not includable in Common Equity Tier 1 capital, equity exposures, and claims on securities firms, that are used in the denominator of the three risk-based capital ratios.

It is management's belief that, as of March 31, 2017, the Company and the Bank would have met all capital adequacy requirements under Basel III on a fully phased-in basis if such requirements were currently effective.

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The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements.

|  | Actual     |        | For capital adequacy purposes minimum |       | March 31, 2017<br>To be well capitalized under prompt corrective action provisions minimum |        |
|--|------------|--------|---------------------------------------|-------|--|--------|
|  | Amount     | Ratio  | Amount                                | Ratio | Amount   | Ratio  |
| (dollars in thousands)                                 |            |        |                                       |       |  |        |
| Total Capital (to risk weighted assets)                | \$ 145,063 | 12.20% | 95,093                                | 8.00% | 118,866  | 10.00% |
| Tier 1 Capital (to risk weighted assets)               | 130,200    | 10.95% | 71,319                                | 6.00% | 95,093   | 8.00%  |
| Common Equity Tier 1 Capital (to risk weighted assets) | 130,200    | 10.95% | 53,490                                | 4.50% | 77,263   | 6.50%  |
| Tier 1 Capital (to average assets)                     | 130,200    | 9.47%  | 54,994                                | 4.00% | 68,743   | 5.00%  |

The following table summarizes the capital amounts and ratios of the Company and the minimum regulatory requirements.

|  | Actual  |        | For capital adequacy purposes minimum |       | March 31, 2017<br>To be well capitalized under prompt corrective action provisions minimum |       |
|--|---------|--------|---------------------------------------|-------|--|-------|
|  | Amount  | Ratio  | Amount                                | Ratio | Amount   | Ratio |
| (dollars in thousands)                                 |         |        |                                       |       |  |       |
| Total Capital (to risk weighted assets)                | 141,776 | 11.93% | 95,093                                | 8.00% | N/A  | N/A   |
| Tier 1 Capital (to risk weighted assets)               | 126,913 | 10.68% | 71,319                                | 6.00% | N/A  | N/A   |
| Common Equity Tier 1 Capital (to risk weighted assets) | 113,913 | 9.58%  | 53,490                                | 4.50% | N/A  | N/A   |
| Tier 1 Capital (to average assets)                     | 126,913 | 9.21%  | 55,121                                | 4.00% | N/A  | N/A   |

The ability of the Company to pay cash dividends is dependent upon receiving cash in the form of dividends from the Bank. The dividends that may be paid by the Bank to the Company are subject to legal limitations and regulatory capital requirements.

**EFFECT OF INFLATION AND CHANGING PRICES**

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

**OFF-BALANCE SHEET RISK**

Commitments to extend credit are agreements to lend money to a client as long as the client has not violated any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the



payment of a fee. At March 31, 2017, unfunded commitments to extend credit were \$268.0 million, of which \$66.8 million was at fixed rates and \$201.2 million was at variable rates. At December 31, 2016, unfunded commitments to extend credit were \$226.6 million, of which approximately \$57.8 million was at fixed rates and \$168.8 million was at variable rates. A significant portion of the unfunded commitments related to consumer equity lines of credit. Based on historical experience, we anticipate that a significant portion of these lines of credit will not be funded. We evaluate each client's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. The type of collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate.

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At both March 31, 2017 and December 31, 2016, there were commitments under letters of credit for \$4.1 million and \$4.4 million, respectively. The credit risk and collateral involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Since most of the letters of credit are expected to expire without being drawn upon, they do not necessarily represent future cash requirements.

A portion of our business is to originate mortgage loans that will be sold in the secondary market to investors. Loan types that we originate include conventional loans, jumbo loans and other governmental agency loan products. We adhere to the legal lending limits and guidelines as set forth by the various governmental agencies and investors to whom we sell loans. Under a best efforts selling procedure, we make our best effort to process, fund, and deliver the loan to a particular investor. If the loan fails to fund, there is no immediate cost to us, as the market risk has been transferred to the investor. In the event of a customer loan default, we may be required to reimburse the investor.

Except as disclosed in this report, we are not involved in off-balance sheet contractual relationships, unconsolidated related entities that have off-balance sheet arrangements or transactions that could result in liquidity needs or other commitments that significantly impact earnings.

## **MARKET RISK AND INTEREST RATE SENSITIVITY**

Market risk is the risk of loss from adverse changes in market prices and rates, which principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business.

We actively monitor and manage our interest rate risk exposure in order to control the mix and maturities of our assets and liabilities utilizing a process we call asset/liability management. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. Our asset/liability management committee (ALCO) monitors and considers methods of managing exposure to interest rate risk. We have both an internal ALCO consisting of senior management that meets at various times during each month and a board ALCO that meets monthly. The ALCOs are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

As of March 31, 2017, the following table summarizes the forecasted impact on net interest income using a base case scenario given upward and downward movements in interest rates of 100, 200, and 300 basis points based on forecasted assumptions of prepayment speeds, nominal interest rates and loan and deposit repricing rates. Estimates are based on current economic conditions, historical interest rate cycles and other factors deemed to be relevant. However, underlying assumptions may be impacted in future periods which were not known to management at the time of the issuance of the Consolidated Financial Statements. Therefore, management's assumptions may or may not prove valid. No assurance can be given that changing economic conditions and other relevant factors impacting our net interest income will not cause actual occurrences to differ from underlying assumptions. In addition, this analysis does not consider any strategic changes to our balance sheet which management may consider as a result of changes in market conditions.

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| Interest rate scenario | Change in net interest<br>income from base |
|------------------------|--|
| Up 300 basis points    | 9.09 %                                     |
| Up 200 basis points    | 6.50 %                                     |
| Up 100 basis points    | 3.65 %                                     |
| Base                   | -  |
| Down 100 basis points  | (6.18)%                                    |
| Down 200 basis points  | (8.52)%                                    |
| Down 300 basis points  | (10.60)%                                   |

**CRITICAL ACCOUNTING POLICIES**

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2016, as filed in our Annual Report on Form 10-K.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Our Critical Accounting Policies are the allowance for loan losses, fair value of financial instruments, other-than-temporary impairment analysis, other real estate owned, and income taxes. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

**ACCOUNTING, REPORTING, AND REGULATORY MATTERS***Recently Issued Accounting Standards*

The following is a summary of recent authoritative pronouncements that could affect accounting, reporting, and disclosure of financial information by us:

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. In March 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify the implementation guidance on principal versus agent considerations and address how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. In April 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to identifying performance obligations and accounting for licenses of intellectual property. In May 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2015, the FASB deferred the effective date of ASU 2014-09, *Revenue from Contracts with Customers*. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2015, the FASB amended the Income Taxes topic of the Accounting Standards Codification to simplify the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments will be effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted as of the beginning of an interim

or annual reporting period. The Company does not expect these amendments to have a material effect on its financial statements.

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In January 2016, the FASB amended the Financial Instruments topic of the ASC to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions including the income tax consequences, the classification of awards as either equity or liabilities, and the classification on the statement of cash flows. Additionally, the guidance simplifies two areas specific to entities other than public business entities allowing them to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that have certain characteristics and also allowing them to make a one-time election to switch from measuring all liability-classified awards at fair value to measuring them at intrinsic value. The amendments will be effective for the Company for annual periods beginning after December 15, 2016 and interim periods within those annual periods. These amendments did not have a material effect on the Company's financial statements.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2019. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In August 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2016, the FASB amended the Statement of Cash Flows topic of the Accounting Standards Codification to clarify how restricted cash is presented and classified in the statement of cash flows. The amendments will be effective for the Company for fiscal years beginning after December 15, 2017 including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2017, the FASB updated the Accounting Changes and Error Corrections and the Investments - Equity Method and Joint Ventures Topics of the Accounting Standards Codification. The ASU incorporates into the Accounting Standards Codification recent SEC guidance about disclosing, under SEC SAB Topic 11.M, the effect on financial statements of adopting the revenue, leases, and credit losses standards. The ASU was effective upon issuance. The Company is currently evaluating the impact on additional disclosure requirements as each of the standards is adopted, however it does not expect these amendments to have a material effect on its financial position, results of operations or cash flows.

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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.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk and Interest Rate Sensitivity and Liquidity Risk.

**Item 4. CONTROLS AND PROCEDURES.**

*Evaluation of Disclosure Controls and Procedures*

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported as and when required and (ii) accumulated and communicated to our management, including our Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control over Financial Reporting*

There has been no change in the Company's internal control over financial reporting during the three months ended March 31, 2017, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS.**

We are a party to claims and lawsuits arising in the course of normal business activities. Management is not aware of any material pending legal proceedings against the Company which, if determined adversely, would have a material adverse impact on the company's financial position, results of operations or cash flows.

**Item 1A RISK FACTORS.**

Certain risks described below update the risk factors discussed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, which could materially affect our business, financial condition, results of operations, or cash flows. The risks described below and in the Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known or currently deemed to be immaterial also may materially and adversely affect our business, financial condition, results of operations or cash flows.

***New bank office facilities and other facilities, such as our planned office in Atlanta, Georgia, may not be profitable.***

On April 25, 2017, we announced that we are expanding our operations to the greater Atlanta, Georgia market through the hiring of experienced banker Richard E. S. Bowen. The costs to start up new bank branches and loan production offices in new markets such as Atlanta, other than through acquisitions, and the additional costs to operate and integrate these facilities will increase our non-interest expense and may decrease our earnings. It may be difficult to adequately and profitably manage our growth through the establishment of bank branches and loan production offices in new markets. In addition, we can provide no assurance that our expansion into any such new markets will successfully attract enough new business to offset the expenses of their operation. If we are not able to do so, our earnings and stock price may be negatively impacted.

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**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

Not applicable

**Item 3. DEFAULTS UPON SENIOR SECURITIES.**

Not applicable

**Item 4. MINE SAFETY DISCLOSURES.**

Not applicable

**Item 5. OTHER INFORMATION.**

Not applicable

**Item 6. EXHIBITS.**

The exhibits required to be filed as part of this Quarterly Report on Form 10-Q are listed in the Index to Exhibits attached hereto and are incorporated herein by reference.

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**SIGNATURES**

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

**SOUTHERN FIRST BANCSHARES, INC.**  
Registrant

Date: April 26, 2017

/s/R. Arthur Seaver, Jr.  
R. Arthur Seaver, Jr.  
Chief Executive Officer (Principal Executive Officer)

Date: April 26, 2017

/s/Michael D. Dowling  
Michael D. Dowling  
Chief Financial Officer (Principal Financial and Accounting Officer)



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**INDEX TO EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 31.1                      | Rule 13a-14(a) Certification of the Principal Executive Officer.   |
| 31.2                      | Rule 13a-14(a) Certification of the Principal Financial Officer.   |
| 32                        | Section 1350 Certifications.   |
| 101                       | The following materials from the Quarterly Report on Form 10-Q of Southern First Bancshares, Inc. for the quarter ended March 31, 2017, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statement of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) Notes to Unaudited Consolidated Financial Statements. |