

LAKELAND FINANCIAL CORP
Form 10-Q
May 03, 2019
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, 2019

OR

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

For the transition period from _____ to _____

LAKELAND FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

| | | |
|---|--------------------------|--------------------------------------|
| Indiana | 0-11487 | 35-1559596 |
| (State or Other Jurisdiction of Incorporation or Organization) | (Commission File Number) | (IRS Employer Identification No.) |

202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581 1387
(Address of Principal Executive Offices)(Zip Code)

(574) 267 6144
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

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

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

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

Number of shares of common stock outstanding at April 30, 2019: 25,614,665

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ITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS (in thousands, except share data)

| | March 31, 2019 (Unaudited) | December 31, 2018 |
|---|----------------------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$143,081 | \$192,290 |
| Short-term investments | 45,672 | 24,632 |
| Total cash and cash equivalents | 188,753 | 216,922 |
| Securities available for sale (carried at fair value) | 595,553 | 585,549 |
| Real estate mortgage loans held for sale | 3,047 | 2,293 |
| Loans, net of allowance for loan losses of \$49,562 and \$48,453 | 3,889,448 | 3,866,292 |
| Land, premises and equipment, net | 58,760 | 58,097 |
| Bank owned life insurance | 82,253 | 77,106 |
| Federal Reserve and Federal Home Loan Bank stock | 13,772 | 13,772 |
| Accrued interest receivable | 17,387 | 15,518 |
| Goodwill | 4,970 | 4,970 |
| Other assets | 37,942 | 34,735 |
| Total assets | \$4,891,885 | \$4,875,254 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| LIABILITIES | | |
| Noninterest bearing deposits | \$931,832 | \$946,838 |
| Interest bearing deposits | 3,215,605 | 3,097,227 |
| Total deposits | 4,147,437 | 4,044,065 |
| Borrowings | | |
| Federal funds purchased | 122,000 | 0 |
| Securities sold under agreements to repurchase | 0 | 75,555 |
| Federal Home Loan Bank advances | 0 | 170,000 |
| Subordinated debentures | 30,928 | 30,928 |
| Total borrowings | 152,928 | 276,483 |
| Accrued interest payable | 11,794 | 10,404 |
| Other liabilities | 36,459 | 22,598 |
| Total liabilities | 4,348,618 | 4,353,550 |
| STOCKHOLDERS' EQUITY | | |
| Common stock: 90,000,000 shares authorized, no par value | | |
| 25,614,665 shares issued and 25,442,827 outstanding as of March 31, 2019 | | |
| 25,301,732 shares issued and 25,128,773 outstanding as of December 31, 2018 | 111,571 | 112,383 |
| Retained earnings | 432,953 | 419,179 |
| Accumulated other comprehensive income (loss) | 2,487 | (6,191) |
| Treasury stock, at cost (2019 - 171,838 shares, 2018 - 172,959 shares) | (3,833) | (3,756) |
| Total stockholders' equity | 543,178 | 521,615 |
| Noncontrolling interest | 89 | 89 |

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| | | |
|------------------------------|-------------|-------------|
| Total equity | 543,267 | 521,704 |
| Total liabilities and equity | \$4,891,885 | \$4,875,254 |

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME (unaudited - in thousands, except share and per share data)

| | Three Months Ended March 31, | |
|--|---------------------------------|---------------|
| | 2019 | 2018 |
| NET INTEREST INCOME | | |
| Interest and fees on loans | | |
| Taxable | \$48,866 | \$41,794 |
| Tax exempt | 251 | 217 |
| Interest and dividends on securities | | |
| Taxable | 2,497 | 2,434 |
| Tax exempt | 1,642 | 1,331 |
| Other interest income | 238 | 292 |
| Total interest income | 53,494 | 46,068 |
| Interest on deposits | 13,883 | 9,367 |
| Interest on borrowings | | |
| Short-term | 950 | 111 |
| Long-term | 452 | 367 |
| Total interest expense | 15,285 | 9,845 |
| NET INTEREST INCOME | 38,209 | 36,223 |
| Provision for loan losses | 1,200 | 3,300 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 37,009 | 32,923 |
| NONINTEREST INCOME | | |
| Wealth advisory fees | 1,620 | 1,505 |
| Investment brokerage fees | 386 | 290 |
| Service charges on deposit accounts | 4,287 | 3,628 |
| Loan and service fees | 2,404 | 2,177 |
| Merchant card fee income | 622 | 642 |
| Bank owned life insurance income | 444 | 363 |
| Mortgage banking income | 222 | 241 |
| Net securities gains (losses) | 23 | (6) |
| Other income | 1,517 | 1,039 |
| Total noninterest income | 11,525 | 9,879 |
| NONINTEREST EXPENSE | | |
| Salaries and employee benefits | 12,559 | 12,019 |
| Net occupancy expense | 1,366 | 1,426 |
| Equipment costs | 1,349 | 1,274 |
| Data processing fees and supplies | 2,425 | 2,513 |
| Corporate and business development | 1,206 | 1,133 |
| FDIC insurance and other regulatory fees | 406 | 461 |
| Professional fees | 937 | 872 |
| Other expense | 2,225 | 1,504 |

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| | | |
|--|------------|------------|
| Total noninterest expense | 22,473 | 21,202 |
| INCOME BEFORE INCOME TAX EXPENSE | 26,061 | 21,600 |
| Income tax expense | 4,379 | 3,264 |
| NET INCOME | \$21,682 | \$18,336 |
| | | |
| BASIC WEIGHTED AVERAGE COMMON SHARES | 25,491,093 | 25,257,414 |
| BASIC EARNINGS PER COMMON SHARE | \$0.85 | \$0.73 |
| DILUTED WEIGHTED AVERAGE COMMON SHARES | 25,665,287 | 25,696,864 |
| DILUTED EARNINGS PER COMMON SHARE | \$0.84 | \$0.71 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited - in thousands)

| | Three months ended March 31, | |
|--|---------------------------------|--------------|
| | 2019 | 2018 |
| Net income | \$21,682 | \$18,336 |
| Other comprehensive income | | |
| Change in securities available for sale: | | |
| Unrealized holding gain/(loss) on securities available for sale arising during the period | 10,960 | (9,161) |
| Reclassification adjustment for (gains)/losses included in net income | (23) | 6 |
| Net securities gain/(loss) activity during the period | 10,937 | (9,155) |
| Tax effect | (2,297) | 2,029 |
| Net of tax amount | 8,640 | (7,126) |
| Defined benefit pension plans: | | |
| Amortization of net actuarial loss | 50 | 66 |
| Net gain activity during the period | 50 | 66 |
| Tax effect | (12) | (17) |
| Net of tax amount | 38 | 49 |
| Total other comprehensive income, net of tax | 8,678 | (7,077) |
| Comprehensive income | \$30,360 | \$11,259 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (unaudited - in thousands, except share and per share data)

| | Common Stock Shares | Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Stockholders' Equity | Noncontrolling Interest | Total Equity |
|--|------------------------|-----------|----------------------|--|-------------------|----------------------------------|----------------------------|-----------------|
| Balance at January 1, 2018 | 25,025,933 | \$108,862 | \$363,794 | \$(670) | \$(3,408) | \$468,578 | \$89 | \$468,667 |
| Adoption of ASU 2018-02 | | | 173 | (173) | | 0 | | 0 |
| Adoption of ASU 2014-09 | | | 24 | | | 24 | | 24 |
| Adoption of ASU 2016-01 | | | 68 | (68) | | 0 | | 0 |
| Comprehensive income: | | | | | | | | |
| Net income | | | 18,336 | | | 18,336 | | 18,336 |
| Other comprehensive loss, net of tax | | | | (7,077) | | (7,077) | | (7,077) |
| Cash dividends declared, \$0.22 per share | | | (5,545) | | | (5,545) | | (5,545) |
| Treasury shares purchased under deferred directors' plan | (3,807) | 185 | | | (185) | 0 | | 0 |
| Treasury shares sold and distributed under deferred directors' plan | 5,636 | (115) | | | 115 | 0 | | 0 |
| Stock activity under equity compensation plans | 96,679 | (2,483) | | | | (2,483) | | (2,483) |
| Stock based compensation expense | | 1,411 | | | | 1,411 | | 1,411 |
| | 25,124,441 | \$107,860 | \$376,850 | \$(7,988) | \$(3,478) | \$473,244 | \$89 | \$473,333 |

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Balance at
March 31, 2018

| | | | | | | | | | |
|--|------------|-----------|-----------|-----------|-------|-----------|-----------|------|-----------|
| Balance at January 1, 2019 | 25,128,773 | \$112,383 | \$419,179 | \$(6,191) | | \$(3,756) | \$521,615 | \$89 | \$521,704 |
| Adoption of ASU 2017-08 (See Note 1) | | | (1,327) | | | | (1,327) | | (1,327) |
| Comprehensive income: | | | | | | | | | |
| Net income | | | 21,682 | | | | 21,682 | | 21,682 |
| Other comprehensive income, net of tax | | | | 8,678 | | | 8,678 | | 8,678 |
| Cash dividends declared, \$0.26 per share | | | (6,581) | | | | (6,581) | | (6,581) |
| Cashless exercise of warrants | 224,066 | 0 | | | | | 0 | | 0 |
| Treasury shares purchased under deferred directors' plan | (4,578) | 195 | | | (195) | 0 | | | 0 |
| Treasury shares sold and distributed under deferred directors' plan | 5,699 | (118) | | | 118 | 0 | | | 0 |
| Stock activity under equity compensation plans | 88,867 | (2,089) | | | | | (2,089) | | (2,089) |
| Stock based compensation expense | | 1,200 | | | | | 1,200 | | 1,200 |
| Balance at March 31, 2019 | 25,442,827 | \$111,571 | \$432,953 | \$2,487 | | \$(3,833) | \$543,178 | \$89 | \$543,267 |

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited - in thousands)

| Three Months Ended March 31 | 2019 | 2018 |
|---|-----------|----------|
| Cash flows from operating activities: | | |
| Net income | \$21,682 | \$18,336 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation | 1,417 | 1,404 |
| Provision for loan losses | 1,200 | 3,300 |
| Net loss on sale and write down of other real estate owned | 0 | 16 |
| Amortization of loan servicing rights | 122 | 132 |
| Loans originated for sale, including participations | (7,454) | (9,506) |
| Net gain on sales of loans | (258) | (350) |
| Proceeds from sale of loans, including participations | 6,835 | 11,499 |
| Net loss on sales of premises and equipment | 1 | 2 |
| Net loss (gain) on sales and calls of securities available for sale | (23) | 6 |
| Net securities amortization | 817 | 749 |
| Stock based compensation expense | 1,200 | 1,411 |
| Earnings on life insurance | (444) | (363) |
| Gain on life insurance | (841) | (201) |
| Tax benefit of stock award issuances | (529) | (761) |
| Net change: | | |
| Interest receivable and other assets | (1,342) | (2,130) |
| Interest payable and other liabilities | 1,276 | 2,395 |
| Total adjustments | 1,977 | 7,603 |
| Net cash from operating activities | 23,659 | 25,939 |
| Cash flows from investing activities: | | |
| Proceeds from sale of securities available for sale | 13,693 | 12,322 |
| Proceeds from maturities, calls and principal paydowns of securities available for sale | 16,026 | 12,659 |
| Purchases of securities available for sale | (22,183) | (53,841) |
| Purchase of life insurance | (5,362) | (258) |
| Net increase in total loans | (24,356) | (32,003) |
| Proceeds from sales of land, premises and equipment | 10 | 1 |
| Purchases of land, premises and equipment | (2,091) | (678) |
| Proceeds from sales of other real estate | 0 | 12 |
| Proceeds from life insurance | 1,483 | 564 |
| Net cash from investing activities | (22,780) | (61,222) |
| Cash flows from financing activities: | | |
| Net increase in total deposits | 103,372 | 90,833 |
| Net increase in short-term borrowings | 46,445 | 24,064 |
| Payments on short-term FHLB borrowings | (170,000) | 0 |
| Payments on long-term FHLB borrowings | 0 | (80,030) |
| Common dividends paid | (6,581) | (5,545) |
| Payments related to equity incentive plans | (2,089) | (2,483) |
| Purchase of treasury stock | (195) | (185) |

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| | | |
|--|-----------|-----------|
| Net cash from financing activities | (29,048) | 26,654 |
| Net change in cash and cash equivalents | (28,169) | (8,629) |
| Cash and cash equivalents at beginning of the period | 216,922 | 176,180 |
| Cash and cash equivalents at end of the period | \$188,753 | \$167,551 |
| Cash paid during the period for: | | |
| Interest | \$13,896 | \$8,672 |
| Supplemental non-cash disclosures: | | |
| Securities purchases payable | 8,725 | 3,081 |
| Right-of-use assets obtained in exchange for lease liabilities | 5,483 | 0 |

The accompanying notes are an integral part of these consolidated financial statements.

NOTE 1. BASIS OF PRESENTATION

This report is filed for Lakeland Financial Corporation (the “Company”), which has two wholly owned subsidiaries, Lake City Bank (the “Bank”) and LCB Risk Management, a captive insurance company. Also included in this report is the Bank’s wholly owned subsidiary, LCB Investments II, Inc. (“LCB Investments”), which manages the Bank’s investment portfolio. LCB Investments owns LCB Funding, Inc. (“LCB Funding”), a real estate investment trust. All significant inter-company balances and transactions have been eliminated in consolidation.

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and are unaudited. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-months ended March 31, 2019 are not necessarily indicative of the results that may be expected for any subsequent reporting periods, including the year ending December 31, 2019. The Company’s 2018 Annual Report on Form 10-K should be read in conjunction with these statements.

Adoption of New Accounting Standards

The Company accounts for leases in accordance with ASU 2016-02, “Leases”, which the Company adopted on January 1, 2019. This guidance replaced existing lease guidance in GAAP and requires lessees to recognize lease assets and lease liabilities on the balance sheet for all leases and disclose key information about leasing arrangements. Lessees and lessors are required to recognize and measure leases that exist at the beginning of the earliest period presented using a modified retrospective approach. The Company recorded a right-of-use asset of \$5.5 million and a lease liability of \$5.5 million upon adoption, and there was no cumulative period adjustment made to retained earnings. This standard did not have a material impact on the Company’s balance sheets or cash flows from operations and had no impact on the Company’s operating results. The most significant impact was the recognition of right-of-use assets and lease obligations for operating leases. The Company elected to adopt the package of practical expedients for this standard.

In March 2017, the FASB issued ASU No. 2017-08, “Receivables—Nonrefundable Fees and Other Costs: Premium Amortization on Purchased Callable Debt Securities.” This update amends the amortization period for certain purchased callable debt securities held at a premium. FASB is shortening the amortization period for the premium to the earliest call date. Under current GAAP, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. Concerns were raised that current GAAP excludes certain callable debt securities from consideration of early repayment of principal even if the holder is certain that the call will be exercised. As a result, upon the exercise of a call on a callable debt security held at a premium, the unamortized premium is recorded as a loss in earnings. There is diversity in practice (1) in the amortization period for premiums of callable debt securities and (2) in how the potential for exercise of a call is factored into current impairment assessments. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. The Company adopted this new accounting standard on January 1, 2019. The effect of adoption was a reduction in retained earnings of approximately \$1.3 million, net of tax, to reflect the acceleration of amortization of premiums on debt securities.

In August 2017, the FASB issued ASU 2017-12, “Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities”. The purpose of this updated guidance is to better align a company's financial reporting for hedging activities with the economic objectives of those activities. ASU 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, with early adoption, including adoption in an interim period, permitted. The Company adopted ASU 2017-12 on January 1, 2019. ASU 2017-12 requires a modified retrospective transition method in which the Company will recognize the cumulative effect of the change on the

opening balance of each affected component of equity in the statement of financial position as of the date of adoption. Adopting this standard did not have an impact on the Company's financial condition or results of operations.

Newly Issued But Not Yet Effective Accounting Standards

In June 2016, the FASB issued guidance related to credit losses on financial instruments. This update will change the accounting for credit losses on loans and debt securities. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. For loans, this measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the "incurred loss" model required under current GAAP, which delays recognition until it is probable a loss has been incurred. In addition, the guidance will modify the other-than-temporary

impairment model for available-for-sale debt securities to require an allowance for credit impairment instead of a direct write-down, which will allow for reversal of credit impairments in future periods. This guidance is effective for public business entities that meet the definition of an SEC filer for fiscal years beginning after December 15, 2019, including interim periods in those fiscal years. The Company has formed a cross-functional committee that has evaluated existing technology and other solutions for calculating losses under this new standard, selected a vendor to validate data currently loaded in the technology solution selected, and reviewed the validation assessment report. The committee has selected a model and is working on initial calculations under the model. Management expects to recognize credit losses earlier upon adoption of this accounting standard and the expected credit loss model than it has historically done under the current incurred credit loss model. While the impact of implementing the CECL model cannot be quantified at this time, the Company expects to recognize a one-time cumulative-effect adjustment to the allowance upon adoption.

In January 2017, the FASB issued ASU No. 2017-04 "Intangibles - Goodwill and Other - Simplifying the Test for Goodwill Impairment." These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. Management does not expect the adoption of this new accounting standard to have a material impact on our financial statements.

Reclassifications

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassifications had no effect on net income or stockholders' equity as previously reported.

NOTE 2. SECURITIES

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income is provided in the tables below.

| (dollars in thousands) | Amortized Cost | Gross Unrealized Gain | Gross Unrealized Losses | Fair Value |
|---|-------------------|-----------------------------|-------------------------------|---------------|
| March 31, 2019 | | | | |
| U.S. Treasury securities | \$994 | \$0 | \$0 | \$994 |
| U.S. government sponsored agencies | 4,066 | 0 | (77) | 3,989 |
| Mortgage-backed securities: residential | 320,460 | 2,378 | (2,559) | 320,279 |
| Mortgage-backed securities: commercial | 38,244 | 1 | (216) | 38,029 |
| State and municipal securities | 226,924 | 5,624 | (286) | 232,262 |
| Total | \$590,688 | \$8,003 | \$(3,138) | \$595,553 |
| December 31, 2018 | | | | |
| U.S. Treasury securities | \$994 | \$0 | \$(7) | \$987 |
| U.S. government sponsored agencies | 4,435 | 0 | (85) | 4,350 |
| Mortgage-backed securities: residential | 329,516 | 1,392 | (5,496) | 325,412 |
| Mortgage-backed securities: commercial | 38,712 | 0 | (571) | 38,141 |
| State and municipal securities | 217,964 | 1,403 | (2,708) | 216,659 |
| Total | \$591,621 | \$2,795 | \$(8,867) | \$585,549 |

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of March 31, 2019 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without a prepayment penalty.

| (dollars in thousands) | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| Due in one year or less | \$1,732 | \$1,742 |
| Due after one year through five years | 25,086 | 25,342 |
| Due after five years through ten years | 25,267 | 25,970 |
| Due after ten years | 179,899 | 184,191 |
| Mortgage-backed securities | 231,984 | 237,245 |
| Total debt securities | 358,704 | 358,308 |
| | \$590,688 | \$595,553 |

Securities proceeds, gross gains and gross losses are presented below.

| (dollars in thousands) | Three months ended March 31, | |
|--|---------------------------------|----------|
| | 2019 | 2018 |
| Sales of securities available for sale | | |
| Proceeds | \$13,693 | \$12,322 |
| Gross gains | 70 | 21 |

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| | | |
|----------------------|------|------|
| Gross losses | (47) | (27) |
| Number of securities | 17 | 22 |

In accordance with ASU No. 2017-08, purchase premiums for callable securities are amortized to the earliest call date and premiums on non-callable securities as well as discounts are recognized in interest income using the interest method over the terms of

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the securities or over the estimated lives of mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date.

Securities with carrying values of \$62.0 million and \$164.7 million were pledged as of March 31, 2019 and December 31, 2018, respectively, as collateral for securities sold under agreements to repurchase, borrowings from the Federal Home Loan Bank and for other purposes as permitted or required by law.

Information regarding securities with unrealized losses as of March 31, 2019 and December 31, 2018 is presented below. The tables divide the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

| (dollars in thousands) | Less than 12 months | | 12 months or more | | Total | |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| March 31, 2019 | | | | | | |
| U.S. government sponsored agencies | \$1,644 | \$4 | \$2,345 | \$73 | \$3,989 | \$77 |
| Mortgage-backed securities: residential | 27,476 | 22 | 161,955 | 2,537 | 189,431 | 2,559 |
| Mortgage-backed securities: commercial | 5,096 | 8 | 28,819 | 208 | 33,915 | 216 |
| State and municipal securities | 7,138 | 51 | 19,685 | 235 | 26,823 | 286 |
| Total temporarily impaired | \$41,354 | \$85 | \$212,804 | \$3,053 | \$254,158 | \$3,138 |
| December 31, 2018 | | | | | | |
| U.S. Treasury securities | \$0 | \$0 | \$987 | \$7 | \$987 | \$7 |
| U.S. government sponsored agencies | 0 | 0 | 4,350 | 85 | 4,350 | 85 |
| Mortgage-backed securities: residential | 11,619 | 12 | 217,182 | 5,484 | 228,801 | 5,496 |
| Mortgage-backed securities: commercial | 0 | 0 | 38,141 | 571 | 38,141 | 571 |
| State and municipal securities | 26,229 | 124 | 85,982 | 2,584 | 112,211 | 2,708 |
| Total temporarily impaired | \$37,848 | \$136 | \$346,642 | \$8,731 | \$384,490 | \$8,867 |

The total number of securities with unrealized losses as of March 31, 2019 and December 31, 2018 is presented below.

| | Less than 12 months | | Total |
|---|---------------------|---------|-------|
| | 12 months | or more | |
| March 31, 2019 | | | |
| U.S. government sponsored agencies | 1 | 1 | 2 |
| Mortgage-backed securities: residential | 12 | 64 | 76 |
| Mortgage-backed securities: commercial | 1 | 7 | 8 |
| State and municipal securities | 10 | 22 | 32 |
| Total temporarily impaired | 24 | 94 | 118 |
| December 31, 2018 | | | |
| U.S. Treasury securities | 0 | 1 | 1 |
| U.S. government sponsored agencies | 0 | 2 | 2 |
| Mortgage-backed securities: residential | 5 | 84 | 89 |
| Mortgage-backed securities: commercial | 0 | 9 | 9 |
| State and municipal securities | 35 | 111 | 146 |

| | | | |
|----------------------------|----|-----|-----|
| Total temporarily impaired | 40 | 207 | 247 |
|----------------------------|----|-----|-----|

The following factors are considered in determining whether or not the impairment of these securities is other-than-temporary. In making this determination, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer, as well as the underlying fundamentals of the relevant market and the outlook for such market in the near future. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is

recognized in other comprehensive income. Credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. As of March 31, 2019 and December 31, 2018, all of the securities in the Company's portfolio were backed by the U.S. government, government agencies, government sponsored entities or were A-rated or better, except for certain non-local or local municipal securities, which are not rated. For the government, government agency, government-sponsored entity and municipal securities, management did not believe that there would be credit losses or that full principal would not be received. Management considers the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold. However, at this time management does not have the intent to sell, and it is more likely than not that the Company will not be required to sell these securities before the recovery of their amortized cost basis.

NOTE 3. LOANS

| (dollars in thousands) | March 31, 2019 | | December 31, 2018 | |
|---|-------------------|---------|----------------------|---------|
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | \$726,895 | 18.4 % | \$690,620 | 17.6 % |
| Non-working capital loans | 700,447 | 17.8 | 714,759 | 18.3 |
| Total commercial and industrial loans | 1,427,342 | 36.2 | 1,405,379 | 35.9 |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 293,818 | 7.5 | 266,805 | 6.8 |
| Owner occupied loans | 557,296 | 14.1 | 586,325 | 15.0 |
| Nonowner occupied loans | 537,569 | 13.7 | 520,901 | 13.3 |
| Multifamily loans | 240,939 | 6.1 | 195,604 | 5.0 |
| Total commercial real estate and multi-family residential loans | 1,629,622 | 41.4 | 1,569,635 | 40.1 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 139,645 | 3.6 | 177,503 | 4.6 |
| Loans for agricultural production | 162,662 | 4.1 | 193,010 | 4.9 |
| Total agri-business and agricultural loans | 302,307 | 7.7 | 370,513 | 9.5 |
| Other commercial loans | 112,021 | 2.8 | 95,657 | 2.4 |
| Total commercial loans | 3,471,292 | 88.1 | 3,441,184 | 87.9 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 188,777 | 4.8 | 185,822 | 4.7 |
| Open end and junior lien loans | 182,791 | 4.7 | 187,030 | 4.8 |
| Residential construction and land development loans | 13,142 | 0.3 | 16,226 | 0.4 |
| Total consumer 1-4 family mortgage loans | 384,710 | 9.8 | 389,078 | 9.9 |
| Other consumer loans | 84,650 | 2.1 | 86,064 | 2.2 |
| Total consumer loans | 469,360 | 11.9 | 475,142 | 12.1 |
| Subtotal | 3,940,652 | 100.0 % | 3,916,326 | 100.0 % |
| Less: Allowance for loan losses | (49,562) | | (48,453) | |
| Net deferred loan fees | (1,642) | | (1,581) | |
| Loans, net | \$3,889,448 | | \$3,866,292 | |

The recorded investment in loans does not include accrued interest.

The Company had \$533,000 in residential real estate loans in the process of foreclosure as of March 31, 2019, compared to \$586,000 as of December 31, 2018.

NOTE 4. ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The following tables present the activity in the allowance for loan losses by portfolio segment for the three-month periods ended March 31, 2019 and 2018:

| | Commercial | Commercial | Agri-business | Other | Consumer | Other | Unallocated | Total |
|-----------------------------------|------------|--------------------------------|---------------|------------|------------------------|----------|-------------|----------|
| | and | and Real Estate Multifamily | and | | 1-4 Family Mortgage | | | |
| (dollars in thousands) | Industrial | Residential | Agricultural | Commercial | Mortgage | Consumer | | |
| Three Months Ended March 31, 2019 | | | | | | | | |
| Beginning balance, January 1 | \$22,518 | \$15,393 | \$4,305 | \$368 | \$2,292 | \$283 | \$3,294 | \$48,453 |
| Provision for loan losses | 1,493 | 18 | (161) | 5 | 45 | 85 | (285) | 1,200 |
| Loans charged-off | (83) | 0 | 0 | 0 | (82) | (119) | 0 | (284) |
| Recoveries | 102 | 36 | 2 | 0 | 11 | 42 | 0 | 193 |
| Net loans charged-off | 19 | 36 | 2 | 0 | (71) | (77) | 0 | (91) |
| Ending balance | \$24,030 | \$15,447 | \$4,146 | \$373 | \$2,266 | \$291 | \$3,009 | \$49,562 |

| | Commercial | Commercial | Agri-business | Other | Consumer | Other | Unallocated | Total |
|-----------------------------------|------------|--------------------------------|---------------|------------|------------------------|----------|-------------|----------|
| | and | and Real Estate Multifamily | and | | 1-4 Family Mortgage | | | |
| (dollars in thousands) | Industrial | Residential | Agricultural | Commercial | Mortgage | Consumer | | |
| Three Months Ended March 31, 2018 | | | | | | | | |
| Beginning balance, January 1 | \$21,097 | \$14,714 | \$4,920 | \$577 | \$2,768 | \$379 | \$2,666 | \$47,121 |
| Provision for loan losses | 3,902 | 207 | (76) | (67) | (794) | (49) | 177 | 3,300 |
| Loans charged-off | (4,360) | (491) | 0 | 0 | (7) | (119) | 0 | (4,977) |
| Recoveries | 86 | 8 | 4 | 0 | 51 | 34 | 0 | 183 |
| Net loans charged-off | (4,274) | (483) | 4 | 0 | 44 | (85) | 0 | (4,794) |
| Ending balance | \$20,725 | \$14,438 | \$4,848 | \$510 | \$2,018 | \$245 | \$2,843 | \$45,627 |

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The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of March 31, 2019 and December 31, 2018:

| | Commercial and Industrial | Commercial Real Estate and Multifamily Residential | Agri-business and Agricultural | Other Commercial | Consumer 1-4 Family Mortgage | Consumer Other Consumer | Unallocated | Total |
|--|---------------------------------|--|--------------------------------------|---------------------|---------------------------------------|-------------------------------|-------------|-------------|
| (dollars in thousands) March 31, 2019 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |
| Ending allowance balance attributable to loans: | | | | | | | | |
| Individually evaluated for impairment | \$8,860 | \$398 | \$81 | \$0 | \$467 | \$28 | \$0 | \$9,834 |
| Collectively evaluated for impairment | 15,170 | 15,049 | 4,065 | 373 | 1,799 | 263 | 3,009 | 39,728 |
| Total ending allowance balance | \$24,030 | \$15,447 | \$4,146 | \$373 | \$2,266 | \$291 | \$3,009 | \$49,562 |
| Loans: | | | | | | | | |
| Loans individually evaluated for impairment | \$18,611 | \$3,441 | \$430 | \$0 | \$2,022 | \$43 | \$0 | \$24,547 |
| Loans collectively evaluated for impairment | 1,408,737 | 1,623,594 | 301,976 | 111,875 | 383,913 | 84,368 | 0 | 3,914,463 |
| Total ending loans balance | \$1,427,348 | \$1,627,035 | \$302,406 | \$111,875 | \$385,935 | \$84,411 | \$0 | \$3,939,010 |

| | Commercial and Industrial | Commercial Real Estate and Multifamily Residential | Agri-business and Agricultural | Other Commercial | Consumer 1-4 Family Mortgage | Consumer Other Consumer | Unallocated | Total |
|--|---------------------------------|--|--------------------------------------|---------------------|---------------------------------------|-------------------------------|-------------|-------|
| (dollars in thousands) December 31, 2018 | | | | | | | | |
| Allowance for loan losses: | | | | | | | | |

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Ending allowance balance
attributable to loans:

| | | | | | | | | |
|---|----------|----------|---------|-------|---------|-------|---------|----------|
| Individually evaluated for impairment | \$8,552 | \$921 | \$73 | \$0 | \$457 | \$26 | \$0 | \$10,029 |
| Collectively evaluated for impairment | 13,966 | 14,472 | 4,232 | 368 | 1,835 | 257 | 3,294 | 38,424 |
| Total ending allowance balance | \$22,518 | \$15,393 | \$4,305 | \$368 | \$2,292 | \$283 | \$3,294 | \$48,453 |

Loans:

| | | | | | | | | |
|--|-------------|-------------|-----------|----------|-----------|----------|-----|-------------|
| Loans individually evaluated for impairment | \$19,734 | \$4,266 | \$433 | \$0 | \$2,240 | \$44 | \$0 | \$26,717 |
| Loans collectively evaluated for impairment | 1,385,604 | 1,562,899 | 370,174 | 95,520 | 388,053 | 85,778 | 0 | 3,888,028 |
| Total ending loans balance | \$1,405,338 | \$1,567,165 | \$370,607 | \$95,520 | \$390,293 | \$85,822 | \$0 | \$3,914,745 |

The following table presents loans individually evaluated for impairment by class of loans as of March 31, 2019:

| (dollars in thousands) | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
|--|--------------------------------|------------------------|---|
| With no related allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | \$2,904 | \$212 | \$0 |
| Non-working capital loans | 2,345 | 950 | 0 |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 2,272 | 1,667 | 0 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 603 | 283 | 0 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 224 | 143 | 0 |
| Open end and junior lien loans | 98 | 98 | 0 |
| With an allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | 6,698 | 6,390 | 2,874 |
| Non-working capital loans | 11,016 | 11,059 | 5,986 |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 1,774 | 1,774 | 398 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 147 | 147 | 81 |
| Consumer 1-4 family mortgage loans: | | | |
| Closed end first mortgage loans | 1,779 | 1,781 | 467 |
| Other consumer loans | 43 | 43 | 28 |
| Total | \$29,903 | \$24,547 | \$9,834 |

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The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2018:

| (dollars in thousands) | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
|--|--------------------------------|------------------------|---|
| With no related allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Non-working capital loans | \$3,284 | \$1,889 | \$0 |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 1,773 | 1,527 | 0 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 603 | 283 | 0 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 583 | 502 | 0 |
| Open end and junior lien loans | 220 | 220 | 0 |
| With an allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | 9,691 | 6,694 | 2,602 |
| Non-working capital loans | 11,099 | 11,151 | 5,950 |
| Commercial real estate and multi-family residential loans: | | | |
| Construction and land development loans | 291 | 291 | 142 |
| Owner occupied loans | 2,938 | 2,448 | 779 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 150 | 150 | 73 |
| Consumer 1-4 family mortgage loans: | | | |
| Closed end first mortgage loans | 1,517 | 1,518 | 457 |
| Other consumer loans | 45 | 44 | 26 |
| Total | \$32,194 | \$26,717 | \$10,029 |

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The following table presents loans individually evaluated for impairment by class of loans as of and for the three-month period ended March 31, 2019:

| (dollars in thousands) | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized |
|--|-----------------------------------|----------------------------------|--|
| With no related allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | \$155 | \$1 | \$0 |
| Non-working capital loans | 1,549 | 29 | 24 |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 1,621 | 11 | 8 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 283 | 0 | 0 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 380 | 1 | 1 |
| Open end and junior lien loans | 193 | 0 | 0 |
| With an allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | 6,487 | 72 | 59 |
| Non-working capital loans | 11,416 | 132 | 128 |
| Commercial real estate and multi-family residential loans: | | | |
| Owner occupied loans | 2,080 | 13 | 12 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 147 | 2 | 1 |
| Consumer 1-4 family mortgage loans: | | | |
| Closed end first mortgage loans | 1,598 | 12 | 12 |
| Other consumer loans | 43 | 1 | 1 |
| Total | \$25,952 | \$274 | \$246 |

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The following table presents loans individually evaluated for impairment by class of loans as of and for the three-month period ended March 31, 2018:

| (dollars in thousands) | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized |
|--|-----------------------------------|----------------------------------|--|
| With no related allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | \$1,011 | \$7 | \$2 |
| Non-working capital loans | 1,728 | 15 | 5 |
| Commercial real estate and multi-family residential loans: | | | |
| Construction and land development loans | 102 | 1 | 0 |
| Owner occupied loans | 2,557 | 7 | 2 |
| Agri-business and agricultural loans: | | | |
| Loans secured by farmland | 283 | 0 | 0 |
| Consumer 1-4 family loans: | | | |
| Closed end first mortgage loans | 543 | 2 | 1 |
| Open end and junior lien loans | 92 | 0 | 0 |
| With an allowance recorded: | | | |
| Commercial and industrial loans: | | | |
| Working capital lines of credit loans | 1,608 | 2 | 1 |
| Non-working capital loans | 3,216 | 2 | 0 |
| Commercial real estate and multi-family residential loans: | | | |
| Construction and land development loans | 721 | 11 | 5 |
| Owner occupied loans | 1,194 | 0 | 0 |
| Consumer 1-4 family mortgage loans: | | | |
| Closed end first mortgage loans | 968 | 7 | 4 |
| Open end and junior lien loans | 154 | 0 | 0 |
| Other consumer loans | 49 | 1 | 0 |
| Total | \$14,226 | \$55 | \$20 |

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The following table presents the aging of the recorded investment in past due loans as of March 31, 2019 by class of loans:

| (dollars in thousands) | Loans Not Past Due | 30-89 Days Past Due | Greater than 90 Days Past Due and Still Accruing | Nonaccrual | Total Past Due and Nonaccrual | Total |
|--|-----------------------|---------------------------|---|----------------|-------------------------------------|--------------------|
| Commercial and industrial loans: | | | | | | |
| Working capital lines of credit loans | \$720,597 | \$4,308 | \$0 | \$2,118 | \$6,426 | \$727,023 |
| Non-working capital loans | 695,711 | 3,354 | 0 | 1,260 | 4,614 | 700,325 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Construction and land development loans | 292,627 | 0 | 0 | 0 | 0 | 292,627 |
| Owner occupied loans | 554,668 | 47 | 481 | 1,749 | 2,277 | 556,945 |
| Nonowner occupied loans | 536,900 | 142 | 0 | 0 | 142 | 537,042 |
| Multifamily loans | 240,421 | 0 | 0 | 0 | 0 | 240,421 |
| Agri-business and agricultural loans: | | | | | | |
| Loans secured by farmland | 139,230 | 147 | 0 | 283 | 430 | 139,660 |
| Loans for agricultural production | 162,746 | 0 | 0 | 0 | 0 | 162,746 |
| Other commercial loans | 111,875 | 0 | 0 | 0 | 0 | 111,875 |
| Consumer 1-4 family mortgage loans: | | | | | | |
| Closed end first mortgage loans | 186,373 | 1,466 | 0 | 588 | 2,054 | 188,427 |
| Open end and junior lien loans | 184,217 | 87 | 0 | 98 | 185 | 184,402 |
| Residential construction loans | 13,106 | 0 | 0 | 0 | 0 | 13,106 |
| Other consumer loans | 84,265 | 146 | 0 | 0 | 146 | 84,411 |
| Total | \$3,922,736 | \$9,697 | \$481 | \$6,096 | \$16,274 | \$3,939,010 |

The following table presents the aging of the recorded investment in past due loans as of December 31, 2018 by class of loans:

| (dollars in thousands) | Loans Not Past Due | 30-89 Days Past Due | Greater than 90 Days Past Due and Still Accruing | Nonaccrual | Total Past Due and Nonaccrual | Total |
|--|-----------------------|---------------------------|---|------------|-------------------------------------|-----------|
| Commercial and industrial loans: | | | | | | |
| Working capital lines of credit loans | \$684,191 | \$4,328 | \$0 | \$2,245 | \$6,573 | \$690,764 |
| Non-working capital loans | 709,629 | 3,368 | 0 | 1,577 | 4,945 | 714,574 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Construction and land development loans | 265,544 | 0 | 0 | 0 | 0 | 265,544 |
| Owner occupied loans | 583,214 | 486 | 0 | 2,269 | 2,755 | 585,969 |
| Nonowner occupied loans | 520,431 | 57 | 0 | 0 | 57 | 520,488 |
| Multi-family loans | 195,164 | 0 | 0 | 0 | 0 | 195,164 |
| Agri-business and agricultural loans: | | | | | | |
| Loans secured by farmland | 177,080 | 150 | 0 | 283 | 433 | 177,513 |
| Loans for agricultural production | 193,094 | 0 | 0 | 0 | 0 | 193,094 |
| Other commercial loans | 95,520 | 0 | 0 | 0 | 0 | 95,520 |

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| | | | | | | |
|-------------------------------------|-------------|----------|-----|---------|----------|-------------|
| Consumer 1-4 family mortgage loans: | | | | | | |
| Closed end first mortgage loans | 183,420 | 1,370 | 0 | 671 | 2,041 | 185,461 |
| Open end and junior lien loans | 188,320 | 98 | 0 | 220 | 318 | 188,638 |
| Residential construction loans | 16,194 | 0 | 0 | 0 | 0 | 16,194 |
| Other consumer loans | 85,654 | 168 | 0 | 0 | 168 | 85,822 |
| Total | \$3,897,455 | \$10,025 | \$0 | \$7,265 | \$17,290 | \$3,914,745 |

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Troubled Debt Restructurings:

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated \$2.9 million and \$3.7 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of March 31, 2019 and December 31, 2018, respectively. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

| (dollars in thousands) | March 31 | December 31 |
|---|----------|-------------|
| | 2019 | 2018 |
| Accruing troubled debt restructured loans | \$6,196 | \$8,016 |
| Nonaccrual troubled debt restructured loans | 3,812 | 4,384 |
| Total troubled debt restructured loans | \$10,008 | \$12,400 |

During the three months ending March 31, 2019, certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

Additional concessions were granted to borrowers with previously identified troubled debt restructured loans during the period. One of the loans is for a commercial real estate building where the cash flow does not support the loan with a recorded investment of \$533,000. The other loan is for commercial and industrial non-working capital purposes and this borrower had a recorded investment of \$70,000 that was subsequently paid off prior to March 31, 2019. These concessions are not included in table below.

The following table presents loans by class modified as new troubled debt restructurings that occurred during the three months ended March 31, 2019:

| (dollars in thousands) | Number of Loans | Pre-Modification | Post-Modification | Modified Repayment Terms | |
|---------------------------------------|-----------------|---------------------------------|---------------------------------|--------------------------|---------------------------------------|
| | | Outstanding Recorded Investment | Outstanding Recorded Investment | Number of Loans | Extension Period or Range (in months) |
| Troubled Debt Restructurings | | | | | |
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | 1 | 35 | 35 | 1 | 0 |
| Total | 1 | \$35 | \$35 | 1 | 0 |

For the three month period ending March 31, 2019, the troubled debt restructurings described above did not impact the allowance for loan losses and no charge-offs were recorded.

During the three months ended March 31, 2018, certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

Additional concessions were granted to borrowers with previously identified troubled debt restructured loans during the period. The loan to one of the borrowers is for a commercial real estate building where the collateral value and cash flows from the companies occupying the buildings do not support the loan with recorded investments of \$341,000. The loans to two other borrowers are for commercial and industrial capital and non-working capital loans with recorded investments of \$551,000. These concessions are not included in the following table.

The following table presents loans by class modified as new troubled debt restructurings that occurred during the three months ended March 31, 2018:

| (dollars in thousands) | Number of Loans | Pre-Modification | Post-Modification | Modified Repayment Terms | |
|--|-----------------|---------------------------------|---------------------------------|--------------------------|---------------------------------------|
| | | Outstanding Recorded Investment | Outstanding Recorded Investment | Number of Loans | Extension Period or Range (in months) |
| Troubled Debt Restructurings | | | | | |
| Commercial and industrial loans: | | | | | |
| Working capital lines of credit loans | 1 | \$600 | \$600 | 1 | 0 |
| Non-working capital loans | 1 | 1,400 | 1,400 | 1 | 0 |
| Commercial real estate and multi-family residential loans: | | | | | |
| Construction and land development loans | | | | | |
| Owner occupied loans | 1 | 824 | 824 | 1 | 12 |
| Owner occupied loans | 1 | 387 | 387 | 1 | 12 |
| Consumer 1-4 family loans: | | | | | |
| Closed end first mortgage loans | 1 | 198 | 197 | 1 | 239 |
| Total | 5 | \$3,409 | \$3,408 | 5 | 0-239 |

For the three-month period ending March 31, 2018, the troubled debt restructurings described in the table above decreased the allowance for loan losses by \$227,000, primarily due to the reduction of the allowance for loan losses on the construction and land development loan described in the table above.

For the three-month period ending March 31, 2018, charge-offs of \$1.6 million were recorded on the troubled debt restructurings described in the table above, which were from the charge-offs taken on the two commercial and industrial loans described in the table above.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$250,000.

The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as Special Mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as Substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain

some loss if the deficiencies are not corrected.

Doubtful. Loans classified as Doubtful have all the weaknesses inherent in those classified as Substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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Loans not meeting the criteria above that are analyzed individually as part of the above-described process are considered to be Pass rated loans with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans and consumer nonaccrual loans which are evaluated individually and listed with Not Rated loans. Loans listed as Not Rated are consumer loans or commercial loans with consumer characteristics included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of March 31, 2019, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| (dollars in thousands) | Pass | Special Mention | Substandard | Doubtful | Not Rated | Total |
|--|-------------|--------------------|-------------|----------|--------------|-------------|
| Commercial and industrial loans: | | | | | | |
| Working capital lines of credit loans | \$638,075 | \$59,140 | \$29,489 | \$0 | \$319 | \$727,023 |
| Non-working capital loans | 651,748 | 17,072 | 25,632 | 0 | 5,873 | 700,325 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Construction and land development loans | 292,275 | 352 | 0 | 0 | 0 | 292,627 |
| Owner occupied loans | 509,539 | 25,024 | 22,382 | 0 | 0 | 556,945 |
| Nonowner occupied loans | 533,975 | 2,439 | 628 | 0 | 0 | 537,042 |
| Multifamily loans | 240,211 | 210 | 0 | 0 | 0 | 240,421 |
| Agri-business and agricultural loans: | | | | | | |
| Loans secured by farmland | 128,492 | 9,388 | 1,780 | 0 | 0 | 139,660 |
| Loans for agricultural production | 153,470 | 7,476 | 1,800 | 0 | 0 | 162,746 |
| Other commercial loans | 111,871 | 0 | 0 | 0 | 4 | 111,875 |
| Consumer 1-4 family mortgage loans: | | | | | | |
| Closed end first mortgage loans | 56,681 | 0 | 1,924 | 0 | 129,822 | 188,427 |
| Open end and junior lien loans | 8,613 | 0 | 98 | 0 | 175,691 | 184,402 |
| Residential construction loans | 0 | 0 | 0 | 0 | 13,106 | 13,106 |
| Other consumer loans | 12,868 | 0 | 43 | 0 | 71,500 | 84,411 |
| Total | \$3,337,818 | \$121,101 | \$83,776 | \$0 | \$396,315 | \$3,939,010 |

As of December 31, 2018, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| (dollars in thousands) | Pass | Special Mention | Substandard | Doubtful | Not Rated | Total |
|--|-----------|--------------------|-------------|----------|--------------|-----------|
| Commercial and industrial loans: | | | | | | |
| Working capital lines of credit loans | \$618,612 | \$43,240 | \$28,563 | \$0 | \$349 | \$690,764 |
| Non-working capital loans | 664,787 | 15,992 | 27,548 | 0 | 6,247 | 714,574 |
| Commercial real estate and multi-family residential loans: | | | | | | |
| Construction and land development loans | 264,900 | 353 | 291 | 0 | 0 | 265,544 |
| Owner occupied loans | 541,734 | 21,864 | 22,371 | 0 | 0 | 585,969 |
| Nonowner occupied loans | 517,356 | 2,491 | 641 | 0 | 0 | 520,488 |
| Multifamily loans | 194,948 | 216 | 0 | 0 | 0 | 195,164 |
| Agri-business and agricultural loans: | | | | | | |
| Loans secured by farmland | 166,623 | 9,107 | 1,783 | 0 | 0 | 177,513 |
| Loans for agricultural production | 183,189 | 8,155 | 1,750 | 0 | 0 | 193,094 |
| Other commercial loans | 95,516 | 0 | 0 | 0 | 4 | 95,520 |
| Consumer 1-4 family mortgage loans: | | | | | | |

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| | | | | | | |
|---------------------------------|-------------|-----------|----------|-----|-----------|-------------|
| Closed end first mortgage loans | 54,879 | 0 | 2,021 | 0 | 128,561 | 185,461 |
| Open end and junior lien loans | 8,810 | 0 | 220 | 0 | 179,608 | 188,638 |
| Residential construction loans | 0 | 0 | 0 | 0 | 16,194 | 16,194 |
| Other consumer loans | 12,700 | 0 | 44 | 0 | 73,078 | 85,822 |
| Total | \$3,324,054 | \$101,418 | \$85,232 | \$0 | \$404,041 | \$3,914,745 |

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NOTE 5. FAIR VALUE DISCLOSURES

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (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. There are three levels of inputs that may be used to measure fair values:

- Level 1 Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2 Significant other 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.
- Level 3 Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Securities: Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. For certain municipal securities that are not rated and observable inputs about the specific issuer are not available, fair values are estimated using observable data from other municipal securities presumed to be similar or other market data on other non-rated municipal securities (Level 3 inputs).

The Company's Finance Department, which is responsible for all accounting and SEC compliance, and the Company's Treasury Department, which is responsible for investment portfolio management and asset/liability modeling, are the two areas that determine the Company's valuation policies and procedures. Both of these areas report directly to the Executive Vice President and Chief Financial Officer of the Company. For assets or liabilities that may be considered for Level 3 fair value measurement on a recurring basis, these two departments and the Executive Vice President and Chief Financial Officer determine the appropriate level of the assets or liabilities under consideration. If there are assets or liabilities that are determined to be Level 3 by this group, the Risk Management Committee of the Company and the Audit Committee of the Board are made aware of such assets at their next scheduled meeting.

Securities pricing is obtained on securities from a third party pricing service and all security prices are tested annually against prices from another third party provider and reviewed with a market value price tolerance variance that varies by sector: municipal securities +/- 5%, government mbs/cmo +/- 3% and U.S. treasuries +/-1%. If any securities fall outside the tolerance threshold and have a variance of \$100,000 or more, a determination of materiality is made for the amount over the threshold. Any security that would have a material threshold difference would be further investigated to determine why the variance exists and if any action is needed concerning the security pricing for that individual security. Changes in market value are reviewed monthly in aggregate by security type and any material differences are reviewed to determine why they exist. At least annually, the pricing methodology of the pricing service is received and reviewed to support the fair value levels used by the Company. A detailed pricing evaluation is requested and reviewed on any security determined to be fair valued using unobservable inputs by the pricing service.

Mortgage banking derivative: The fair values of mortgage banking derivatives are based on observable market data as of the measurement date (Level 2).

Interest rate swap derivatives: Our derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. The fair value of interest rate swap derivatives is determined by pricing or valuation models using observable market data as of the measurement date (Level 2).

Impaired loans: Impaired loans with specific allocations of the allowance for loan losses are generally based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Fair value is determined using several methods. Generally, the fair value of real estate is based on appraisals by qualified third party appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and result in a Level 3 classification of the inputs for determining fair value. In addition, the Company's management routinely applies internal discount factors to the value of appraisals used in the fair value evaluation of impaired loans. The deductions to the appraisals take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. Commercial real estate is generally discounted from its appraised value by 0-50% with the higher discounts applied to real estate that is determined to have a thin trading market or to be specialized collateral. In addition to real estate, the Company's management evaluates other types of collateral as follows: (a) raw and finished inventory is discounted from its cost or book value by 35-65%, depending on the marketability of the goods (b) finished goods are generally discounted by 30-60%, depending on the ease of marketability, cost of transportation or scope of use of the finished good (c) work in process inventory is typically discounted by 50-100%, depending on the length of manufacturing time, types of components used in the completion process, and the breadth of the user base (d) equipment is valued at a percentage of depreciated book value or recent appraised value, if available, and is typically discounted at 30-70% after various considerations including age and condition of the equipment, marketability, breadth of use, and whether the equipment includes unique components or add-ons; and (e) marketable securities are discounted by 10-30%, depending on the type of investment, age of valuation report and general market conditions. This methodology is based on a market approach and typically results in a Level 3 classification of the inputs for determining fair value.

Mortgage servicing rights: As of March 31, 2019, the fair value of the Company's Level 3 servicing assets for residential mortgage loans ("MSRs") was \$4.5 million, none of which are currently impaired and therefore are carried at amortized cost. These residential mortgage loans have a weighted average interest rate of 3.93%, a weighted average maturity of 20 years and are secured by homes generally within the Company's market area of Northern Indiana and Indianapolis. A valuation model is used to estimate fair value by stratifying the portfolios on the basis of certain risk characteristics, including loan type and interest rate. Impairment is estimated based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value MSRs is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. The most significant unobservable assumption is the discount rate. At March 31, 2019, the constant prepayment speed ("PSA") used was 77 and discount rate used was 9.4%. At December 31, 2018, the PSA used was 81 and the discount rate used was 9.4%.

Other real estate owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are reviewed by the Company's internal appraisal officer. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable properties used to determine value. Such adjustments are usually significant and result in a Level 3 classification. In addition, the Company's management may apply discount factors to the appraisals to take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Real estate mortgage loans held for sale: Real estate mortgage loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors, and result in a Level 2 classification.

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The table below presents the balances of assets measured at fair value on a recurring basis:

| (dollars in thousands) | March 31, 2019 | | | Assets at Fair Value |
|---|----------------|------------|---------|-------------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets | | | | |
| U.S. Treasury securities | \$ 994 | \$ 0 | \$ 0 | \$ 994 |
| U.S. government sponsored agency securities | 0 | 3,989 | 0 | 3,989 |
| Mortgage-backed securities: residential | 0 | 320,279 | 0 | 320,279 |
| Mortgage-backed securities: commercial | 0 | 38,029 | 0 | 38,029 |
| State and municipal securities | 0 | 232,112 | 150 | 232,262 |
| Total Securities | 994 | 594,409 | 150 | 595,553 |
| Mortgage banking derivative | 0 | 209 | 0 | 209 |
| Interest rate swap derivative | 0 | 4,061 | 0 | 4,061 |
| Total assets | \$ 994 | \$ 598,679 | \$ 150 | \$ 599,823 |
| Liabilities | | | | |
| Mortgage banking derivative | 0 | 52 | 0 | 52 |
| Interest rate swap derivative | 0 | 4,388 | 0 | 4,388 |
| Total liabilities | \$ 0 | \$ 4,440 | \$ 0 | \$ 4,440 |

| (dollars in thousands) | December 31, 2018 | | | Assets at Fair Value |
|---|-------------------|------------|---------|-------------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets | | | | |
| U.S. Treasury securities | \$ 987 | \$ 0 | \$ 0 | \$ 987 |
| U.S. government sponsored agency securities | 0 | 4,350 | 0 | 4,350 |
| Mortgage-backed securities: residential | 0 | 325,412 | 0 | 325,412 |
| Mortgage-backed securities: commercial | 0 | 38,141 | 0 | 38,141 |
| State and municipal securities | 0 | 216,509 | 150 | 216,659 |
| Total Securities | 987 | 584,412 | 150 | 585,549 |
| Mortgage banking derivative | 0 | 95 | 0 | 95 |
| Interest rate swap derivative | 0 | 3,869 | 0 | 3,869 |
| Total assets | \$ 987 | \$ 588,376 | \$ 150 | \$ 589,513 |
| Liabilities | | | | |
| Mortgage banking derivative | 0 | 23 | 0 | 23 |
| Interest rate swap derivative | 0 | 4,025 | 0 | 4,025 |
| Total liabilities | \$ 0 | \$ 4,048 | \$ 0 | \$ 4,048 |

There were no transfers between Level 1 and Level 2 during the three months ended March 31, 2019 and there were no transfers between Level 1 and Level 2 during 2018.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2019 and 2018:

| (dollars in thousands) | State and Municipal Securities | |
|--|--------------------------------|--------|
| | 2019 | 2018 |
| Balance of recurring Level 3 assets at January 1 | \$ 150 | \$ 880 |
| Changes in fair value of securities | | |
| included in other comprehensive income | 0 | (4) |
| Principal payments | 0 | (45) |
| Balance of recurring Level 3 assets at March 31 | \$ 150 | \$ 831 |

The state and municipal securities measured at fair value included below are non-rated Indiana municipal revenue bonds and are not actively traded.

Quantitative Information about Level 3 Fair Value Measurements

| (dollars in thousands) | Fair Value at 3/31/2019 | Valuation Technique | Unobservable Input | Range of Inputs (Average) |
|--------------------------------|----------------------------|--------------------------|-----------------------------|---------------------------------|
| State and municipal securities | \$ 150 | Price to type, par, call | Discount to benchmark index | 0-1% (0.17%) |

Quantitative Information about Level 3 Fair Value Measurements

| (dollars in thousands) | Fair Value at 12/31/2018 | Valuation Technique | Unobservable Input | Range of Inputs (Average) |
|--------------------------------|-----------------------------|--------------------------|-----------------------------|---------------------------------|
| State and municipal securities | \$ 150 | Price to type, par, call | Discount to benchmark index | 0-1% (0.17%) |

The primary methodology used in the fair value measurement of the Company's state and municipal securities classified as Level 3 is a discount to the AAA municipal benchmark index. Significant increases or (decreases) in this index as well as the degree to which the security differs in ratings, coupon, call and duration will result in a higher or (lower) fair value measurement for those securities that are not callable. For those securities that are continuously callable, a slight premium to par is used.

The table below presents the balances of assets measured at fair value on a nonrecurring basis:

| (dollars in thousands) | March 31, 2019 | | | Assets at Fair Value |
|--|----------------|---------|----------|-------------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets | | | | |
| Impaired loans: | | | | |
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | \$ 0 | \$ 0 | \$ 3,693 | \$ 3,693 |
| Non-working capital loans | 0 | 0 | 4,787 | 4,787 |
| Commercial real estate and multi-family residential loans: | | | | |
| Owner occupied loans | 0 | 0 | 732 | 732 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 0 | 0 | 66 | 66 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 0 | 0 | 486 | 486 |
| Total impaired loans | \$ 0 | \$ 0 | \$ 9,764 | \$ 9,764 |
| Other real estate owned | 0 | 0 | 0 | 0 |
| Total assets | \$ 0 | \$ 0 | \$ 9,764 | \$ 9,764 |

| (dollars in thousands) | December 31, 2018 | | | Assets at Fair Value |
|--|-------------------|---------|-----------|-------------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets | | | | |
| Impaired loans: | | | | |
| Commercial and industrial loans: | | | | |
| Working capital lines of credit loans | \$ 0 | \$ 0 | \$ 4,092 | \$ 4,092 |
| Non-working capital loans | 0 | 0 | 4,967 | 4,967 |
| Commercial real estate and multi-family residential loans: | | | | |
| Construction and land development loans | 0 | 0 | 148 | 148 |
| Owner occupied loans | 0 | 0 | 1,669 | 1,669 |
| Agri-business and agricultural loans: | | | | |
| Loans secured by farmland | 0 | 0 | 77 | 77 |
| Consumer 1-4 family mortgage loans: | | | | |
| Closed end first mortgage loans | 0 | 0 | 553 | 553 |
| Total impaired loans | \$ 0 | \$ 0 | \$ 11,506 | \$ 11,506 |
| Other real estate owned | 0 | 0 | 316 | 316 |
| Total assets | \$ 0 | \$ 0 | \$ 11,822 | \$ 11,822 |

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The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at March 31, 2019:

| (dollars in thousands) | Fair Value | Valuation Methodology | Unobservable Inputs | Average | Range of Inputs |
|-------------------------------|------------|-------------------------------|---|---------|-----------------|
| Impaired loans: | | | | | |
| Commercial and industrial | \$ 8,480 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 51% | 0%-100% |
| Impaired loans: | | | | | |
| Commercial real estate | 732 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 35% | 0%-53% |
| Impaired loans: | | | | | |
| Agribusiness and agricultural | 66 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 55% | |
| Impaired loans: | | | | | |
| Consumer 1-4 family mortgage | 486 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 17% | 0%-21% |

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at December 31, 2018:

| (dollars in thousands) | Fair Value | Valuation Methodology | Unobservable Inputs | Average | Range of Inputs |
|---------------------------|------------|-------------------------------|---|---------|-----------------|
| Impaired loans: | | | | | |
| Commercial and industrial | \$ 9,059 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 48% | 4%-100% |
| Impaired loans: | | | | | |
| Commercial real estate | 1,817 | Collateral based measurements | Discount to reflect current market conditions | 34% | 6%-53% |

| | | | and ultimate collectability | | |
|---|-----|----------------------------------|---|-----|--------|
| Impaired loans: Agribusiness and agricultural | 77 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 49% | |
| Impaired loans: Consumer 1-4 family mortgage | 553 | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 23% | 0%-64% |
| Other real estate owned | 316 | Collateral based measurements | Discount to reflect current market conditions | 0% | |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of \$19.1 million, with a valuation allowance of \$9.3 million at March 31, 2019. The change from December 31, 2018 in the fair value of impaired loans resulted in a reduction in the provision for loan losses of \$200,000, over the three months ended March 31, 2019. At March 31, 2018, impaired loans had a gross carrying amount of \$7.9 million, with a valuation allowance of \$1.9 million. The change from December 31, 2017 in the fair value of impaired loans resulted in a net increase in the provision for loan losses of \$4.2 million, primarily due to a partial charge-off on one commercial lending relationship in the amount of \$4.6 million, over the three months ended March 31, 2018.

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments. Items which are not financial instruments are not included.

| (dollars in thousands) | March 31, 2019 | | | | |
|--|-------------------|----------------------|-------------|-----------|-------------|
| | Carrying Value | Estimated Fair Value | | | Total |
| | | Level 1 | Level 2 | Level 3 | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$ 188,753 | \$ 185,998 | \$ 2,755 | \$ 0 | \$ 188,753 |
| Securities available for sale | 595,553 | 994 | 594,409 | 150 | 595,553 |
| Real estate mortgages held for sale | 3,047 | 0 | 3,085 | 0 | 3,085 |
| Loans, net | 3,889,448 | 0 | 0 | 3,816,004 | 3,816,004 |
| Federal Reserve and Federal Home Loan Bank stock | 13,772 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 17,387 | 8 | 3,110 | 14,269 | 17,387 |
| Financial Liabilities: | | | | | |
| Certificates of deposit | (1,406,580) | 0 | (1,413,329) | 0 | (1,413,329) |
| All other deposits | (2,740,857) | (2,740,857) | 0 | 0 | (2,740,857) |
| Other short-term borrowings | (122,000) | (122,000) | 0 | 0 | (122,000) |
| Subordinated debentures | (30,928) | 0 | 0 | (31,199) | (31,199) |
| Standby letters of credit | (1,151) | 0 | 0 | (1,151) | (1,151) |
| Accrued interest payable | (11,794) | (168) | (11,621) | (5) | (11,794) |
| | | | | | |
| (dollars in thousands) | December 31, 2018 | | | | |
| | Carrying Value | Estimated Fair Value | | | Total |
| | | Level 1 | Level 2 | Level 3 | |
| Financial Assets: | | | | | |
| Cash and cash equivalents | \$ 216,922 | \$ 214,452 | \$ 2,470 | \$ 0 | \$ 216,922 |
| Securities available for sale | 585,549 | 987 | 584,412 | 150 | 585,549 |
| Real estate mortgages held for sale | 2,293 | 0 | 2,314 | 0 | 2,314 |
| Loans, net | 3,866,292 | 0 | 0 | 3,786,175 | 3,786,175 |
| Federal Reserve and Federal Home Loan Bank stock | 13,772 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 15,518 | 3 | 3,569 | 11,946 | 15,518 |
| Financial Liabilities: | | | | | |
| Certificates of deposit | (1,419,754) | 0 | (1,424,553) | 0 | (1,424,553) |
| All other deposits | (2,624,311) | (2,624,311) | 0 | 0 | (2,624,311) |
| Securities sold under agreements to repurchase | (75,555) | 0 | (75,555) | 0 | (75,555) |
| Other short-term borrowings | (170,000) | 0 | (169,996) | 0 | (169,996) |
| Subordinated debentures | (30,928) | 0 | 0 | (31,195) | (31,195) |
| Standby letters of credit | (978) | 0 | 0 | (978) | (978) |
| Accrued interest payable | (10,404) | (110) | (10,289) | (5) | (10,404) |

NOTE 6. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase represent collateralized borrowings with customers located primarily within the Company's service area. These repurchase liabilities are not covered by federal deposit insurance and are secured by securities owned. The Company retains the right to substitute similar type securities and has the right to withdraw all excess collateral applicable to the repurchase liabilities whenever the collateral values are in excess of the related repurchase liabilities. However, as a means of mitigating market risk, the Company maintains excess collateral to cover normal changes in the repurchase liability by monitoring daily usage. The Company maintains control of the securities through the use of third-party safekeeping arrangements.

There were no securities sold under agreements to repurchase at March 31, 2019. Securities sold under agreements to repurchase of \$75.6 million, which matured on demand, were secured by mortgage-backed securities with a carrying amount of \$100.7 million at December 31, 2018. Additional information concerning recognition of these liabilities is disclosed in Note 8.

NOTE 7. EMPLOYEE BENEFIT PLANS

Components of net periodic benefit cost:

| | Three Months Ended | | | |
|--------------------------------------|--------------------|----------|----------|----------|
| | March 31, | | SERP | |
| | Pension | | SERP | |
| (dollars in thousands) | Benefits | Benefits | Benefits | Benefits |
| | 2019 | 2018 | 2019 | 2018 |
| Service cost | \$0 | \$0 | \$0 | \$0 |
| Interest cost | 22 | 23 | 9 | 9 |
| Expected return on plan assets | (34) | (34) | (13) | (15) |
| Recognized net actuarial (gain) loss | 32 | 48 | 18 | 18 |
| Net pension expense (benefit) | \$20 | \$37 | \$14 | \$12 |

The Company previously disclosed in its financial statements for the year ended December 31, 2018 that it expected to contribute \$0 to its pension plan and \$0 to its Supplemental Executive Retirement Plan ("SERP") in 2019. The Company has not made any contributions to its pension plan or to its SERP as of March 31, 2019. The Company does not expect to make any additional contributions to its pension plan or SERP during the remainder of 2019. As a result of freezing the plan effective April 1, 2000, there is no service cost to record on the pension plan or the SERP for the three-month periods ending March 31, 2019 and 2018. All other components of cost noted in the table above were recorded in other expense under noninterest expenses on the Consolidated Statements of Income for all periods presented.

NOTE 8. OFFSETTING ASSETS AND LIABILITIES

The following tables summarize gross and net information about financial instruments and derivative instruments that are offset in the statement of financial position or that are subject to an enforceable master netting arrangement at March 31, 2019 and December 31, 2018.

| March 31, 2019 | | | |
|----------------|---------------|--------------|-------------------------|
| | Gross | | |
| Gross | Amounts | Net Amounts | Gross Amounts Not |
| Amounts of | Offset in the | presented in | Offset in the Statement |

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| (dollars in thousands) | Recognized Assets/ Liabilities | Statement of Financial Position | the Statement of Financial Position | of Financial Financial Instruments | Position Cash Collateral Received | of Financial Position Net Amount |
|--------------------------------|--------------------------------------|---------------------------------------|---|--|---|-------------------------------------|
| Assets | | | | | | |
| Interest Rate Swap Derivatives | \$4,061 | \$0 | \$4,061 | \$0 | \$(410) | \$3,651 |
| Total Assets | \$4,061 | \$0 | \$4,061 | \$0 | \$(410) | \$3,651 |
| Liabilities | | | | | | |
| Interest Rate Swap Derivatives | \$4,388 | \$0 | \$4,388 | \$0 | \$(3,730) | \$658 |
| Repurchase Agreements | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Liabilities | \$4,388 | \$0 | \$4,388 | \$0 | \$(3,730) | \$658 |

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| (dollars in thousands) | December 31, 2018 | | | | | |
|--------------------------------|---|--|--|---|--|------------|
| | Gross Amounts of Recognized Assets/ Liabilities | Gross Amounts Offset in the Statement of Financial Position | Net Amounts presented in the Statement of Financial Position | Gross Amounts Offset in the Statement of Financial Position | Gross Amounts Not Offset in the Statement of Financial Position | Net Amount |
| Assets | | | | | | |
| Interest Rate Swap Derivatives | \$3,869 | \$0 | \$3,869 | \$0 | \$(760) | \$3,109 |
| Total Assets | \$3,869 | \$0 | \$3,869 | \$0 | \$(760) | \$3,109 |
| Liabilities | | | | | | |
| Interest Rate Swap Derivatives | \$4,025 | \$0 | \$4,025 | \$0 | \$(560) | \$3,465 |
| Repurchase Agreements | 75,555 | 0 | 75,555 | (75,555) | 0 | 0 |
| Total Liabilities | \$79,580 | \$0 | \$79,580 | \$(75,555) | \$(560) | \$3,465 |

If an event of default occurs causing an early termination of an interest rate swap derivative, any early termination amount payable to one party by the other party may be reduced by set-off against any other amount payable by the one party to the other party. If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions.

NOTE 9. EARNINGS PER SHARE

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period, including shares held in treasury on behalf of participants in the Company's Directors Fee Deferral Plan. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options, stock awards and warrants, none of which were antidilutive.

| | Three Months Ended | |
|---|--------------------|------------|
| | March 31, 2019 | 2018 |
| Weighted average shares outstanding for basic earnings per common share | 25,491,093 | 25,257,414 |
| Dilutive effect of stock options, awards and warrants | 174,194 | 439,450 |
| Weighted average shares outstanding for diluted earnings per common share | 25,665,287 | 25,696,864 |
| Basic earnings per common share | \$0.85 | \$0.73 |
| Diluted earnings per common share | \$0.84 | \$0.71 |

NOTE 10. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss) net of tax for the three months ended March 31, 2019 and 2018:

| (dollars in thousands) | Unrealized Gains and Losses on Available- for-Sales Securities | Defined Benefit Pension Items | Total |
|---|---|--|-----------|
| Balance at January 1, 2019 | \$(4,796) | \$(1,395) | \$(6,191) |
| Other comprehensive income before reclassification | 8,663 | 0 | 8,663 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (23) | 38 | 15 |
| Net current period other comprehensive income | 8,640 | 38 | 8,678 |
| Balance at March 31, 2019 | \$3,844 | \$(1,357) | \$2,487 |

| (dollars in thousands) | Unrealized Gains and Losses on Available- for-Sales Securities | Defined Benefit Pension Items | Total |
|---|---|--|-----------|
| Balance at January 1, 2018 | \$784 | \$(1,454) | \$(670) |
| Other comprehensive income before reclassification | (7,132) | 0 | (7,132) |
| Amounts reclassified from accumulated other comprehensive income (loss) | 6 | 49 | 55 |
| Net current period other comprehensive income | (7,126) | 49 | (7,077) |
| Adoption of ASU 2018-02 | 140 | (313) | (173) |
| Adoption of ASU 2016-01 | (68) | 0 | (68) |
| Balance at March 31, 2018 | \$(6,270) | \$(1,718) | \$(7,988) |

Reclassifications out of accumulated comprehensive income for the three months ended March 31, 2019 are as follows:

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified From Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|--|--|--|
| (dollars in thousands) | | |
| Unrealized gains and losses on available-for-sale securities | \$23 | Net securities gains (losses) |
| Tax effect | 0 | Income tax expense |
| | 23 | Net of tax |
| Amortization of defined benefit pension items | (50) | Other expense |
| Tax effect | 12 | Income tax expense |
| | (38) | Net of tax |
| Total reclassifications for the period | \$(15) | Net income |

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Reclassifications out of accumulated comprehensive income for the three months ended March 31, 2018 are as follows:

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified From Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| (dollars in thousands) | | |
| Unrealized gains and losses on available-for-sale securities | \$(6) | Net securities gains (losses) |
| Tax effect | 0 | Income tax expense |
| | (6) | Net of tax |
| Amortization of defined benefit pension items | (66) | Other expense |
| Tax effect | 17 | Income tax expense |
| | (49) | Net of tax |
| Total reclassifications for the period | \$(55) | Net income |

NOTE 11. LEASES

The Company leases certain office facilities under long-term operating lease agreements. The leases expire at various dates through 2029 and some include renewal options. Many of these leases require the payment of property taxes, insurance premiums, maintenance and other costs. In many cases, rentals are subject to increase in relation to a cost-of-living index. The Company accounts for lease and non-lease components together as a single lease component. The Company determines if an arrangement is a lease at inception. Operating leases are recorded as a right-of-use (“ROU”) lease assets and are included in other assets on the consolidated balance sheet. The Company’s corresponding lease obligations are included in other liabilities on the consolidated balance sheet. ROU lease assets represent the Company’s right to use an underlying asset for the lease term and lease obligations represent the Company’s obligation to make lease payments arising from the lease. Operating ROU lease assets and obligations are recognized at the commencement date based on the present value of lease payments over the lease term. As most of the Company’s leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at the commencement date in determining the present value of lease payments. The ROU lease asset also includes any lease payments made and excludes lease incentives. The Company’s lease terms may include options to extend or terminate the lease when it is reasonably certain that the Company will exercise that option. Lease expense for lease payments is recognized on a straight-line basis over the lease term. Short-term leases are leases having a term of twelve months or less. The Company recognizes short-term leases on a straight-line basis and does not record a related lease asset or liability for such leases, as allowed as practical expedient of the standard. The following is a maturity analysis of the operating lease liabilities as of March 31, 2019:

| Years ending December 31, (in thousands) | Operating lease Obligation |
|---|--------------------------------------|
| 2019 | \$402 |
| 2020 | 561 |
| 2021 | 581 |
| 2022 | 595 |
| 2023 | 606 |
| 2024 - 2029 | 3,495 |
| Total undiscounted lease payments | 6,240 |
| Less imputed interest | (847) |
| Lease liability | \$5,393 |
| Right-of-use asset | \$5,393 |
| | Three months ended March 31, 2019 |
| Lease cost | |
| Operating lease cost | \$119 |
| Short-term lease cost | 6 |
| Total lease cost | \$125 |
| Other information | |
| Operating cash flows from operating leases | \$119 |
| Weighted-average remaining lease term - operating leases | 10.8 years |
| Weighted average discount | |

rate - operating leases 2.8%

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Net income in the first three months of 2019 was \$21.7 million, up 18.2% from \$18.3 million for the comparable period of 2018. Diluted income per common share was \$0.84 in the first three months of 2019, up 18.3% from \$0.71 in the comparable period of 2018. Annualized return on average total equity was 16.59% in the first three months of 2019 versus 15.82% in the comparable period of 2018. Annualized return on average total assets was 1.80% in the first three months of 2019 versus 1.58% in the comparable period of 2018. The average equity to average assets ratio was 10.86% in the first three months of 2019 versus 9.99% in the comparable period of 2018.

Total assets were \$4.892 billion as of March 31, 2019 versus \$4.875 billion as of December 31, 2018, an increase of \$16.6 million, or 0.3%. This increase was primarily due to a \$23.2 million increase in net loans as well as a \$10.0 million increase in securities available for sale, offset by a \$28.2 million decrease in cash and cash equivalents. Total deposits increased by \$103.4 million while total borrowings decreased by \$123.6 million. Total equity increased by \$21.6 million as a result of net income of \$21.7 million as well as an increase in accumulated other comprehensive income of \$8.7 million offset by dividends paid of \$0.26 per share totaling \$6.6 million.

CRITICAL ACCOUNTING POLICIES

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and the valuation and other-than-temporary impairment of investment securities.

Allowance for Loan Losses

The Company maintains an allowance for loan losses to provide for probable incurred credit losses. Loan losses are charged against the allowance when management believes that the principal is uncollectable. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance are made for specific loans and for pools of similar types of loans, although the entire allowance is available for any loan that, in management's judgment, should be charged against the allowance. A provision for loan losses is taken based on management's ongoing evaluation of the appropriate allowance balance. A formal evaluation of the adequacy of the loan loss allowance is conducted monthly. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The level of loan loss provision is influenced by growth in the overall loan portfolio, emerging market risk, emerging concentration risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss analysis. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Furthermore, management's overall view on credit quality is a factor in the determination of the provision.

The determination of the appropriate allowance is inherently subjective, as it requires significant estimates by management. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors although they represent the most commonly cited factors. With respect to specific allocation levels for individual credits, management considers the current valuation of collateral and the amounts and

timing of expected future cash flows as the primary measures. Management also considers trends in adversely classified loans based upon an ongoing review of those credits. With respect to pools of similar loans, allocations are assigned based upon historical experience unless the rate of loss is expected to be greater than historical losses as noted below. A detailed analysis is performed on loans that are classified but determined not to be impaired which incorporates different scenarios where the risk that the borrower will be unable or unwilling to repay its debt in full or on time is combined with an estimate of loss in the event the borrower cannot pay to develop non-specific allocations for such loan pools. These allocations may be adjusted based on the other factors cited above. An appropriate level of general allowance for pooled loans is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. It is also possible that the following could affect the overall process: social,

political, economic and terrorist events or activities. All of these factors are susceptible to change, which may be significant. As a result of this detailed process, the allowance results in two forms of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover probable losses inherent in the loan portfolio.

Commercial loans are subject to a dual standardized grading process administered by the credit administration function. These grade assignments are performed independent of each other and a consensus is reached by credit administration and the loan review officer. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that indicate the loan is impaired. Considerations with respect to specific allocations for these individual credits include, but are not limited to, the following: (a) does the customer's cash flow or net worth appear insufficient to repay the loan; (b) is there adequate collateral to repay the loan; (c) has the loan been criticized in a regulatory examination; (d) is the loan impaired; (e) are there other reasons where the ultimate collectability of the loan is in question; or (f) are there unique loan characteristics that require special monitoring.

Allocations are also applied to categories of loans considered not to be individually impaired, but for which the rate of loss is expected to be consistent with or greater than historical averages. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values. In addition, general allocations are made for other pools of loans, including non-classified loans. These general pooled loan allocations are performed for portfolio segments of commercial and industrial, commercial real estate and multi-family, agri-business and agricultural, other commercial, consumer 1-4 family mortgage and other consumer loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, and are subjectively adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes an unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as the level of classified credits, economic uncertainties, industry trends impacting specific portfolio segments, broad portfolio quality trends and trends in the composition of the Company's large commercial loan portfolio and related large dollar exposures to individual borrowers.

Valuation and Other-Than-Temporary Impairment of Investment Securities

The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges or pricing models, which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Different judgments and assumptions used in pricing could result in different estimates of value. The fair value of certain securities is determined using unobservable inputs, primarily observable inputs of similar securities.

At the end of each reporting period, securities held in the investment portfolio are evaluated on an individual security level for other-than-temporary impairment in accordance with current accounting guidance. Impairment is other-than-temporary if the decline in the fair value of the security is below its amortized cost and it is probable that all amounts due according to the contractual terms of a debt security will not be received.

Significant judgments are required in determining impairment, which includes making assumptions regarding the estimated prepayments, loss assumptions and the change in interest rates.

We consider the following factors when determining other-than-temporary impairment for a security or investment:

- the length of time and the extent to which the market value has been less than amortized cost;
- the financial condition and near-term prospects of the issuer;
- the underlying fundamentals of the relevant market and the outlook for such market for the near future; and
- our intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

The assessment of whether a decline exists that is other-than-temporary, involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. If, in management's judgment, other-than-temporary impairment exists, the cost basis of the security will be written down to the computed net present value, and the unrealized loss will be

transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of other-than-temporary impairment).

RESULTS OF OPERATIONS

Overview

Selected income statement information for the three months ended March 31, 2019 and 2018 is presented in the following table:

| (dollars in thousands) | Three Months Ended March 31, | |
|---|---------------------------------|----------|
| | 2019 | 2018 |
| Income Statement Summary: | | |
| Net interest income | \$38,209 | \$36,223 |
| Provision for loan losses | 1,200 | 3,300 |
| Noninterest income | 11,525 | 9,879 |
| Noninterest expense | 22,473 | 21,202 |
| Other Data: | | |
| Efficiency ratio (1) | 45.19% | 45.99% |
| Dilutive EPS | \$0.84 | \$0.71 |
| Total Equity | 543,267 | 473,333 |
| Tangible capital ratio (2) | 11.04% | 9.94% |
| Net charge-offs (recoveries) to average loans | 0.01% | 0.51% |
| Net interest margin | 3.45% | 3.36% |
| Noninterest income to total revenue | 23.17% | 21.43% |

(1) Noninterest expense/Net interest income plus Noninterest income.

(2) Non-GAAP financial measure. See reconciliation below.

| (dollars in thousands) | Three Months Ended March 31, | |
|---|---------------------------------|-------------|
| | 2019 | 2018 |
| Total Equity | \$543,267 | \$473,333 |
| Less: Goodwill | (4,970) | (4,970) |
| Plus: Deferred tax assets related to goodwill | 1,191 | 1,174 |
| Tangible Common Equity | 539,488 | 469,537 |
| | | |
| Total Assets | \$4,891,885 | \$4,726,948 |
| Less: Goodwill | (4,970) | (4,970) |
| Plus: Deferred tax assets related to goodwill | 1,191 | 1,174 |
| Tangible Assets | 4,888,106 | 4,723,152 |
| | | |
| Tangible Common Equity/Tangible Assets | 11.04% | 9.94% |

Net Income

Net income was \$21.7 million in the first three months of 2019, an increase of \$3.3 million, or 18.2%, versus net income of \$18.3 million in the first three months of 2018. The growth in net income of \$3.3 million for the first three months of 2019 as compared to the prior year period resulted primarily from increased net interest income of \$2.0 million, a decrease in provision expense of \$2.1 million and growth in noninterest income of \$1.6 million. These increases were offset by an increase in noninterest expense of \$1.3 million and an increase in income tax expense of \$1.1 million.

Net Interest Income

The following tables set forth consolidated information regarding average balances and rates:

| (fully tax equivalent basis, dollars in thousands) | Three Months Ended March 31, 2019 | | | 2018 | | | Yield (1)/ Rate | |
|--|-----------------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--|
| | Average Balance | Interest Income | Yield (1)/ Rate | Average Balance | Interest Income | Yield (1)/ Rate | | |
| Earning Assets | | | | | | | | |
| Loans: | | | | | | | | |
| Taxable (2)(3) | \$3,893,035 | \$48,866 | 5.09 | % \$3,767,300 | \$41,794 | 4.50 | % | |
| Tax exempt (1) | 24,989 | 314 | 5.10 | 24,622 | 272 | 4.48 | | |
| Investments: (1) | | | | | | | | |
| Available for sale | 587,026 | 4,575 | 3.16 | 546,042 | 4,119 | 3.06 | | |
| Short-term investments | 4,696 | 26 | 2.25 | 4,579 | 9 | 0.80 | | |
| Interest bearing deposits | 41,204 | 212 | 2.09 | 78,918 | 283 | 1.45 | | |
| Total earning assets | \$4,550,950 | \$53,993 | 4.81 | % \$4,421,461 | \$46,477 | 4.26 | % | |
| Less: Allowance for loan losses | (48,768) | | | (47,189) | | | | |
| Nonearning Assets | | | | | | | | |
| Cash and due from banks | 164,820 | | | 137,738 | | | | |
| Premises and equipment | 58,599 | | | 56,192 | | | | |
| Other nonearning assets | 155,971 | | | 138,524 | | | | |
| Total assets | \$4,881,572 | | | \$4,706,726 | | | | |
| Interest Bearing Liabilities | | | | | | | | |
| Savings deposits | \$247,309 | \$71 | 0.12 | % \$268,091 | \$89 | 0.13 | % | |
| Interest bearing checking accounts | 1,496,893 | 5,954 | 1.61 | 1,491,820 | 3,575 | 0.97 | | |
| Time deposits: | | | | | | | | |
| In denominations under \$100,000 | 276,006 | 1,232 | 1.81 | 255,209 | 848 | 1.35 | | |
| In denominations over \$100,000 | 1,184,996 | 6,626 | 2.27 | 1,238,189 | 4,855 | 1.59 | | |
| Miscellaneous short-term borrowings | 190,118 | 950 | 2.03 | 82,862 | 111 | 0.54 | | |
| Long-term borrowings and subordinated debentures | 30,928 | 452 | 5.93 | 30,933 | 367 | 4.81 | | |
| Total interest bearing liabilities | \$3,426,250 | \$15,285 | 1.81 | % \$3,367,104 | \$9,845 | 1.19 | % | |
| Noninterest Bearing Liabilities | | | | | | | | |
| Demand deposits | 885,126 | | | 841,608 | | | | |
| Other liabilities | 40,207 | | | 28,016 | | | | |
| Stockholders' Equity | 529,989 | | | 469,998 | | | | |
| Total liabilities and stockholders' equity | \$4,881,572 | | | \$4,706,726 | | | | |
| Interest Margin Recap | | | | | | | | |
| Interest income/average earning assets | | 53,993 | 4.81 | | 46,477 | 4.26 | | |
| Interest expense/average earning assets | | 15,285 | 1.36 | | 9,845 | 0.90 | | |
| Net interest income and margin | | \$38,708 | 3.45 | % | \$36,632 | 3.36 | % | |

Tax exempt income was converted to a fully taxable equivalent basis at a 21 percent tax rate. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the Tax Equity and (1)Fiscal Responsibility Act of 1982 (“TEFRA”) adjustment applicable to nondeductible interest expenses. Taxable equivalent basis adjustments were \$499,000 and \$409,000 in the three-month periods ended March 31, 2019 and 2018, respectively.

(2) Loan fees, which are immaterial in relation to total taxable loan interest income for the three months ended March 31, 2019 and 2018, are included as taxable loan interest income.

(3)Nonaccrual loans are included in the average balance of taxable loans.

Net interest income increased \$2.0 million, or 5.5%, for the three months ended March 31, 2019 compared with the first three months of 2018. The increased level of net interest income during the first three months of 2019 was largely driven by an increase in average earning assets of \$129.5 million, due primarily to loan growth. Average loans outstanding increased \$126.1 million to \$3.918 billion during the three months ended March 31, 2019 compared to \$3.792 billion during the same period of 2018, with most of the growth being in commercial loans. The earning asset growth was funded through an increase in short-term borrowings. Average deposits decreased \$4.6 million to \$4.090 billion during the three months ended March 31, 2019 compared to \$4.095 billion for the same period of 2018. Total deposits are comprised of core deposits and brokered deposits. During this same period average core deposits increased \$68.9 million and average brokered deposits decreased \$73.4 million. Average borrowings increased by \$107.3 million to \$221.0 million in the three months ended March 31, 2019, compared to \$113.8 million during the same period of 2018.

The tax equivalent net interest margin was 3.45% for the first three months of 2019 compared to 3.36% during the first three months of 2018. The yield on earning assets totaled 4.81% during the three months ended March 31, 2019 compared to 4.26% in the same period of 2018. Cost of funds (expressed as a percentage of average earning assets) totaled 1.36% during the first three months of 2019 compared to 0.90% in the same period of 2018. The higher margin in the first quarter of 2019 was due to higher yields on loans, partially offset by a higher cost of funds driven by the Federal Reserve Bank increasing the target Federal Funds Rate in March, June, September and December of 2018.

Provision for Loan Losses

The Company recorded a provision for loan loss expense of \$1.2 million in the three-month period ended March 31, 2019, compared to a provision of \$3.3 million during the comparable period of 2018. The primary factors impacting management's decision to record a lower the provision in the first three months of 2019 were lower net charge-offs taken during the first quarter of 2019 versus the first quarter of 2018. Net charge-offs in the first quarter of 2019 were \$91,000 versus net charge-offs of \$4.8 million in the first quarter of 2018 and net charge-offs of \$189,000 during the linked fourth quarter of 2018. Additional factors considered by management included the continued stability in key loan quality metrics, including appropriate reserve coverage of nonperforming loans and stable economic conditions in the Company's markets, and changes in the allocation for specific watch list credits. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continues to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

Noninterest Income

Noninterest income categories for the three-month periods ended March 31, 2019 and 2018 are shown in the following table:

| (dollars in thousands) | Three Months Ended | | Percent | |
|-------------------------------------|--------------------|---------|---------|---|
| | 2019 | 2018 | Change | |
| Wealth advisory fees | \$1,620 | \$1,505 | 7.6 | % |
| Investment brokerage fees | 386 | 290 | 33.1 | |
| Service charges on deposit accounts | 4,287 | 3,628 | 18.2 | |
| Loan and service fees | 2,404 | 2,177 | 10.4 | |
| Merchant card fee income | 622 | 642 | (3.1) | |
| Bank owned life insurance | 444 | 363 | 22.3 | |
| Mortgage banking income | 222 | 241 | (7.9) | |
| Net securities gains (losses) | 23 | (6) | (483.3) | |
| Other income | 1,517 | 1,039 | 46.0 | |
| Total noninterest income | \$11,525 | \$9,879 | 16.7 | % |
| Noninterest income to total revenue | 23.17% | 21.43% | | |

The Company's noninterest income increased \$1.6 million, or 16.7%, to \$11.5 million for the first quarter of 2019, compared to \$9.9 million for the first quarter of 2018. Noninterest income was positively impacted by an 18.2% increase over the prior year first quarter in recurring fee income for service charges on deposit accounts, primarily due to growth in treasury management fees from business accounts. In addition, loan and service fees increased 10.4% and wealth advisory fees increased by 7.6% compared to the year ago period due to continued growth of client relationships. Other income increased primarily due to a gain related to proceeds from bank owned life insurance.

Noninterest Expense

Noninterest expense categories for the three-month periods ended March 31, 2019 and 2018 are shown in the following tables:

| (dollars in thousands) | Three Months Ended March 31, | | |
|--|---------------------------------|----------|-------------------|
| | 2019 | 2018 | Percent Change |
| Salaries and employee benefits | \$12,559 | \$12,019 | 4.5 % |
| Net occupancy expense | 1,366 | 1,426 | (4.2) |
| Equipment costs | 1,349 | 1,274 | 5.9 |
| Data processing fees and supplies | 2,425 | 2,513 | (3.5) |
| Corporate and business development | 1,206 | 1,133 | 6.4 |
| FDIC insurance and other regulatory fees | 406 | 461 | (11.9) |
| Professional fees | 937 | 872 | 7.5 |
| Other expense | 2,225 | 1,504 | 47.9 |
| Total noninterest expense | \$22,473 | \$21,202 | 6.0 % |

The Company's noninterest expense increased \$1.3 million, or 6.0%, to \$22.5 million in the first quarter of 2019, compared to \$21.2 million in the first quarter of 2018 and was lower by \$79,000 on a linked quarter basis. Salaries and employee benefits increased primarily due to higher employee health insurance expense, staffing increases and normal merit increases. The Company's efficiency ratio was 45.2% for the first quarter of 2019, compared to 46.0% for the first quarter of 2018 and 45.4% for the linked fourth quarter of 2018.

The Company's income tax expense increased \$1.1 million, in the three-month period ended March 31, 2019, compared to the same periods in 2018. The effective tax rate was 16.8% in the three-month period ended March 31, 2019, compared to 15.1% in the comparable period of 2018, due primarily to reduced tax benefit associated with the vesting of performance based restricted stock units.

FINANCIAL CONDITION

Overview

Total assets of the Company were \$4.892 billion as of March 31, 2019, an increase of \$16.6 million, or 0.3%, when compared to \$4.875 billion as of December 31, 2018. Overall asset growth was primarily driven by a \$23.2 million, or 0.6%, increase in net loans to \$3.889 billion at March 31, 2019 from \$3.866 billion December 31, 2018 and an increase of \$10.0 million or 1.7% in securities available for sale to \$595.6 million at March 31, 2019 from \$585.5 billion at December 31, 2018. Funding for the loan growth came from a decrease of \$28.2 million in cash and cash equivalents. In addition, total deposits increased by \$103.4 million and total borrowings decreased by \$123.6 million. The increase in deposits was primarily driven by growth in core deposits. Core deposits were \$4.007 billion as of March 31, 2019, an increase of \$128.2 million, or 3.3%, when compared to \$3.879 billion as of December 31, 2018. This was offset by a decrease of \$24.8 million in brokered deposits that matured during the first quarter of 2019. Additionally, commercial deposits increased by \$114.9 million, or 10.7%, to \$1.190 billion at March 31, 2019 compared to \$1.075 billion at December 31, 2018.

Uses of Funds

Total Cash and Cash Equivalents

Total cash and cash equivalents decreased by \$28.2 million, or 13.0%, to \$188.8 million at March 31, 2019, from \$216.9 million at December 31, 2018. The short-term investment component of cash and cash equivalents decreased primarily due to lower noninterest-bearing balances on deposit with correspondent banks.

Investment Portfolio

The amortized cost and the fair value of securities as of March 31, 2019 and December 31, 2018 were as follows:

| (dollars in thousands) | March 31, 2019 | | December 31, 2018 | |
|---|----------------|------------|-------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| U.S. Treasury securities | \$994 | \$994 | \$994 | \$987 |
| U.S. government sponsored agencies | 4,066 | 3,989 | 4,435 | 4,350 |
| Mortgage-backed securities: residential | 320,460 | 320,279 | 329,516 | 325,412 |
| Mortgage-backed securities: commercial | 38,244 | 38,029 | 38,712 | 38,141 |
| State and municipal securities | 226,924 | 232,262 | 217,964 | 216,659 |
| Total | \$590,688 | \$595,553 | \$591,621 | \$585,549 |

At March 31, 2019 and December 31, 2018, there were no holdings of securities of any one issuer, other than the U.S. government, government agencies and government sponsored entities, in an amount greater than 10% of stockholders' equity. Management is aware that, as interest rates rise, any unrealized loss in the investment portfolio will increase. Since the majority of the bonds in the investment portfolio are fixed-rate, with only a few adjustable-rate bonds, the market value of the bonds in the portfolio will decrease as interest rates rise. This is taken into consideration when evaluating the gain or loss of investment securities in the portfolio and the potential for other-than-temporary impairment.

Purchases of securities available for sale totaled \$22.2 million in the first three months of 2019. The purchases consisted primarily of state and municipal securities and also purchases of mortgage-backed securities issued by government sponsored entities. Paydowns from prepayments and scheduled payments of \$10.0 million were received in the first three months of 2019, and the amortization of premiums, net of the accretion of discounts, was \$817,000. Sales of securities totaled \$13.7 million in the first three months of 2019. Maturities and calls of securities totaled \$6.0 million in the first three months of 2019. The increase in the amortization of premiums, net of the accretion of discounts was primarily driven by the adoption of ASU 2017-08 on January 1, 2019. No other-than-temporary impairment was recognized in the first three months of 2019.

Purchases of securities available for sale totaled \$53.8 million in the first three months of 2018. The purchases consisted primarily of mortgage-backed securities issued by government sponsored entities and also purchases of state and municipal securities. Paydowns from prepayments and scheduled payments of \$10.0 million were received in the first three months of 2018, and the amortization of premiums, net of the accretion of discounts, was \$749,000. Sales of securities totaled \$12.3 million in the first three months of 2018. Maturities and calls of securities totaled \$2.7 million in the first three months of 2018. No other-than-temporary impairment was recognized in the first three months of 2018.

The investment portfolio is managed by a third-party firm to provide for an appropriate balance between liquidity, credit risk and investment return and to limit the Company's exposure to risk to an acceptable level. The Company does not trade or invest in or sponsor certain unregistered investment companies defined as hedge funds and private

equity funds under what is commonly referred to as the “Volcker Rule” of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Real Estate Mortgage Loans Held-for-Sale

Real estate mortgage loans held-for-sale increased by \$754,000, or 32.9%, to \$3.0 million at March 31, 2019, from \$2.3 million at December 31, 2018. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. The Company generally sells all of the qualifying mortgage loans it originates on the secondary market. Proceeds from sales totaled \$6.8 million in the first three months of 2019 compared to \$11.5 million in the first three months of 2018.

Loan Portfolio

The loan portfolio by portfolio segment as of March 31, 2019 and December 31, 2018 is summarized as follows:

| (dollars in thousands) | March 31, 2019 | | December 31, 2018 | | Current Period Change |
|---|-------------------|---------|----------------------|---------|-----------------------------|
| Commercial and industrial loans | \$1,427,342 | 36.2 % | \$1,405,379 | 35.9 % | \$21,963 |
| Commercial real estate and multi-family residential loans | 1,629,622 | 41.4 | 1,569,635 | 40.1 | 59,987 |
| Agri-business and agricultural loans | 302,307 | 7.7 | 370,513 | 9.5 | (68,206) |
| Other commercial loans | 112,021 | 2.8 | 95,657 | 2.4 | 16,364 |
| Consumer 1-4 family mortgage loans | 384,710 | 9.8 | 389,078 | 9.9 | (4,368) |
| Other consumer loans | 84,650 | 2.1 | 86,064 | 2.2 | (1,414) |
| Subtotal | 3,940,652 | 100.0 % | 3,916,326 | 100.0 % | 24,326 |
| Less: Allowance for loan losses | (49,562) | | (48,453) | | (1,109) |
| Net deferred loan fees | (1,642) | | (1,581) | | (61) |
| Loans, net | \$3,889,448 | | \$3,866,292 | | \$23,156 |

Total loans, excluding real estate mortgage loans held for sale and deferred fees, increased by \$24.3 million to \$3.941 billion at March 31, 2019 from \$3.916 billion at December 31, 2018. The increase was concentrated in the commercial and commercial real estate categories and reflected the Company's long standing strategic plan that is focused on expanding and growing the commercial lending business throughout our market areas. The increase was partially offset by expected, seasonal loan repayments during the first quarter in our agri-business and agricultural loans. In addition, unanticipated factors affecting loan repayment activity during the year included the sale of client companies and long-term non-bank financing in the agricultural and commercial real estate portfolios.

The following table summarizes the Company's non-performing assets as of March 31, 2019 and December 31, 2018:

| (dollars in thousands) | March 31, 2019 | December 31, 2018 |
|---|-------------------|----------------------|
| Nonaccrual loans including nonaccrual troubled debt restructured loans | \$6,093 | \$7,260 |
| Loans past due over 90 days and still accruing | 481 | 0 |
| Total nonperforming loans | \$6,574 | \$7,260 |
| Other real estate owned | 316 | 316 |
| Repossessions | 83 | 0 |
| Total nonperforming assets | \$6,973 | \$7,576 |
| Impaired loans including troubled debt restructurings | \$24,501 | \$26,661 |
| Nonperforming loans to total loans | 0.17% | 0.19% |
| Nonperforming assets to total assets | 0.14% | 0.16% |
| Performing troubled debt restructured loans | \$6,196 | \$8,016 |
| Nonperforming troubled debt restructured loans (included in nonaccrual loans) | 3,812 | 4,384 |
| Total troubled debt restructured loans | \$10,008 | \$12,400 |

Total nonperforming assets decreased by \$603,000, or 8.0%, to \$7.0 million during the three-month period ended March 31, 2019. The decrease in nonperforming assets was primarily due to payments received on nonperforming

loans.

Net charge offs in the quarter were \$91,000 versus net charge-offs of \$4.8 million in the first quarter of 2018 and net charge-offs of \$189,000 during the linked fourth quarter of 2018.

A loan is impaired when full payment under the original loan terms is not expected. Impairment for smaller loans that are similar in nature and which are not in nonaccrual or troubled debt restructured status, such as residential mortgage, consumer, and credit card loans, is determined based on the class of loans and impairment is determined on an individual loan basis for other loans. If

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a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows or at the fair value of collateral if repayment is expected solely from the collateral.

Total impaired loans decreased by \$2.2 million, or 8.1%, to \$24.5 million at March 31, 2019 from \$26.7 million at December 31, 2018. The decrease in the impaired loans category was primarily due to payments received on impaired loans.

Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation of the loans by management, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans: Substandard, Doubtful and Loss. The regulations also contain a Special Mention category. Special Mention applies to loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification as Substandard, Doubtful or Loss but do possess credit deficiencies or potential weaknesses deserving management's close attention. The Company's policy is to establish a specific allowance for loan losses for any assets where management has identified conditions or circumstances that indicate an asset is impaired. If an asset or portion thereof is classified as a loss, the Company's policy is to either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss or charge-off such amount.

At March 31, 2019, the allowance for loan losses was 1.26% of total loans outstanding, versus 1.24% of total loans outstanding at December 31, 2018. At March 31, 2019, management believed the allowance for loan losses was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions do not remain stable, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require increases in the allowance for loan losses. The process of identifying probable incurred credit losses is a subjective process. Therefore, the Company maintains a general allowance to cover probable credit losses within the entire portfolio. The methodology management uses to determine the adequacy of the loan loss reserve includes the considerations below.

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses from a wide variety of industries. Generally, this type of lending has more credit risk than other types of lending because of the size and diversity of the credits. The Company manages this risk by adjusting its pricing to the perceived risk of each individual credit and by diversifying the portfolio by customer, product, industry and market area.

As of March 31, 2019, on the basis of management's review of the loan portfolio, the Company had 91 credits totaling \$204.9 million on the classified loan list versus 91 credits totaling \$186.6 million on December 31, 2018. The increased in classified loans for the first quarter of 2019 resulted primarily from two commercial borrowers. As of March 31, 2019, the Company had \$121.1 million of assets classified as Special Mention, \$83.8 million classified as Substandard, \$0 classified as Doubtful and \$0 classified as Loss as compared to \$101.4 million, \$85.2 million, \$0 and \$0, respectively, at December 31, 2018.

Allowance estimates are developed by management after taking into account actual loss experience adjusted for current economic conditions. The Company has regular discussions regarding this methodology with regulatory

authorities. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with current accounting guidance, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. For a more thorough discussion of the allowance for loan losses methodology see the Critical Accounting Policies section of this Item 2.

The allowance for loan losses increased 2.3%, or \$1.1 million, from \$48.5 million at December 31, 2018 to \$49.6 million at March 31, 2019. Pooled loan allocations increased from \$35.1 million at December 31, 2018 to \$39.7 million at March 31, 2019, which was primarily due to management's view of current credit quality and the current economic environment. Impaired loan allocations decreased \$195,000 from \$10.0 million at December 31, 2018 to \$9.8 million at March 31, 2019, which was primarily due to paydowns and payoffs received on these loans over the three-month period ended March 31, 2019. The unallocated component of the allowance for loan losses was \$3.0 million at March 31, 2019 compared to \$3.3 million at December 31, 2018. While general trends in the overall economy and credit quality were stable, the Company believes that the unallocated component is appropriate given the uncertainty that exists regarding near term economic conditions.

Most of the Company's recent loan growth has been concentrated in the commercial loan portfolio, which can result in overall asset quality being influenced by a small number of credits. Management has historically considered growth and portfolio composition when determining loan loss allocations. Management believes that it is prudent to continue to provide for loan losses in a manner consistent with its historical approach due to the loan growth described above and current economic conditions.

Economic conditions in the Company's markets have been stable, and management is cautiously optimistic that the economic trends in its footprint remain healthy. While the growth is not robust, commercial real estate activity and manufacturing growth is occurring. The Company's continued growth strategy promotes diversification among industries as well as continued focus on the enforcement of a disciplined credit culture and a conservative position in loan work-out situations. The Company believes that historical industry-specific issues in the Company's markets have are stable and continue to be somewhat mitigated by its overall expansion strategy.

Sources of Funds

The average daily deposits and borrowings together with average rates paid on those deposits and borrowings for the three months ended March 31, 2019 and 2018 are summarized in the following table:

| (dollars in thousands) | Three months ended March 31, | | | |
|-------------------------------------|------------------------------|-------|-------------|-------|
| | 2019 | | 2018 | |
| | Balance | Rate | Balance | Rate |
| Noninterest bearing demand deposits | \$885,126 | 0.00% | \$841,608 | 0.00% |
| Savings and transaction accounts: | | | | |
| Savings deposits | 247,309 | 0.12 | 268,091 | 0.13 |
| Interest bearing demand deposits | 1,496,893 | 1.61 | 1,491,820 | 0.97 |
| Time deposits: | | | | |
| Deposits of \$100,000 or more | 1,184,996 | 2.27 | 1,238,189 | 1.59 |
| Other time deposits | 276,006 | 1.81 | 255,209 | 1.35 |
| Total deposits | \$4,090,330 | 1.38% | \$4,094,917 | 0.93% |
| FHLB advances and other borrowings | 221,046 | 2.57 | 113,795 | 1.71 |
| Total funding sources | \$4,311,376 | 1.44% | \$4,208,712 | 0.95% |

Deposits and Borrowings

As of March 31, 2019, total deposits increased by \$103.4 million, or 2.6%, from December 31, 2018. Core deposits increased by \$128.2 million to \$4.007 billion as of March 31, 2019 from \$3.879 billion as of December 31, 2018. Total brokered deposits were \$140.1 million at March 31, 2019 compared to \$164.9 million at December 31, 2018 reflecting a \$24.8 million decrease during the first three months of 2019.

Since December 31, 2018, the change in core deposits was comprised of increases in commercial deposits of \$114.9 million and in retail deposits of \$17.6 million, which were offset by a decrease in public fund deposits of \$4.4 million. Total public funds deposits, including public funds transaction accounts, were \$1.211 billion at March 31, 2019 and \$1.216 billion at December 31, 2018.

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The following table summarizes deposit composition at March 31, 2019 and December 31, 2018:

| | March 31, | December 31, | Current |
|------------------------|-------------|--------------|-----------|
| (dollars in thousands) | 2019 | 2018 | Period |
| | | | Change |
| Retail | \$1,605,860 | \$1,588,225 | \$17,635 |
| Commercial | 1,190,352 | 1,075,419 | 114,933 |
| Public funds | 1,211,147 | 1,215,533 | (4,386) |
| Core deposits | \$4,007,359 | \$3,879,177 | \$128,182 |
| Brokered deposits | 140,078 | 164,888 | (24,810) |
| Total deposits | \$4,147,437 | \$4,044,065 | \$103,372 |

Total borrowings decreased by \$123.6 million, or 44.7%, from December 31, 2018. The decrease consisted of \$170.0 million in Federal home Loan Bank advances, as well as \$75.6 million in securities sold under agreements to repurchase. Federal funds purchased increased by \$122.0 million at March 31, 2019. The Company utilizes wholesale funding, including brokered deposits and Federal Home Loan Bank advances, to supplement funding of assets, which is primarily loan growth.

Capital

As of March 31, 2019, total stockholders' equity was \$543.2 million, an increase of \$21.6 million, or 4.1%, from \$521.6 million at December 31, 2018. In addition to net income of \$21.7 million, other increases in equity during the first three months of 2019 included \$8.7 million in accumulated other comprehensive income component of equity, which was primarily driven by a net increase in the fair value of available-for-sale securities and \$1.2 million in stock based compensation expense. Offsetting the increases to stockholders' equity were decreases due to dividends paid in the amount of \$6.6 million and \$2.1 million in stock activity under equity compensation plans.

On February 27, 2009, the Company entered into a Letter Agreement with the Treasury, pursuant to which the Company issued Series A Preferred Stock and a warrant to purchase 396,538 shares of the Company's common stock, no par value. This transaction was conducted in accordance with the Treasury's capital purchase program. The warrant had a 10-year term and was immediately exercisable upon issuance, with an exercise price, subject to anti-dilution adjustments. The warrant was valued using the Black-Sholes model with the following assumptions: market price of \$17.45; exercise price of \$21.20; risk-free rate of 3.02%; expected life of 10 years; expected dividend rate on common stock of 4.5759% and volatility of common stock price of 41.8046%. This resulted in a value of \$4.4433 per share of common stock underlying the warrant. On December 3, 2009, the Company was notified by the Treasury that, as a result of the Company's completion of our November 18, 2009 Qualified Equity Offering, the amount of the warrant was reduced by 50% to 198,269 shares. And on June 9, 2010, the Company redeemed the Series A Preferred Stock and accreted the remaining unamortized discount on these shares. The Company did not purchase the warrant, and the Warrant was sold by the Treasury to an independent third-party. The shares issuable upon exercise and the exercise price were adjusted each time the Company paid a dividend to its stockholders in excess of the dividend paid at the time the warrant was issued. Additionally, the number of shares issuable upon exercise and the exercise price were adjusted for a 3-for-2 stock split on July 25, 2016 paid in the form of a dividend on August 5, 2016.

On February 4, 2019, the Company was notified that the holder of the warrant was initiating the exercise on a cashless basis. At the time of exercise, the holder was entitled to 315,961 shares of common stock. The cost to exercise the warrant was approximately \$4.2 million, which was the equivalent of 91,894 shares of common stock with a fair value of \$45.74 per share. As a result of exercising on a cashless basis, the Company issued 224,066 shares to the warrant holder and the warrant was retired.

The impact on equity by other comprehensive income is not included in regulatory capital. The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1, or core capital, as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final rule's requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. The final rules include a capital conservation buffer, comprised of common equity Tier 1 capital, which was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. The capital conservation buffer was 1.875% as of December 31, 2018 and 2.5% as of March 31, 2019. As of March 31, 2019, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

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The actual capital amounts and ratios of the Company and the Bank as of March 31, 2019 and December 31, 2018, are presented in the table below:

| | Actual | | Minimum Required For Capital Adequacy Purposes | | For Capital Adequacy Purposes Plus Conservation Buffer | | Minimum Required to Be Well Capitalized Under Prompt Corrective Regulations | |
|--|-----------|--------|--|-------|--|--------|---|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (dollars in thousands) | | | | | | | | |
| As of March 31, 2019: | | | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | \$615,373 | 14.38% | \$342,322 | 8.00% | \$449,298 | N/A | N/A | N/A |
| Bank | \$595,115 | 13.94% | \$341,636 | 8.00% | \$448,397 | 10.50% | \$427,045 | 10.00% |
| Tier I Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | \$565,721 | 13.22% | \$256,742 | 6.00% | \$363,717 | N/A | N/A | N/A |
| Bank | \$545,463 | 12.77% | \$256,227 | 6.00% | \$362,988 | 8.50% | \$341,636 | 8.00% |
| Common Equity Tier 1 (CET1) | | | | | | | | |
| Consolidated | \$535,721 | 12.52% | \$192,556 | 4.50% | \$299,532 | N/A | N/A | N/A |
| Bank | \$545,463 | 12.77% | \$192,170 | 4.50% | \$298,931 | 7.00% | \$277,579 | 6.50% |
| Tier I Capital (to Average Assets) | | | | | | | | |
| Consolidated | \$565,721 | 11.60% | \$195,082 | 4.00% | \$195,082 | N/A | N/A | N/A |
| Bank | \$545,463 | 11.21% | \$194,591 | 4.00% | \$194,591 | 4.00% | \$243,238 | 5.00% |
| As of December 31, 2018: | | | | | | | | |
| Total Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | \$601,379 | 14.20% | \$338,690 | 8.00% | \$418,070 | N/A | N/A | N/A |
| Bank | \$583,206 | 13.80% | \$338,098 | 8.00% | \$417,340 | 9.875% | \$422,623 | 10.00% |
| Tier I Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | \$552,836 | 13.06% | \$254,017 | 6.00% | \$333,398 | N/A | N/A | N/A |
| Bank | \$534,664 | 12.65% | \$253,574 | 6.00% | \$332,815 | 7.875% | \$338,098 | 8.00% |
| Common Equity Tier 1 (CET1) | | | | | | | | |
| Consolidated | \$522,836 | 12.35% | \$190,513 | 4.50% | \$269,893 | N/A | N/A | N/A |
| Bank | \$534,664 | 12.65% | \$190,180 | 4.50% | \$269,422 | 6.375% | \$274,705 | 6.50% |
| Tier I Capital (to Average Assets) | | | | | | | | |
| Consolidated | \$552,836 | 11.44% | \$193,305 | 4.00% | \$193,305 | N/A | N/A | N/A |
| Bank | \$534,664 | 11.06% | \$193,312 | 4.00% | \$193,312 | 4.00% | \$241,639 | 5.00% |

FORWARD-LOOKING STATEMENTS

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimate," "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. A number of factors, many of which are beyond the Company to control or predict, could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These factors include, but are not limited to, the following:

- the effects of future economic, trade, business and market conditions and changes, both domestic and foreign, including the effects of federal trade policies;
- governmental monetary and fiscal policies;
- the timing and scope of any legislative and regulatory changes, including changes in banking, securities and tax laws and regulations and their application by our regulators;
 - the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities and other interest sensitive assets and liabilities;
- changes in borrowers' credit risks and payment behaviors;
- changes in the availability and cost of credit and capital in the financial markets;
- the effects of disruption and volatility in capital markets on the value of our investment portfolio;
- cyber-security risks and or cyber-security damage that could result from attacks on the Company's or third party service providers networks or data of the Company;
- changes in the prices, values and sales volumes of residential and commercial real estate;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;
- changes in technology or products that may be more difficult or costly, or less effective than anticipated;
- the effects of war or other conflicts, acts of terrorism or other catastrophic events, including storms, droughts, tornados and flooding, that may affect general economic conditions, including agricultural production and demand and prices for agricultural goods and land used for agricultural purposes, generally and in our markets;
- the failure of assumptions and estimates used in our reviews of our loan portfolio, underlying the establishment of reserves for possible loan losses, our analysis of our capital position and other estimates;

changes in the scope and cost of FDIC insurance, the state of Indiana's Public Deposit Insurance Fund and other coverages;

the effects of the Tax Cuts and Jobs Act of 2017, including any effects on the housing market, and on the demand for home equity loans and other loan products that we offer;

changes in accounting policies, rules and practices; and

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Additional information concerning the Company and its business, including additional factors that could

materially affect the Company's financial results, is included in the Company's filings with the Securities and Exchange Commission, including the Company's Annual Report on Form 10-K.

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk represents the Company's primary market risk exposure. The Company does not have a material exposure to foreign currency exchange risk, does not have any material amount of derivative financial instruments and does not maintain a trading portfolio. The Corporate Risk Committee of the Board of Directors annually reviews and approves the policy used to manage interest rate risk. The policy was last reviewed and approved in July 2018. The policy sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income but do not necessarily indicate the effect on future net interest income. The Company, through its Asset and Liability Committee, manages interest rate risk by monitoring the computer simulated earnings impact of various rate scenarios and general market conditions. The Company then modifies its long-term risk parameters by attempting to generate the types of loans, investments, and deposits that currently fit the Company's needs, as determined by its Asset and Liability Committee. This computer simulation analysis measures the net interest income impact of various interest rate scenario changes during the next twelve months. The Company continually evaluates the assumptions used in the model. The current balance sheet structure is considered to be within acceptable risk levels.

Interest rate scenarios for the base, falling 100 basis points, falling 25 basis points, rising 25 basis points, rising 50 basis points, rising 100 basis points, rising 200 basis points and rising 300 basis points are listed below based upon the Company's rate sensitive assets and liabilities at March 31, 2019. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

The base scenario is highly dependent on numerous assumptions embedded in the model. While the base sensitivity analysis incorporates management's best estimate of interest rate and balance sheet dynamics under various market rate movements, the actual behavior and resulting earnings impact will likely differ from that projected. For certain assets, the base simulation model captures the expected prepayment behavior under changing interest rate environments. Assumptions and methodologies regarding the interest rate or balance behavior of indeterminate maturity core deposit products, such as savings, money market, NOW and demand deposits reflect management's best estimate of expected future behavior.

| (dollars in thousands) | Base | Falling (100 Basis Points) | Falling (25 Basis Points) | Rising (25 Basis Points) | Rising (50 Basis Points) | Rising (100 Basis Points) | Rising (200 Basis Points) | Rising (300 Basis Points) | |
|-----------------------------|-----------|----------------------------------|---------------------------------|--------------------------------|--------------------------------|---------------------------------|---------------------------------|---------------------------------|---|
| Net interest income | \$160,904 | \$148,107 | \$157,999 | \$163,637 | \$166,354 | \$171,654 | \$181,806 | \$191,558 | |
| Variance from Base | | (\$12,797) | (\$2,905) | \$2,733 | \$5,450 | \$10,750 | \$20,902 | \$30,654 | |
| Percent of change from Base | | -7.95 | %-1.81 | %1.70 | %3.39 | %6.68 | %12.99 | %19.05 | % |

ITEM 4 – CONTROLS AND PROCEDURES

As required by Rules 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934, management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's

disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of March 31, 2019. Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

During the quarter ended March 31, 2019, there were no changes to the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect its internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routine litigation incidental to their respective businesses.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. of Part I of the Company's Form 10-K for the year ended December 31, 2018. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

As discussed above under the heading "Financial Condition – Capital," on February 8, 2019, the Company issued 224,066 shares of common stock to the holder of a warrant the Company originally issued to the Treasury in February 2009. The aggregate exercise price was approximately \$4.2 million, which was paid pursuant to a cashless exercise of the warrant. The issuance of the shares was exempt from registration pursuant to Section 3(a)(9) under the Securities Act of 1933.

The following table provides information as of March 31, 2019 with respect to shares of common stock repurchased by the Company during the quarter then ended:

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------|----------------------------------|------------------------------|--|--|
| January 1-31 | 3,601 | \$ 41.89 | 0 | \$ 0 |
| February 1-28 | 977 | 45.42 | 0 | 0 |
| March 1-31 | 0 | 0 | 0 | 0 |
| Total | 4,578 | \$ 42.65 | 0 | \$ 0 |

(a) The shares purchased during the periods were credited to the deferred share accounts of non-employee directors under the Company's directors' deferred compensation plan. These shares were purchased in the ordinary course of business and consistent with past practice.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

N/A

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Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive Data File

Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets as of March 31, 2019 and December 31, 2018; (ii) Consolidated Statements of Income for the three months ended March 31, 2019 and March 31, 2018; (iii) Consolidated Statements of Comprehensive Income for the three months ended March 31, 2019 and March 31, 2018; (iv) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2019 and March 31, 2018; (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2019 and March 31, 2018; and (vi) Notes to Unaudited Consolidated Financial Statements.

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.

LAKELAND FINANCIAL CORPORATION
(Registrant)

Date: May 3, 2019 /s/ David M. Findlay
David M. Findlay – President and
Chief Executive Officer

Date: May 3, 2019 /s/ Lisa M. O’Neill
Lisa M. O’Neill – Executive Vice President and
Chief Financial Officer
(principal financial officer)

Date: May 3, 2019 /s/ Brok A. Lahrman
Brok A. Lahrman – Senior Vice President and Chief Accounting Officer
(principal accounting officer)