AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
August 02, 2018
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended June 30, 2018

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period _____ to _____

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**63-0885779**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization) Identification No.)

100 N. Gay Street

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Yes No

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

Yes No

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

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

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 Act). Yes No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at August 1, 2018
Common Stock, $0.01 par value per share	3,643,813 shares

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION		PAGE
Item 1	Financial Statements	
	Consolidated Balance Sheets (Unaudited) as of June 30, 2018 and December 31, 2017	3
	Consolidated Statements of Earnings (Unaudited) for the quarter and six months ended June 30, 2018 and 2017	4
	Consolidated Statements of Comprehensive Income (Unaudited) for the quarter and six months ended June 30, 2018 and 2017	5
	Consolidated Statements of Stockholders Equity (Unaudited) for the six months ended June 30, 2018 and 2017	6
	Consolidated Statements of Cash Flows (Unaudited) for the six months ended June 30, 2018 and 2017	7
	Notes to Consolidated Financial Statements (Unaudited)	8
Item 2	Management s Discussion and Analysis of Financial Condition and Results of Operations	29
	Table 1 Explanation of Non-GAAP Financial Measures	46
	Table 2 Selected Quarterly Financial Data	47
	Table 3 Selected Financial Data	48
	Table 4 Average Balances and Net Interest Income Analysis for the quarter ended June 30, 2018 and 2017	49
	Table 5 Average Balances and Net Interest Income Analysis for the six months ended June 30, 2018 and 2017	50
	Table 6 Loan Portfolio Composition	51
	Table 7 Allowance for Loan Losses and Nonperforming Assets	52
	Table 8 Allocation of Allowance for Loan Losses	53
	Table 9 CDs and Other Time Deposits of $100,000 or more	54
Item 3	Quantitative and Qualitative Disclosures About Market Risk	55
Item 4	Controls and Procedures	55

PART II. OTHER INFORMATION

Item 1	Legal Proceedings	55
Item 1A	Risk Factors	55
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	55
Item 3	Defaults Upon Senior Securities	55
Item 4	Mine Safety Disclosures	55
Item 5	Other Information	55
Item 6	Exhibits	56

Table of Contents

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	June 30, 2018	December 31, 2017
Assets:		
Cash and due from banks	$ 16,297	$ 12,942
Federal funds sold	37,576	41,540
Interest bearing bank deposits	12,072	51,046
Cash and cash equivalents	65,945	105,528
Securities available-for-sale	251,320	257,697
Loans held for sale	1,943	1,922
Loans, net of unearned income	456,572	453,651
Allowance for loan losses	(4,750)	(4,757)
Loans, net	451,822	448,894
Premises and equipment, net	13,613	13,791
Bank-owned life insurance	18,543	18,330
Other assets	8,605	7,219
Total assets	$ 811,791	$ 853,381
Liabilities:		
Deposits:		
Noninterest-bearing	$ 199,469	$ 193,917
Interest-bearing	521,536	563,742
Total deposits	721,005	757,659
Federal funds purchased and securities sold under agreements to repurchase	2,732	2,658
Long-term debt		3,217
Accrued expenses and other liabilities	2,306	2,941
Total liabilities	726,043	766,475
Stockholders equity:		

Preferred stock of $.01 par value; authorized 200,000 shares; no issued shares		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,776	3,771
Retained earnings	93,009	90,299
Accumulated other comprehensive loss, net	(4,440)	(566)
Less treasury stock, at cost - 313,342 shares and 313,467 shares at June 30, 2018 and December 31, 2017, respectively	(6,636)	(6,637)
Total stockholders equity	85,748	86,906
Total liabilities and stockholders equity	$ 811,791	$ 853,381

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

(In thousands, except share and per share data)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Interest income:				
Loans, including fees	$ 5,307	$ 5,121	$ 10,538	$ 10,102
Securities:				
Taxable	1,012	1,112	2,089	2,133
Tax-exempt	572	587	1,157	1,168
Federal funds sold and interest bearing bank deposits	290	182	592	383
Total interest income	7,181	7,002	14,376	13,786
Interest expense:				
Deposits	845	866	1,717	1,728
Short-term borrowings	8	5	12	9
Long-term debt	11	30	46	59
Total interest expense	864	901	1,775	1,796
Net interest income	6,317	6,101	12,601	11,990
Provision for loan losses		100		100
Net interest income after provision for loan losses	6,317	6,001	12,601	11,890
Noninterest income:				
Service charges on deposit accounts	182	183	361	372
Mortgage lending	166	139	372	304
Bank-owned life insurance	108	110	214	217
Other	383	361	745	734
Securities gains, net				2
Total noninterest income	839	793	1,692	1,629
Noninterest expense:				
Salaries and benefits	2,618	2,392	5,286	4,773
Net occupancy and equipment	360	351	730	732
Professional fees	266	254	494	484
FDIC and other regulatory assessments	89	89	178	178

Other	993	929	2,040	1,966
Total noninterest expense	4,326	4,015	8,728	8,133
Earnings before income taxes	2,830	2,779	5,565	5,386
Income tax expense	566	784	1,106	1,501
Net earnings	$ 2,264	$ 1,995	$ 4,459	$ 3,885
Net earnings per share:				
Basic and diluted	$ 0.62	$ 0.55	$ 1.22	$ 1.07
Weighted average shares outstanding:				
Basic and diluted	3,643,731	3,643,593	3,643,707	3,643,567

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Net earnings	$ 2,264	$ 1,995	$ 4,459	$ 3,885
Other comprehensive (loss) income, net of tax:				
Unrealized net holding (loss) gain on securities	(754)	573	(3,874)	711
Reclassification adjustment for net gain on securities recognized in net earnings				(1)
Other comprehensive (loss) income	(754)	573	(3,874)	710
Comprehensive income	$ 1,510	$ 2,568	$ 585	$ 4,595

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Unaudited)

lars in thousands, except share data)	Common Stock Shares	Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
nce, December 31, 2016	3,957,135	$ 39	$ 3,767	$ 85,716	$ (708)	$ (6,637)	$ 82,
earnings				3,885			3,
r comprehensive income					710		
dividends paid ($0.46 per share)				(1,676)			(1,
of treasury stock (120 shares)			3				
nce, June 30, 2017	3,957,135	$ 39	$ 3,770	$ 87,925	$ 2	$ (6,637)	$ 85,
nce, December 31, 2017	3,957,135	$ 39	$ 3,771	$ 90,299	$ (566)	$ (6,637)	$ 86,
earnings				4,459			4,
r comprehensive loss					(3,874)		(3,
dividends paid ($0.48 per share)				(1,749)			(1,
of treasury stock (125 shares)			5			1	
nce, June 30, 2018	3,957,135	$ 39	$ 3,776	$ 93,009	$ (4,440)	$ (6,636)	$ 85,

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Six Months ended June 30, 2018	2017
Cash flows from operating activities:		
Net earnings	$ 4,459	$ 3,885
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses		100
Depreciation and amortization	467	536
Premium amortization and discount accretion, net	1,053	1,058
Net gain on securities available-for-sale		(2)
Net gain on sale of loans held for sale	(198)	(176)
Decrease in MSR valuation allowance		(1)
Net gain on other real estate owned		(11)
Loans originated for sale	(17,282)	(11,945)
Proceeds from sale of loans	17,344	12,089
Increase in cash surrender value of bank-owned life insurance	(213)	(217)
Net (increase) decrease in other assets	(68)	343
Net decrease in accrued expenses and other liabilities	(629)	(1,967)
Net cash provided by operating activities	4,933	3,692
Cash flows from investing activities:		
Proceeds from prepayments and maturities of securities available-for-sale	17,275	17,611
Purchase of securities available-for-sale	(17,124)	(51,334)
Increase in loans, net	(4,288)	(6,119)
Net purchases of premises and equipment	(36)	(615)
Increase in FHLB stock	(20)	(13)
Proceeds from sale of other real estate owned	1,223	60
Net cash used in investing activities	(2,970)	(40,410)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	5,552	421
Net (decrease) increase in interest-bearing deposits	(42,206)	2,892
Net increase in federal funds purchased and securities sold under agreements to repurchase	74	103
Repayments or retirement of long-term debt	(3,217)	
Dividends paid	(1,749)	(1,676)

Net cash (used in) provided by financing activities		(41,546)		1,740
Net change in cash and cash equivalents		(39,583)		(34,978)
Cash and cash equivalents at beginning of period		105,528		121,277
Cash and cash equivalents at end of period	$	65,945	$	86,299
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest	$	1,770	$	1,858
Income taxes		1,678		2,007
Supplemental disclosure of non-cash transactions:				
Real estate acquired through foreclosure		1,360		

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

Basis of Presentation and Use of Estimates

The unaudited consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The unaudited consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations in the interim statements are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2017.

The unaudited consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Auburn National Bancorporation Capital Trust I is an affiliate of the Company and was included in these unaudited consolidated financial statements pursuant to the equity method of accounting. Significant intercompany transactions and accounts are eliminated in consolidation.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, and the valuation of deferred tax assets and other real estate owned.

Subsequent Events

The Company has evaluated the effects of events and transactions through the date of this filing that have occurred subsequent to June 30, 2018. The Company does not believe there were any material subsequent events during this period that would have required further recognition or disclosure in the unaudited consolidated financial statements included in this report.

Table of Contents

Accounting Developments

In the first six months of 2018, the Company adopted new guidance related to the following Accounting Standards Updates (Updates or ASUs):

ASU 2014-09, *Revenue from Contracts with Customers*;

ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities;*

ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments; and*

ASU 2016-18, *Restricted Cash*

Information about these pronouncements is described in more detail below.

ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, was developed as a joint project with the International Accounting Standards Board to remove inconsistencies in revenue requirements and provide a more robust framework for addressing revenue issues. The ASU s core principle is that an entity should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14, which deferred the effective date by one year (i.e., interim and annual reporting periods beginning after December 15, 2017). Early adoption is permitted, but not before the original effective date (i.e., interim and annual reporting periods beginning after December 15, 2016). The ASU may be adopted using either a modified retrospective method or a full retrospective method. The Company adopted the ASU during the first quarter of 2018, as required, using a modified retrospective approach. The majority of the Company s revenue stream is generated from interest income on loans and deposits, which are outside the scope of Topic 606. The Company s sources of income that fall within the scope of Topic 606 include service charges on deposits, investment services, interchange fees and gains and losses on sales of other real estate, all of which are presented as components of noninterest income. The Company has evaluated the effect of Topic 606 on these fee-based income streams and concluded that adoption of the standard did not materially impact its financial statements. The following is a summary of the implementation considerations for the revenue streams that fall within the scope of Topic 606:

Service charges on deposits, investment services, ATM and interchange fees Fees from these services are either transaction-based, for which the performance obligations are satisfied when the individual transaction is processed, or set periodic service charges, for which the performance obligations are satisfied over the period the service is provided. Transaction-based fees are recognized at the time the transaction is processed, and periodic service charges are recognized over the service period. The adoption of Topic 606 had no impact on the Company s revenue recognition practice for these services.

Gains on sales of other real estate ASU 2014-09 creates Topic 610-20, under which a gain on sale should be recognized when a contract for sale exists and control of the asset has been transferred to the buyer. Topic

606 lists several criteria required to conclude that a contract for sale exists, including a determination that the institution will collect substantially all of the consideration to which it is entitled. This presents a key difference between the prior and new guidance related to the recognition of the gain when the institution finances the sale of the property. Rather than basing recognition on the amount of the buyer s initial investment, which was the primary consideration under prior guidance, the analysis is now based on various factors including not only the loan to value, but also the credit quality of the borrower, the structure of the loan, and any other factors that may affect collectability. While these differences may affect the decision to recognize or defer gains on sales of other real estate in circumstances where the Company has financed the sale, the effects would not be material to its consolidated financial statements.

Table of Contents

ASU 2016-01, *Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, enhances the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Some of the amendments include the following: (1) Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (4) Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others. For public business entities, the amendments of this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The adoption of this ASU on January 1, 2018 did not have a material impact on the Company s Consolidated Financial Statements. In accordance with (3) above, the Company measured the fair value of its loan portfolio as of June 30, 2018 using an exit price notion and will continue to do so going forward (see Note 7).

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*, provides guidance on eight specific cash flow issues where current GAAP is either unclear or does not include specific guidance on classification in the statement of cash flows. The new guidance is effective for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-15 on January 1, 2018. ASU No. 2016-15 did not have a material impact on the Company s Consolidated Financial Statements.

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash,* amends guidance on how the statement of cash flows presents the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Under the new guidance, amounts generally described as restricted cash and restricted cash equivalents are included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments in this Update do not provide a definition of restricted cash or restricted cash equivalents. The new guidance is effective for public business entities for annual and interim reporting periods in fiscal years beginning after December 15, 2017. The Company adopted ASU No. 2016-18 on January 1, 2018. ASU No. 2016-18 did not have a material impact on the Company s Consolidated Financial Statements.

NOTE 2: BASIC AND DILUTED NET EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the respective period. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company s common stock. At June 30, 2018 and 2017, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted net earnings per share calculation.

The basic and diluted net earnings per share computations for the respective periods are presented below.

	Quarter ended June 30,		Six Months ended June 30,	
(In thousands, except share and per share data)	**2018**	**2017**	**2018**	**2017**

Basic and diluted:				
Net earnings	$ 2,264	$ 1,995	$ 4,459	$ 3,885
Weighted average common shares outstanding	3,643,731	3,643,593	3,643,707	3,643,567
Net earnings per share	$ 0.62	$ 0.55	$ 1.22	$ 1.07

Table of Contents

NOTE 3: SECURITIES

At June 30, 2018 and December 31, 2017, respectively, all securities within the scope of Accounting Standards Codification (ASC) 320, *Investments Debt and Equity Securities,* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at June 30, 2018 and December 31, 2017, respectively, are presented below.

(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
June 30, 2018								
Agency obligations (a)	$ 4,474	24,482	22,405		51,361		1,672	$ 53,033
Agency RMBS (a)			9,617	119,389	129,006	80	4,337	133,263
State and political subdivisions		3,406	8,338	59,209	70,953	754	754	70,953
Total available-for-sale	$ 4,474	27,888	40,360	178,598	251,320	834	6,763	$ 257,249
December 31, 2017								
Agency obligations (a)	$	29,253	23,809		53,062	79	904	$ 53,887
Agency RMBS (a)			11,201	121,871	133,072	330	1,639	134,381
State and political subdivisions		2,564	9,999	59,000	71,563	1,616	237	70,184
Total available-for-sale	$	31,817	45,009	180,871	257,697	2,025	2,780	$ 258,452

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of $144.5 million and $149.4 million at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are non-marketable equity securities, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock. The carrying amounts of non-marketable equity securities were $1.4 million at June 30, 2018 and December 31, 2017, respectively.

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at June 30, 2018 and December 31, 2017, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in thousands)	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized

		Value	Losses	Value	Losses		Value	Losses
June 30, 2018:								
Agency obligations	$	31,523	437	19,838	1,235	$	51,361	1,672
Agency RMBS		55,415	1,360	65,608	2,977		121,023	4,337
State and political subdivisions		14,879	302	9,867	452		24,746	754
Total	$	101,817	2,099	95,313	4,664	$	197,130	6,763
December 31, 2017:								
Agency obligations	$	14,381	99	20,353	805	$	34,734	904
Agency RMBS		53,440	363	50,729	1,276		104,169	1,639
State and political subdivisions		2,009	22	10,155	215		12,164	237
Total	$	69,830	484	81,237	2,296	$	151,067	2,780

Table of Contents

For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. On a quarterly basis, the Company assesses each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis.

In determining whether a loss is temporary, the Company considers all relevant information including:

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;
- the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;
- failure of the issuer of the security to make scheduled interest or principal payments;
- any changes to the rating of the security by a rating agency; and
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Agency obligations

The unrealized losses associated with agency obligations were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Agency RMBS

The unrealized losses associated with agency residential mortgage-backed securities (RMBS) were primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities were issued by U.S. government agencies or government-sponsored entities and did not have any credit losses given the explicit government guarantee or other government support.

Securities of U.S. states and political subdivisions

The unrealized losses associated with securities of U.S. states and political subdivisions were primarily driven by changes in interest rates and were not due to the credit quality of the securities. Some of these securities are guaranteed by a bond insurer, but management did not rely on the guarantee in making its investment decision. These securities will continue to be monitored as part of the Company s quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

The carrying values of the Company s investment securities could decline in the future if the financial condition of an issuer deteriorates and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that other-than-temporary impairment charges may occur in the future.

Table of Contents

Other-Than-Temporarily Impaired Securities

Credit-impaired debt securities are debt securities where the Company has written down the amortized cost basis of a security for other-than-temporary impairment and the credit component of the loss is recognized in earnings. At June 30, 2018 and December 31, 2017, the Company had no credit-impaired debt securities and there were no additions or reductions in the credit loss component of credit-impaired debt securities during the six months ended June 30, 2018 and 2017, respectively.

Realized Gains and Losses

The following table presents the gross realized gains and losses on sales of securities.

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Gross realized gains	$		$	2
Realized gains, net	$		$	2

NOTE 4: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	$ 52,921	$ 59,086
Construction and land development	42,675	39,607
Commercial real estate:		
Owner occupied	45,266	44,192
Multi-family	40,497	52,167
Other	160,366	142,674
Total commercial real estate	246,129	239,033
Residential real estate:		
Consumer mortgage	58,676	59,540
Investment property	47,029	47,323
Total residential real estate	105,705	106,863
Consumer installment	9,824	9,588
Total loans	457,254	454,177
Less: unearned income	(682)	(526)

Loans, net of unearned income	$ 456,572	$ 453,651

Loans secured by real estate were approximately 86.3% of the Company s total loan portfolio at June 30, 2018. At June 30, 2018, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama, and surrounding areas.

In accordance with ASC 310, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. As part of the Company s quarterly assessment of the allowance, the loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment. Where appropriate, the Company s loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity s method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments and classes.

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally, the primary source of repayment is the cash flow from business operations and activities of the borrower.

Table of Contents

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying, and developing land into commercial developments or residential subdivisions. Also included are loans and credit lines for construction of residential, multi-family, and commercial buildings. Generally, the primary source of repayment is dependent upon the sale or refinance of the real estate collateral.

Commercial real estate (CRE) includes loans disaggregated into three classes: (1) owner occupied, (2) multifamily and (3) other.

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally, the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

Multi-family primarily includes loans to finance income-producing multi-family properties. Loans in this class include loans for 5 or more unit residential property and apartments leased to residents. Generally, the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

Other primarily includes loans to finance income-producing commercial properties that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, and warehouses leased to local businesses. Generally, the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

Residential real estate (RRE) includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

Consumer mortgage primarily includes first or second lien mortgages and home equity lines of credit to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history, and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally, the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates and property value, as well as the financial health of the borrower.

Consumer installment includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank s general loan policies and procedures which require, among other things, proper documentation of each borrower s financial condition, satisfactory credit history, and, if applicable, property value.

Table of Contents

The following is a summary of current, accruing past due, and nonaccrual loans by portfolio segment and class as of June 30, 2018 and December 31, 2017.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
June 30, 2018:						
Commercial and industrial	$ 52,813	108		52,921		$ 52,921
Construction and land development	42,501	138		42,639	36	42,675
Commercial real estate:						
Owner occupied	45,266			45,266		45,266
Multi-family	40,497			40,497		40,497
Other	159,656			159,656	710	160,366
Total commercial real estate	245,419			245,419	710	246,129
Residential real estate:						
Consumer mortgage	57,740	589		58,329	347	58,676
Investment property	46,733	296		47,029		47,029
Total residential real estate	104,473	885		105,358	347	105,705
Consumer installment	9,806	7		9,813	11	9,824
Total	$ 455,012	1,138		456,150	1,104	$ 457,254
December 31, 2017:						
Commercial and industrial	$ 59,047	8		59,055	31	$ 59,086
Construction and land development	39,607			39,607		39,607
Commercial real estate:						
Owner occupied	44,192			44,192		44,192
Multi-family	52,167			52,167		52,167
Other	140,486			140,486	2,188	142,674
Total commercial real estate	236,845			236,845	2,188	239,033
Residential real estate:						
Consumer mortgage	58,195	746		58,941	599	59,540
Investment property	46,871	312		47,183	140	47,323

Total residential real estate		105,066	1,058	106,124	739	106,863
Consumer installment		9,517	57	9,574	14	9,588
Total	$	450,082	1,123	451,205	2,972	$ 454,177

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates, and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred, which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

Table of Contents

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, the impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for each loan segment. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At June 30, 2018 and December 31, 2017, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures, and other factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the quarter ended June 30, 2018, the Company increased its look-back period to 37 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company

will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Table of Contents

The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

							June 30, 2018
(In thousands)	Commercial and industrial	Construction and land development	Commercial real estate	Residential real estate	Consumer installment		Total
Quarter ended:							
Beginning balance	$ 724	670	2,119	1,053	166	$	4,732
Charge-offs			(39)				(39)
Recoveries	32			17	8		57
Net recoveries (charge-offs)	32		(39)	17	8		18
Provision for loan losses	(156)	117	117	(53)	(25)		
Ending balance	$ 600	787	2,197	1,017	149	$	4,750
Six months ended:							
Beginning balance	$ 653	734	2,126	1,071	173	$	4,757
Charge-offs	(52)		(39)	(4)	(2)		(97)
Recoveries	46			33	11		90
Net (charge-offs) recoveries	(6)		(39)	29	9		(7)
Provision for loan losses	(47)	53	110	(83)	(33)		
Ending balance	$ 600	787	2,197	1,017	149	$	4,750

							June 30, 2017
(In thousands)	Commercial and industrial	Construction and land development	Commercial real estate	Residential real estate	Consumer installment		Total
Quarter ended:							
Beginning balance	$ 524	845	2,004	1,064	151	$	4,588
Charge-offs					(5)		(5)
Recoveries	4	209		63	6		282
Net recoveries (charge-offs)	4	209		63	1		277
Provision for loan losses	149	(180)	117	(8)	22		100
Ending balance	$ 677	874	2,121	1,119	174	$	4,965

Six months ended:							
Beginning balance	$ 540	812	2,071	1,107	113	$	4,643
Charge-offs				(78)	(6)		(84)
Recoveries	6	214		77	9		306
Net recoveries (charge-offs)	6	214		(1)	3		222
Provision for loan losses	131	(152)	50	13	58		100
Ending balance	$ 677	874	2,121	1,119	174	$	4,965

Table of Contents

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of June 30, 2018 and 2017.

	Collectively evaluated (1)		Individually evaluated (2)		Total	
(In thousands)	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
June 30, 2018:						
Commercial and industrial	$ 600	52,921			600	52,921
Construction and land development	787	42,675			787	42,675
Commercial real estate	2,194	245,252	3	877	2,197	246,129
Residential real estate	1,017	105,705			1,017	105,705
Consumer installment	149	9,824			149	9,824
Total	$ 4,747	456,377	3	877	4,750	457,254
June 30, 2017:						
Commercial and industrial	$ 677	50,974			677	50,974
Construction and land development	874	46,386			874	46,386
Commercial real estate	2,099	218,882	22	1,981	2,121	220,863
Residential real estate	1,119	110,288			1,119	110,288
Consumer installment	174	9,409			174	9,409
Total	$ 4,943	435,939	22	1,981	4,965	437,920

(1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for non-impaired loans.
(2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

Credit Quality Indicators

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for qualitative and environmental factors and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company s position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Substandard Accruing loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected.

Nonaccrual includes loans where management has determined that full payment of principal and interest is not expected.

Table of Contents

(In thousands)	Pass	Special Mention	Substandard Accruing	Nonaccrual	Total loans
June 30, 2018:					
Commercial and industrial	$ 52,197	506	218		$ 52,921
Construction and land development	41,892	90	657	36	42,675
Commercial real estate:					
Owner occupied	44,548	391	327		45,266
Multi-family	40,497				40,497
Other	158,644	629	383	710	160,366
Total commercial real estate	243,689	1,020	710	710	246,129
Residential real estate:					
Consumer mortgage	52,988	2,051	3,290	347	58,676
Investment property	46,082	308	639		47,029
Total residential real estate	99,070	2,359	3,929	347	105,705
Consumer installment	9,709	53	51	11	9,824
Total	$ 446,557	4,028	5,565	1,104	$ 457,254
December 31, 2017:					
Commercial and industrial	$ 58,842	94	119	31	$ 59,086
Construction and land development	39,049	90	468		39,607
Commercial real estate:					
Owner occupied	43,615	240	337		44,192
Multi-family	52,167				52,167
Other	139,695	395	396	2,188	142,674
Total commercial real estate	235,477	635	733	2,188	239,033
Residential real estate:					
Consumer mortgage	54,101	1,254	3,586	599	59,540
Investment property	46,463	53	667	140	47,323
Total residential real estate	100,564	1,307	4,253	739	106,863
Consumer installment	9,430	66	78	14	9,588
Total	$ 443,362	2,192	5,651	2,972	$ 454,177

Impaired loans

The following tables present details related to the Company s impaired loans. Loans that have been fully charged-off are not included in the following tables. The related allowance generally represents the following components that correspond to impaired loans:

Individually evaluated impaired loans equal to or greater than $500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).

Individually evaluated impaired loans equal to or greater than $250,000 not secured by real estate (nonaccrual commercial and industrial and consumer installment loans).

Table of Contents

The following tables set forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at June 30, 2018 and December 31, 2017.

	June 30, 2018			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial real estate:				
Other	$ 759	(49)	710	
Total commercial real estate	759	(49)	710	
Total	$ 759	(49)	710	
With allowance recorded:				
Commercial real estate:				
Owner occupied	167		167	3
Total commercial real estate	167		167	3
Total	167		167	3
Total impaired loans	$ 926	(49)	877	$ 3

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

	December 31, 2017			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance

With no allowance recorded:					
Commercial real estate:					
Other	3,630	(1,094)	2,536		
Total commercial real estate	3,630	(1,094)	2,536		
Total	$ 3,630	(1,094)	2,536		
With allowance recorded:					
Commercial and industrial	52	(21)	31		31
Commercial real estate:					
Owner occupied	$ 175		175	$	11
Total commercial real estate	175		175		11
Total	227	(21)	206		42
Total impaired loans	$ 3,857	(1,115)	2,742	$	42

(1) Unpaid principal balance represents the contractual obligation due from the customer.
(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance subsequent to the loans being placed on nonaccrual status.
(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

Table of Contents

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

	Quarter ended June 30, 2018		Six months ended June 30, 2018	
(In thousands)	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
Impaired loans:				
Commercial and industrial	$ 7		17	
Commercial real estate:				
Owner occupied	168	2	170	5
Other	1,392		1,827	
Total commercial real estate	1,560	2	1,997	5
Total	$ 1,567	2	2,014	5

	Quarter ended June 30, 2017		Six months ended June 30, 2017	
(In thousands)	Average recorded investment	Total interest income recognized	Average recorded investment	Total interest income recognized
Impaired loans:				
Commercial and industrial	$ 2		6	
Construction and land development	15		21	
Commercial real estate:				
Owner occupied	186	2	189	5
Other	1,821		1,845	
Total commercial real estate	2,007	2	2,034	5
Total	$ 2,024	2	2,061	5

Troubled Debt Restructurings

Impaired loans also include troubled debt restructurings (TDRs). In the normal course of business, management may grant concessions to borrowers that are experiencing financial difficulty. A concession may include, but is not limited to, delays in required payments of principal and interest for a specified period, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date, or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect, where due, all amounts owed, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. In making the determination of whether a loan modification is a TDR, the Company considers

the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan s original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are individually evaluated for possible impairment.

Table of Contents

The following is a summary of accruing and nonaccrual TDRs, which are included in the impaired loan totals, and the related allowance for loan losses, by portfolio segment and class as of June 30, 2018 and December 31, 2017.

	TDRs			
(In thousands)	**Accruing**	**Nonaccrual**	**Total**	**Related Allowance**
June 30, 2018				
Commercial real estate:				
Owner occupied	$ 167		167	$ 3
Other		710	710	
Total commercial real estate	167	710	877	3
Total	$ 167	710	877	$ 3
December 31, 2017				
Commercial and industrial	$	31	31	$ 31
Commercial real estate:				
Owner occupied	175		175	11
Other	287	1,431	1,718	
Total commercial real estate	462	1,431	1,893	11
Total	$ 462	1,462	1,924	$ 42

The following table summarizes loans modified in a TDR during the respective periods both before and after their modification.

	Quarter ended June 30,			Six Months ended June 30,		
(Dollars in thousands)	**Number of contracts**	**Pre-modification outstanding recorded investment**	**Post - modification outstanding recorded investment**	**Number of contracts**	**Pre-modification outstanding recorded investment**	**Post - modification outstanding recorded investment**
2018:						
Commercial real estate:						
Other	$			1	$ 737	737
Total commercial real estate				1	737	737

Total		$			1	$ 737	737
2017:							
Other	1	$ 1,275	1,266	1	$ 1,275		1,266
Total commercial real estate	1		1,275	1,266	1	1,275	1,266
Total	1	$ 1,275	1,266	1	$ 1,275		1,266

One loan was modified in a TDR during the six months ended June 30, 2018 and 2017. The only concession granted by the Company in each instance was a delay in the required payment of interest.

Table of Contents

The following table summarizes the recorded investment in loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due) during the respective periods. During the quarter and six months ended June 30, 2017, there were no loans modified in a TDR within the previous 12 months for which there was a payment default (defined as 90 days or more past due).

	Quarter ended June 30,		Six Months ended June 30,	
(Dollars in thousands)	Number of Contracts	Recorded investment[1]	Number of Contracts	Recorded investment[1]
2018:				
Commercial real estate:				
Other	$	1	$	1,259
Total commercial real estate		1		1,259
Total	$	1	$	1,259

(1) Amount as of applicable month end during the respective period for which there was a payment default.

NOTE 5: MORTGAGE SERVICING RIGHTS, NET

Mortgage servicing rights (MSRs) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the fair value of the Company s MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rates, default rates, costs to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying consolidated balance sheets.

The Company evaluates MSRs for impairment on a quarterly basis. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation allowance is established. The valuation allowance is adjusted as the fair value changes. Changes in the valuation allowance are recognized in earnings as a component of mortgage lending income.

The following table details the changes in amortized MSRs and the related valuation allowance for the respective periods.

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
MSRs, net:				
Beginning balance	$ 1,604	$ 1,862	$ 1,644	$ 1,952
Additions, net	62	40	115	93
Amortization expense	(117)	(140)	(210)	(284)
Decrease in valuation allowance				1
Ending balance	$ 1,549	$ 1,762	$ 1,549	$ 1,762
Valuation allowance included in MSRs, net:				
Beginning of period	$	$	$	$ 1
End of period				
Fair value of amortized MSRs:				
Beginning of period	$ 2,738	$ 2,689	$ 2,528	$ 2,678
End of period	2,659	2,520	2,659	2,520

Table of Contents

NOTE 6: DERIVATIVE INSTRUMENTS

Financial derivatives are reported at fair value in other assets or other liabilities on the accompanying consolidated balance sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings within other noninterest income on the accompanying consolidated statements of earnings. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. Upon entering into these swaps, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

The Company had no interest rate swap agreements at June 30, 2018. A summary of the Company s interest rate swap agreements at December 31, 2017 is presented below.

			Other Assets	Other Liabilities
(Dollars in thousands)		**Notional**	**Estimated Fair Value**	**Estimated Fair Value**
December 31, 2017:				
Pay fixed / receive variable	$	3,617		52
Pay variable / receive fixed		3,617	52	
Total interest rate swap agreements	$	7,234	52	52

NOTE 7: FAIR VALUE

Fair Value Hierarchy

Fair value is defined by ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for an asset or liability at the measurement date. GAAP establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs that are observable for the asset or liability, either directly or indirectly.

Level 3 inputs to the valuation methodology are unobservable and reflect the Company s own assumptions about the inputs market participants would use in pricing the asset or liability.

Level changes in fair value measurements

Transfers between levels of the fair value hierarchy are generally recognized at the end of each reporting period. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company s financial assets and liabilities generally is such that transfers in and out of any level are expected to be infrequent. For the six months ended June 30, 2018, there were no transfers between levels and no changes in valuation techniques for the Company s financial assets and liabilities.

Table of Contents

Assets and liabilities measured at fair value on a recurring basis

Securities available-for-sale

Fair values of securities available for sale were primarily measured using Level 2 inputs. For these securities, the Company obtains pricing from third party pricing services. These third party pricing services consider observable data that may include broker/dealer quotes, market spreads, cash flows, benchmark yields, reported trades for similar securities, market consensus prepayment speeds, credit information, and the securities terms and conditions. On a quarterly basis, management reviews the pricing received from the third party pricing services for reasonableness given current market conditions. As part of its review, management may obtain non-binding third party broker quotes to validate the fair value measurements. In addition, management will periodically submit pricing provided by the third party pricing services to another independent valuation firm on a sample basis. This independent valuation firm will compare the price provided by the third party pricing service with its own price and will review the significant assumptions and valuation methodologies used with management.

Interest rate swap agreements

The carrying amount of interest rate swap agreements was included in other assets and accrued expenses and other liabilities on the accompanying consolidated balance sheets. The Company had no interest rate swap agreements at June 30, 2018. The fair value measurements for our interest rate swap agreements were based on information obtained from a third party bank. This information is periodically tested by the Company and validated against other third party valuations. If needed, other third party market participants may be utilized to corroborate the fair value measurements for our interest rate swap agreements. The Company classified these derivative assets and liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments.

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017, respectively, by caption, on the accompanying consolidated balance sheets by ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)		**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
June 30, 2018:					
Securities available-for-sale:					
Agency obligations	$	51,361		51,361	
Agency RMBS		129,006		129,006	
State and political subdivisions		70,953		70,953	
Total securities available-for-sale		251,320		251,320	
Total assets at fair value	$	251,320		251,320	

December 31, 2017:			
Securities available-for-sale:			
Agency obligations	$	53,062	53,062
Agency RMBS		133,072	133,072
State and political subdivisions		71,563	71,563
Total securities available-for-sale		257,697	257,697
Other assets [1]		52	52
Total assets at fair value	$	257,749	257,749
Other liabilities[1]	$	52	52
Total liabilities at fair value	$	52	52

[1] Represents the fair value of interest rate swap agreements.

Table of Contents

Assets and liabilities measured at fair value on a nonrecurring basis

Loans held for sale

Loans held for sale are carried at the lower of cost or fair value. Fair values of loans held for sale are determined using quoted market secondary market prices for similar loans. Loans held for sale are classified within Level 2 of the fair value hierarchy.

Impaired Loans

Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan s original effective rate as the discount rate, the loan s observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management s historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management s expertise and knowledge of the customer and the customer s business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Other real estate owned

Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan s carrying amount or the fair value of collateral less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management s historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management s expertise and knowledge of the customer and the customer s business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, a loss is recognized in noninterest expense.

Mortgage servicing rights, net

Mortgage servicing rights, net, included in other assets on the accompanying consolidated balance sheets, are carried at the lower of cost or estimated fair value. MSRs do not trade in an active market with readily observable prices. To determine the fair value of MSRs, the Company engages an independent third party. The independent third party s valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rates, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Periodically, the Company will review broker surveys and other market research to validate significant

assumptions used in the model. The significant unobservable inputs include prepayment speeds or the constant prepayment rate (CPR) and the weighted average discount rate. Because the valuation of MSRs requires the use of significant unobservable inputs, all of the Company s MSRs are classified within Level 3 of the valuation hierarchy.

Table of Contents

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2018 and December 31, 2017, respectively, by caption, on the accompanying consolidated balance sheets and by FASB ASC 820 valuation hierarchy (as described above):

(Dollars in thousands)		Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2018:					
Loans held for sale	$	1,943		1,943	
Loans, net[1]		874			874
Other assets [2]		1,686			1,686
Total assets at fair value	$	4,503		1,943	2,560
December 31, 2017:					
Loans held for sale	$	1,922		1,922	
Loans, net[1]		2,700			2,700
Other assets [2]		1,644			1,644
Total assets at fair value	$	6,266		1,922	4,344

[1] Loans considered impaired under ASC 310-10-35, *Receivables*. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.

[2] Represents MSRs, net and other real estate owned, both of which are carried at lower of cost or estimated fair value.

Quantitative Disclosures for Level 3 Fair Value Measurements

At June 30, 2018, the Company had no Level 3 assets measured at fair value on a recurring basis. For Level 3 assets measured at fair value on a non-recurring basis at June 30, 2018, the significant unobservable inputs used in the fair value measurements are presented below.

(Dollars in thousands)	Carrying Amount	Valuation Technique	Significant Unobservable Input	Weighted Average of Input
Nonrecurring:				

Impaired loans	$ 874	Appraisal	Appraisal discounts (%)	52.4%
Other real estate owned	137	Appraisal	Appraisal discounts (%)	10.0%
Mortgage servicing rights, net	1,549	Discounted cash flow	Prepayment speed or CPR (%)	9.4%
			Discount rate (%)	10.0%

Fair Value of Financial Instruments

ASC 825, *Financial Instruments*, requires disclosure of fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company s financial instruments are explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow analyses. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company s financial instruments, but rather are a good-faith estimate of the fair value of financial instruments held by the Company. ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.

Table of Contents

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

Loans, net

Fair values for loans were calculated using discounted cash flows. The discount rates reflected current rates at which similar loans would be made for the same remaining maturities. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Loans held for sale

Fair values of loans held for sale are determined using quoted secondary market prices for similar loans.

Time Deposits

Fair values for time deposits were estimated using discounted cash flows. The discount rates were based on rates currently offered for deposits with similar remaining maturities.

Long-term debt

The carrying amount of the Company s variable rate long-term debt approximates its fair value.

The carrying value, related estimated fair value, and placement in the fair value hierarchy of the Company s financial instruments at June 30, 2018 and December 31, 2017 are presented below. This table excludes financial instruments for which the carrying amount approximates fair value. Financial assets for which fair value approximates carrying value included cash and cash equivalents. Financial liabilities for which fair value approximates carrying value included noninterest-bearing demand deposits, interest-bearing demand deposits, and savings deposits due to these products having no stated maturity. In addition, financial liabilities for which fair value approximates carrying value included overnight borrowings such as federal funds purchased and securities sold under agreements to repurchase.

			Fair Value Hierarchy		
(Dollars in thousands)	**Carrying amount**	**Estimated fair value**	**Level 1 inputs**	**Level 2 inputs**	**Level 3 Inputs**
June 30, 2018:					
Financial Assets:					
Loans, net (1)	$ 451,822	$ 449,078	$	$	$ 449,078
Loans held for sale	1,943	1,976		1,976	
Financial Liabilities:					
Time Deposits	$ 183,001	$ 183,631	$	$ 183,631	$
December 31, 2017:					
Financial Assets:					

Loans, net (1)	$ 448,894	$ 447,468	$	$	$ 447,468
Loans held for sale	1,922	1,950		1,950	
Financial Liabilities:					
Time Deposits	$ 188,071	$ 185,564	$	$ 185,564	$
Long-term debt	3,217	3,217		3,217	

(1) Represents loans, net of unearned income and the allowance for loan losses. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of June 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Table of Contents

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

General

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of the Company and the Bank. This discussion is intended to supplement and highlight information contained in the accompanying unaudited condensed consolidated financial statements and related notes for the quarters and six months ended June 30, 2018 and 2017, as well as the information contained in our Annual Report on Form 10-K for the year ended December 31, 2017 and our subsequent Quarterly Reports on Form 10-Q.

Special Notice Regarding Forward-Looking Statements

Certain of the statements made in this discussion and analysis and elsewhere, including information incorporated herein by reference to other documents, are forward-looking statements within the meaning of, and subject to, the protections of Section 27A of the Securities Act of 1933, as amended, (the Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance, achievements, or financial condition of the Company to be materially different from future results, performance, achievements, or financial condition expressed or implied by such forward-looking statements. You should not expect us to update any forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, assume, sho indicate, would, believe, contemplate, expect, estimate, continue, plan, point to, project, could, similar words and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

- the effects of future economic, business, and market conditions and changes, domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities, and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance;
- changes in accounting policies, rules, and practices;

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 interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable;

changes in borrower credit risks and payment behaviors;

changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes;

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, including the disruptive effects of financial technology and other competitors who are not subject to the same regulations as the Company and the Bank;

the failure of assumptions and estimates underlying the establishment of allowances for possible loan and other asset impairments, losses, valuations of assets and liabilities and other estimates;

Table of Contents

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;

changes in our technology or products that may be more difficult, costly, or less effective than anticipated;

the effects of war, or other conflicts, acts of terrorism, or other catastrophic events that may affect general economic conditions;

cyber attacks and data breaches that may compromise our systems or customers information;

the failure of assumptions and estimates, as well as differences in, and changes to, economic, market, and credit conditions, including changes in borrowers credit risks and payment behaviors from those used in our loan portfolio stress tests and other evaluations;

the risk that our deferred tax assets, if any, could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards, if any, that we may be able to utilize for income tax purposes; and

other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our Annual Report on Form 10-K for the year ended December 31, 2017 and subsequent quarterly and current reports. See Part II, Item 1A. RISK FACTORS .

All written or oral forward-looking statements that are made by or attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

Business

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company s principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates 8 full-service branches in Auburn, Opelika, Notasulga, and Valley, Alabama. The Bank also operates a loan production office in Phenix City, Alabama.

Summary of Results of Operations

(Dollars in thousands, except per share amounts)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Net interest income (a)	$ 6,469	$ 6,402	$ 12,909	$ 12,591
Less: tax-equivalent adjustment	152	301	308	601
Net interest income (GAAP)	6,317	6,101	12,601	11,990
Noninterest income	839	793	1,692	1,629
Total revenue	7,156	6,894	14,293	13,619
Provision for loan losses		100		100
Noninterest expense	4,326	4,015	8,728	8,133
Income tax expense	566	784	1,106	1,501
Net earnings	$ 2,264	$ 1,995	$ 4,459	$ 3,885
Basic and diluted earnings per share	$ 0.62	$ 0.55	$ 1.22	$ 1.07

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures.

Table of Contents

Financial Summary

The Company s net earnings were $4.5 million for the first six months of 2018, compared to $3.9 million for the first six months of 2017. Basic and diluted earnings per share were $1.22 per share for the first six months of 2018, compared to $1.07 per share for the first six months of 2017.

Net interest income (tax-equivalent) was $12.9 million for the first six months of 2018, a 3% increase compared to $12.6 million for the first six months of 2017. This increase was primarily due to loan growth and recent increases in short-term market interest rates. Average loans were up 4% to $449.9 million in the first six months of 2018, compared to $433.2 million in the first six months of 2017. The Company s net interest margin (tax-equivalent) increased to 3.33% in the first six months of 2018, compared to 3.23% for the first six months of 2017 as yields on earning assets improved.

The Company recorded no provision for loan losses during the first six months of 2018 and $0.1 million during the first six months 2017. The provision for loan losses is based upon various estimates and judgements, including the absolute level of loans, loan growth, credit quality and the amount of net charge-offs.

Noninterest income was $1.7 million compared to $1.6 million for the first six months of 2017. Noninterest expense was $8.7 million compared to $8.1 million for the first six months of 2017. This increase in noninterest expense was primarily due to increases in salaries and benefits expense of $0.5 million.

Income tax expense was $1.1 million and $1.5 million for the first six months of 2018 and 2017 reflecting an effective tax rate of 19.87 and 27.87%, respectively. The decrease in the effective tax rate was primarily due to the Tax Cuts and Jobs Act, signed into law December 22, 2017, which lowered the Company s statutory federal tax rate from 34% to 21%.

The Company paid cash dividends of $0.48 per share in the first six months of 2018, an increase of 4.3% from the same period of 2017. At June 30, 2018, the Bank s regulatory capital ratios were well above the minimum amounts required to be well capitalized under current regulatory standards with a total risk-based capital ratio of 17.29%, a tier 1 leverage ratio of 10.93% and common equity tier 1 of 16.40% at June 30, 2018.

In the second quarter of 2018, net earnings were $2.3 million, or $0.62 per share, compared to $2.0 million, or $0.55 per share, for the second quarter of 2017. Net interest income (tax-equivalent) was $6.5 million for the second quarter of 2018, compared to $6.4 million for the second quarter of 2017. This increase was due to the same factors as described above. The Company recorded no provision for loan losses in the second quarter of 2018 and $0.1 million in the second quarter of 2017. Noninterest income was $0.8 million in the second quarter of 2018 and 2017. Noninterest expense was $4.3 million in the second quarter of 2018 compared to $4.0 million in the second quarter of 2017. This increase was mainly due to increases in salaries and benefits expense. Income tax expense was $0.6 million for the second quarter of 2018, compared to $0.8 million in the second quarter of 2017. The Company s effective tax rate for the second quarter of 2018 was 20.00%, compared to 28.21% in the second quarter of 2017. This decrease was due to the same factors described above.

CRITICAL ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the

valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

Table of Contents

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates, and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred, which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, the impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for each loan segment. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At June 30, 2018 and December 31, 2017, and for the periods then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures, and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

Table of Contents

The Company regularly re-evaluates its practices in determining the allowance for loan losses. Since the fourth quarter of 2016, the Company has increased its look-back period each quarter to incorporate the effects of at least one economic downturn in its loss history. The Company believes the extension of its look-back period is appropriate due to the risks inherent in the loan portfolio. Absent this extension, the early cycle periods in which the Company experienced significant losses would be excluded from the determination of the allowance for loan losses and its balance would decrease. For the quarter ended June 30, 2018, the Company increased its look-back period to 37 quarters to continue to include losses incurred by the Company beginning with the first quarter of 2009. The Company will likely continue to increase its look-back period to incorporate the effects of at least one economic downturn in its loss history. Other than expanding the look-back period each quarter, the Company has not made any material changes to its methodology that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security s amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company s assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 7, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company s assets or liabilities lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management s best estimates for appropriate discount rates, default rates, prepayments, market volatility, and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

Other Real Estate Owned

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value of collateral, less estimated costs to sell at the date acquired, with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

Table of Contents

Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at June 30, 2018. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

RESULTS OF OPERATIONS

Average Balance Sheet and Interest Rates

	Six Months ended June 30,			
	2018		2017	
(Dollars in thousands)	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
Loans and loans held for sale	$ 451,063	4.71%	$ 434,054	4.69%
Securities - taxable	189,442	2.22%	196,886	2.18%
Securities - tax-exempt	71,283	4.14%	69,353	5.14%
Total securities	260,725	2.75%	266,239	2.96%
Federal funds sold	28,932	1.64%	35,206	0.89%
Interest bearing bank deposits	41,765	1.72%	50,238	0.91%
Total interest-earning assets	782,485	3.78%	785,737	3.69%
Deposits:				
NOW	138,163	0.30%	126,200	0.19%
Savings and money market	220,022	0.36%	231,127	0.37%
Time Deposits	185,588	1.21%	203,189	1.18%
Total interest-bearing deposits	543,773	0.64%	560,516	0.62%
Short-term borrowings	2,888	0.84%	3,649	0.50%
Long-term debt	2,062	4.50%	3,217	3.70%
Total interest-bearing liabilities	548,723	0.65%	567,382	0.64%
Net interest income and margin (tax-equivalent)	$ 12,909	3.33%	$ 12,591	3.23%

Net Interest Income and Margin

Net interest income (tax-equivalent) was $12.9 million for the first six months of 2018 compared to $12.6 million for the first six months of 2017. This increase was primarily due to improved yields on interest-earning assets.

Expansion of our earning asset yields was primarily driven by loan growth and recent increases in short-term market interest rates, which positively impacted the yields on our short-term assets, including federal funds sold and interest bearing bank deposits. This expansion was partially offset by a decrease in the tax-equivalent yield on tax-exempt available-for-sale securities due to a reduction in the Company s statutory federal tax rate from 34% to 21%.

The cost of total interest-bearing liabilities was largely unchanged in the first six months of 2018 from the first six months of 2017.

Table of Contents

The Company continues to deploy various asset liability management strategies to manage its risk to interest rate fluctuations. The Company s net interest margin could experience pressure due to reduced earning asset yields during the extended period of low interest rates, increased competition for quality loan opportunities, and possible increases in our costs of funds, if the Federal Reserve continues its gradual increase in interest rates. The Company anticipates that this challenging, competitive environment will continue throughout 2018 and it is unclear what impact the reduction in corporate tax rates under the Tax Cuts and Jobs Act will have on the interest rates the Company is able to charge for loans or pay on deposits though it is believed it will increase competition. However, the Company believes our net interest income should continue to increase in 2018 compared to 2017 primarily due to an increase in average earning asset volumes, primarily loans.

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that management believes, based on its processes and estimates, should be adequate to provide for the probable losses on outstanding loans. The Company recorded no provision for loan losses for the first six months of 2018 and $0.1 million for the first six months of 2017. The provision for loan losses is based upon various factors, including the absolute level of loans, loan growth, the credit quality, and the amount of net charge-offs or recoveries.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover its estimate of probable losses in the loan portfolio. The Company s allowance for loan losses as a percentage of total loans was 1.04% at June 30, 2018, compared to 1.05% at December 31, 2017. While the policies and procedures used to estimate the allowance for loan losses, as well as the resulting provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgments and are therefore approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate markets, or industries) may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses resulting in significant increases in the provision for loan losses.

Noninterest Income

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Service charges on deposit accounts	$ 182	$ 183	$ 361	$ 372
Mortgage lending income	166	139	372	304
Bank-owned life insurance	108	110	214	217
Securities gains, net				2
Other	383	361	745	734
Total noninterest income	$ 839	$ 793	$ 1,692	$ 1,629

The Company s income from mortgage lending was primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income, net, is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees, and other fees associated with the origination of loans, which are netted against the commission expense associated with these originations. The Company s normal practice is to originate mortgage loans for sale in the secondary market and to either sell or retain

the associated mortgage servicing rights (MSRs) when the loan is sold.

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

MSRs are also evaluated for impairment on a quarterly basis. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group s aggregate fair value, a valuation allowance for that group is established. The valuation allowance is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

Table of Contents

The following table presents a breakdown of the Company s mortgage lending income.

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Origination income	$ 92	$ 77	$ 198	$ 176
Servicing fees, net	74	62	174	127
Decrease in MSR valuation allowance				1
Total mortgage lending income	$ 166	$ 139	$ 372	$ 304

The increase in mortgage lending income was due to an increase in the volume of mortgage loans originated and sold and a decrease in MSR amortization expense as prepayment speeds have slowed.

Noninterest Expense

(Dollars in thousands)	Quarter ended June 30, 2018	2017	Six Months ended June 30, 2018	2017
Salaries and benefits	$ 2,618	$ 2,392	$ 5,286	$ 4,773
Net occupancy and equipment	360	351	730	732
Professional fees	266	254	494	484
FDIC and other regulatory assessments	89	89	178	178
Other	993	929	2,040	1,966
Total noninterest expense	$ 4,326	$ 4,015	$ 8,728	$ 8,133

The increase in noninterest expense was primarily due to routine annual increases in salaries and benefits expense.

Income Tax Expense

Income tax expense was $1.1 million and $1.5 million for the first six months of 2018 and 2017 reflecting an effective tax rate of 19.87% and 27.87%, respectively. The decrease in the effective tax rate was primarily due to the Tax Cuts and Jobs Act, signed into law December 22, 2017, which lowered the Company s statutory federal tax rate from 34% to 21%.

BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale were $251.3 million at June 30, 2018 compared to $257.7 million at December 31, 2017. This decrease reflects a decrease in the fair value of securities available-for-sale of $5.2 million and a decrease in the

amortized cost basis of securities available-for-sale of $1.2 million. The decrease in the fair value of securities was primarily due to an increase in long-term interest rates. The average annualized tax-equivalent yields earned on total securities were 2.75% in 2018 and 2.96% in 2017. This decrease in the tax-equivalent yields was primarily due to a decrease in the Company s statutory federal tax rate from 34% to 21%.

Loans

	2018		2017		
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Commercial and industrial	$ 52,921	57,877	59,086	50,101	50,974
Construction and land development	42,675	35,910	39,607	47,455	46,386
Commercial real estate	246,129	234,345	239,033	232,380	220,863
Residential real estate	105,705	106,496	106,863	110,159	110,288
Consumer installment	9,824	9,685	9,588	9,877	9,409
Total loans	457,254	444,313	454,177	449,972	437,920
Less: unearned income	(682)	(509)	(526)	(594)	(633)
Loans, net of unearned income	$ 456,572	443,804	453,651	449,378	437,287

Table of Contents

Total loans, net of unearned income, were $456.6 million at June 30, 2018, compared to $453.7 million at December 31, 2017. The increase of $2.9 million was primarily due to increases in the construction and land development and commercial real estate portfolio segments, which was partially offset by pay-downs in the commercial and industrial loan portfolio segment. Four loan categories represented the majority of the loan portfolio at June 30, 2018: commercial real estate (54%), residential real estate (23%), construction and land development (9%) and commercial and industrial (12%). Approximately 18% of the Company s commercial real estate loans were classified as owner-occupied at June 30, 2018.

Within the residential real estate portfolio segment, the Company had junior lien mortgages of approximately $12.3 million, or 3% of total loans, at June 30, 2018, compared to $12.6 million, or 3% of total loans, at December 31, 2017. For residential real estate mortgage loans with a consumer purpose, $1.4 million required interest-only payments at June 30, 2018, compared to $2.1 million at December 31, 2017. The Company s residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

The average yield earned on loans and loans held for sale was 4.71% in the first six months of 2018 and 4.69% in the first six months of 2017.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current economic conditions on our borrowers cash flows, real estate market sales volumes, valuations, availability and cost of financing properties, real estate industry concentrations, competitive pressures from a wide range of other lenders, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of applicable laws and regulations.

The Company attempts to reduce these economic and credit risks through its loan-to-value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers financial position. Also, we have established and periodically review, lending policies and procedures. Banking regulations limit a bank s credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital; or 20% of capital, if loans in excess of 10% of capital are fully secured. Under these regulations, we are prohibited from having secured loan relationships in excess of approximately $18.8 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $16.9 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At June 30, 2018, the Bank had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank s total risk-based capital at June 30, 2018 (and related balances at December 31, 2017).

(In thousands)	**June 30, 2018**	**December 31, 2017**
Lessors of 1 to 4 family residential properties	$ 47,029	$ 47,323

Multi-family residential properties	40,497	52,167
Shopping centers	38,446	39,966
Hotel/motel	33,491	22,384
Office buildings	25,450	24,483

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company s estimate of probable losses inherent in the loan portfolio. The allowance for loan losses was $4.8 million and $4.7 million at June 30, 2018 and December 31, 2017, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under Critical Accounting Policies.

Table of Contents

A summary of the changes in the allowance for loan losses and certain asset quality ratios for the second quarter of 2018 and the previous four quarters is presented below.

	2018		2017		
(Dollars in thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Balance at beginning of period	$ 4,732	4,757	4,670	4,965	4,588
Charge-offs:					
Commercial and industrial		(52)		(449)	
Commercial real estate	(39)				
Residential real estate		(4)		(30)	
Consumer installment		(2)	(23)	(10)	(5)
Total charge-offs	(39)	(58)	(23)	(489)	(5)
Recoveries	57	33	510	194	282
Net recoveries (charge-offs)	18	(25)	487	(295)	277
Provision for loan losses			(400)		100
Ending balance	$ 4,750	4,732	4,757	4,670	4,965
as a % of loans	1.04 %	1.07	1.05	1.04	1.14
as a % of nonperforming loans	430 %	146	160	161	220
Net (recoveries) charge-offs as % of average loans (a)	(0.02)%	0.02	(0.43)	0.27	(0.25)

(a) Net (recoveries) charge-offs are annualized.

As described under Critical Accounting Policies, management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates, and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.04% at June 30, 2018, compared to 1.05% at December 31, 2017. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken. In addition, our regulators, as an integral part of their examination process, will periodically review the Company s allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

The Company s recorded investment in loans considered impaired was $0.9 million at June 30, 2018 and $2.7 million at December 31, 2017, respectively, with corresponding valuation allowances (included in the allowance for loan losses) of $3 thousand and $42 thousand at each respective date.

Nonperforming Assets

The Company had $1.2 million in nonperforming assets at June 30, 2018, compared to $3.0 million in nonperforming assets at December 31, 2017. The decrease in nonperforming assets was primarily due to the resolution of one nonperforming commercial real estate loan with a recorded investment of $1.3 million at December 31, 2017.

Table of Contents

The table below provides information concerning total nonperforming assets and certain asset quality ratios for the second quarter of 2018 and the previous four quarters.

	2018		2017		
(Dollars in thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Nonperforming assets:					
Nonaccrual loans	$ 1,104	3,239	2,972	2,902	2,255
Other real estate owned	137			103	103
Total nonperforming assets	$ 1,241	3,239	2,972	3,005	2,358
as a % of loans and other real estate owned	0.27 %	0.73	0.66	0.67	0.54
as a % of total assets	0.15 %	0.39	0.35	0.36	0.28
Nonperforming loans as a % of total loans	0.24 %	0.73	0.66	0.65	0.52
Accruing loans 90 days or more past due	$			5	42

The table below provides information concerning the composition of nonaccrual loans for the second quarter of 2018 and the previous four quarters.

	2018		2017		
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Nonaccrual loans:					
Commercial and industrial	$	234	31	33	34
Construction and land development	36				
Commercial real estate	710	2,463	2,188	2,500	1,797
Residential real estate	347	530	739	353	406
Consumer installment	11	12	14	16	18
Total nonaccrual loans	$ 1,104	3,239	2,972	2,902	2,255

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is 90 days or more past due, unless the loan is both well-secured and in the process of collection. At June 30, 2018 and December 31, 2017, respectively, the Company had $1.1 million and $3.0 million in loans on nonaccrual.

At June 30, 2018 and December 31, 2017 there were no loans 90 days or more past due and still accruing.

The table below provides information concerning the composition of other real estate owned for the second quarter of 2018 and the previous four quarters.

	2018		2017		
(In thousands)	**Second Quarter**	**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**
Other real estate owned:					
Residential	$ 137			103	103
Total other real estate owned	$ 137			103	103

Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of a borrower has caused management to have serious doubts about the borrower s ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve Bank, the Company s primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to $5.6 million, or 1.2% of total loans at June 30, 2018, compared to $5.7 million, or 1.2% of total loans at December 31, 2017.

Table of Contents

The table below provides information concerning the composition of potential problem loans for the second quarter of 2018 and the previous four quarters.

	2018			2017	
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Potential problem loans:					
Commercial and industrial	$ 218	112	119	130	609
Construction and land development	657	450	468	273	286
Commercial real estate	710	725	733	767	1,528
Residential real estate	3,929	3,992	4,253	4,524	4,416
Consumer installment	51	70	78	96	97
Total potential problem loans	$ 5,565	5,349	5,651	5,790	6,936

At June 30, 2018, approximately $0.6 million, or 11% of total potential problem loans were past due at least 30 days, but less than 90 days.

The following table is a summary of the Company s performing loans that were past due at least 30 days, but less than 90 days, for the second quarter of 2018 and the previous four quarters.

	2018			2017	
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Performing loans past due 30 to 89 days:					
Commercial and industrial	$ 108	3	8	64	195
Construction and land development	138	253		175	2
Commercial real estate					748
Residential real estate	885	573	1,058	513	496
Consumer installment	7	9	57	33	25
Total	$ 1,138	838	1,123	785	1,466

Deposits

Total deposits were $721.0 million at June 30, 2018, compared to $757.7 million at December 31, 2017. Decreases of $42.2 million in interest bearing deposits were partially offset by increases in noninterest bearing deposits of

$5.6 million during the first six months of 2018. Of the $42.2 million decrease in interest bearing deposits, $39.0 million was due to fluctuations in public depositor account balances. Noninterest bearing deposits were $199.5 million, or 27.7% of total deposits, at June 30, 2018, compared to $193.9 million, or 25.6% of total deposits at December 31, 2017.

The average rate paid on total interest-bearing deposits was 0.64% in the first six months of 2018 and 0.62% in the first six months of 2017.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings generally consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity less than one year. The Bank had available federal funds lines totaling $41.0 million with none outstanding at June 30, 2018, and at December 31, 2017, respectively. Securities sold under agreements to repurchase totaled $2.7 million at June 30, 2018 and December 31, 2017.

The average rate paid on short-term borrowings was 0.84% in the first six months of 2018 compared to 0.50% in the first six months of 2017.

Table of Contents

Long-term debt includes junior subordinated debentures related to trust preferred securities. The Company had $3.2 million in junior subordinated debentures related to trust preferred securities outstanding at December 31, 2017. On April 27, 2018, the Company formally redeemed all of the issued and outstanding junior subordinated debentures, including accrued and unpaid distributions, and the Trust formally redeemed all of the issued and outstanding trust preferred securities and common securities at par, including accrued and unpaid distributions. The junior subordinated debentures would have matured on December 31, 2033 and were redeemable since December 31, 2008.

The average rate paid on long-term debt was 4.50% in the first six months of 2018 and 3.70% in the first six months of 2017.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity was $85.7 million and $86.9 million as of June 30, 2018 and December 31, 2017, respectively. The decrease from December 31, 2017 was primarily driven by an other comprehensive loss due to the change in unrealized losses on securities available-for-sale, net-of-tax, of $3.9 million and cash dividends paid of $1.8 million, which were partially offset by net earnings of $4.5 million.

On January 1, 2015, the Company and Bank became subject to the rules of the Basel III regulatory capital framework and related Dodd-Frank Wall Street Reform and Consumer Protection Act changes. The new rules included the implementation of a new capital conservation buffer that is added to the minimum requirements for capital adequacy purposes. The capital conservation buffer is subject to a three year phase-in period that began on January 1, 2016 and will be fully phased-in on January 1, 2019 at 2.5%. The required phase-in capital conservation buffer during 2018 is 1.875%. A banking organization with a conservation buffer of less than the required amount will be subject to limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. At June 30, 2018, the ratios for the Company and Bank were sufficient to meet the fully phased-in conservation buffer.

The Company s tier 1 leverage ratio was 10.93%, common equity tier 1 (CET1) risk-based capital ratio was 16.40%, tier 1 risk-based capital ratio was 16.40%, and total risk-based capital ratio was 17.29% at June 30, 2018. These ratios exceed the minimum regulatory capital percentages of 5.0% for tier 1 leverage ratio, 6.5% for CET1 risk-based capital ratio, 8.0% for tier 1 risk-based capital ratio, and 10.0% for total risk-based capital ratio to be considered well capitalized. The Company s capital conservation buffer was 9.29% at June 30, 2018.

MARKET AND LIQUIDITY RISK MANAGEMENT

Management s objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank s Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure an acceptable asset/liability composition. Two critical areas of focus for ALCO are interest rate risk and liquidity risk management.

Interest Rate Risk Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates interest rate risk so that the Bank can meet customer demands for various types of loans and deposits. Measurements used to help manage interest rate sensitivity include an earnings simulation model and an economic value of equity (EVE) model.

Earnings simulation. Management believes that interest rate risk is best estimated by our earnings simulation modeling. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates. To help limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income from gradual changes in interest rates. For changes up or down in rates from management s flat interest rate forecast over the next 12 months, policy limits for net interest income variances are as follows:

+/- 20% for a gradual change of 400 basis points
+/- 15% for a gradual change of 300 basis points
+/- 10% for a gradual change of 200 basis points
+/- 5% for a gradual change of 100 basis points

Table of Contents

At June 30, 2018, our earnings simulation model indicated that we were in compliance with the policy guidelines noted above.

Economic Value of Equity. EVE measures the extent that the estimated economic values of our assets, liabilities, and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities, and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model, which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the re-pricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions. To help limit interest rate risk, we have stated policy guidelines for an instantaneous basis point change in interest rates, such that our EVE should not decrease from our base case by more than the following:

45% for an instantaneous change of +/- 400 basis points
35% for an instantaneous change of +/- 300 basis points
25% for an instantaneous change of +/- 200 basis points
15% for an instantaneous change of +/- 100 basis points

At June 30, 2018, our EVE model indicated that we were in compliance with the policy guidelines noted above.

Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors, including market perceptions. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types of assets and liabilities may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company s established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities, and as a tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At June 30, 2018 and December 31, 2017, the Company had no derivative contracts designated as part of a hedging relationship to assist in managing its interest rate sensitivity.

Liquidity Risk Management

Liquidity is the Company s ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management

of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels. The first is the liquidity of the Company. The second is the liquidity of the Bank. The management of liquidity at both levels is essential, because the Company and the Bank are separate and distinct legal entities with different funding needs and sources, and each are subject to regulatory guidelines and requirements. The Company depends upon dividends from the Bank for liquidity to pay its operating expenses, debt obligations and dividends. The Bank s payment of dividends depends on its earnings, liquidity, capital and the absence of any regulatory restrictions.

Table of Contents

The primary source of funding and liquidity for the Company has been dividends received from the Bank. If needed, the Company could also issue common stock or other securities. Primary uses of funds by the Company include dividends paid to stockholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. On April 27, 2018, the Trust formally redeemed all of its issued and outstanding trust preferred securities at par, including accrued and unpaid distributions. The additional amount paid on April 27, 2018 for trust preferred securities not previously purchased by the Company was approximately $3.0 million, including accrued and unpaid distributions. All junior subordinated debentures related to the Trust were redeemed, including accrued and unpaid distributions, and retired as a result of the action. The Company now has no outstanding trust preferred securities or junior subordinated debentures, and the Trust has been dissolved.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, sales of securities, and the sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank may participate in the FHLB s advance program to obtain funding for its growth. Advances include both fixed and variable terms and may be taken out with varying maturities. At June 30, 2018, the Bank had a remaining available line of credit with the FHLB of $248.7 million. At June 30, 2018, the Bank also had $41.0 million of available federal funds lines with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

Management believes that the Company and the Bank have adequate sources of liquidity to meet all their respective known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next twelve months.

Off-Balance Sheet Arrangements, Commitments, Contingencies and Contractual Obligations

At June 30, 2018, the Bank had outstanding standby letters of credit of $6.7 million and unfunded loan commitments outstanding of $65.1 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank could liquidate federal funds sold or a portion of securities available-for-sale, or draw on its available credit facilities.

Mortgage lending activities

Since 2009, we have primarily sold residential mortgage loans in the secondary market to Fannie Mae while retaining the servicing of these loans. The sale agreements for these residential mortgage loans with Fannie Mae and other investors include various representations and warranties regarding the origination and characteristics of the residential mortgage loans. Although the representations and warranties vary among investors, they typically cover ownership of the loan, validity of the lien securing the loan, the absence of delinquent taxes or liens against the property securing the loan, compliance with loan criteria set forth in the applicable agreement, compliance with applicable federal, state, and local laws, among other matters.

As of June 30, 2018, the unpaid principal balance of residential mortgage loans, which we have originated and sold, but retained the servicing rights was $302.5 million. Although these loans are generally sold on a non-recourse basis, we may be obligated to repurchase residential mortgage loans or reimburse investors for losses incurred (make whole requests) if a loan review reveals a potential breach of seller representations and warranties. Upon receipt of a repurchase or make whole request, we work with investors to arrive at a mutually agreeable resolution. Repurchase and make whole requests are typically reviewed on an individual loan by loan basis to validate the claims made by the

investor and to determine if a contractually required repurchase or make whole event has occurred. We seek to reduce and manage the risks of potential repurchases, make whole requests, or other claims by mortgage loan investors through our underwriting and quality assurance practices and by servicing mortgage loans to meet investor and secondary market standards.

The Company was required to repurchase $53 thousand in loans during the first six months of 2018 as a result of representation and warranty provisions contained in the Company s sale agreements with Fannie Mae, and had no pending repurchase requests at June 30, 2018.

We service all residential mortgage loans originated and sold by us to Fannie Mae. As servicer, our primary duties are to: (1) collect payments due from borrowers; (2) advance certain delinquent payments of principal and interest; (3) maintain and administer any hazard, title, or primary mortgage insurance policies relating to the mortgage loans; (4) maintain any required escrow accounts for payment of taxes and insurance and administer escrow payments; and (5) foreclose on defaulted mortgage loans or take other actions to mitigate the potential losses to investors consistent with the agreements governing our rights and duties as servicer.

Table of Contents

The agreement under which we act as servicer generally specifies a standard of responsibility for actions taken by us in such capacity and provides protection against expenses and liabilities incurred by us when acting in compliance with the respective servicing agreements. However, if we commit a material breach of our obligations as servicer, we may be subject to termination if the breach is not cured within a specified period following notice. The standards governing servicing and the possible remedies for violations of such standards are determined by servicing guides issued by Fannie Mae as well as the contract provisions established between Fannie Mae and the Bank. Remedies could include repurchase of an affected loan.

Although repurchase and make whole requests related to representation and warranty provisions and servicing activities have been limited to date, it is possible that requests to repurchase mortgage loans or reimburse investors for losses incurred (make whole requests) may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of June 30, 2018, we do not believe that this exposure is material due to the historical level of repurchase requests and loss trends, in addition to the fact that 99% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

Changes to Contractual Obligations

On April 27, 2018, the Trust formally redeemed all of its issued and outstanding trust preferred securities at par. The additional amount paid on April 27, 2018 for trust preferred securities not previously purchased by the Company was approximately $3.0 million, including accrued and unpaid distributions. All junior subordinated debentures related to the Trust were redeemed, including accrued and unpaid distributions, and retired as a result of the action.

The Company now has no outstanding trust preferred securities or junior subordinated debentures, and the Trust has been dissolved.

Effects of Inflation and Changing Prices

The Consolidated Financial Statements and related consolidated financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution s performance than the effects of general levels of inflation.

CURRENT ACCOUNTING DEVELOPMENTS

The following Accounting Standards Updates (Updates or ASUs) have been issued by the FASB but are not yet effective.

ASU 2016-02, *Leases;*

ASU 2016-13, *Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments; and*

ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities.*

Information about these pronouncements is described in more detail below.

ASU 2016-02, *Leases,* requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for lease term. The new guidance is effective for annual and interim reporting periods beginning after December 15, 2018. The amendment should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

Table of Contents

ASU 2016-13, *Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, amends guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For assets held at amortized cost basis, the new standard eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses using a broader range of information regarding past events, current conditions and forecasts assessing the collectability of cash flows. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP, however the new standard will require that credit losses be presented as an allowance rather than as a write-down. The new guidance affects entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. For public business entities that are SEC filers, the new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019, and early adoption is permitted beginning in 2019. The Company is currently evaluating the impact this ASU will have on its consolidated financial statements.

ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*, improves the transparency and understandability of information conveyed to financial statement users about an entity s risk management activities by better aligning the entity s financial reporting for hedging relationships with those risk management activities and reduces the complexity of and simplifies the application of hedge accounting by preparers. For public entities, the guidance is effective for fiscal years beginning after December 15, 2018, and interim periods therein; however, early adoption by all entities is permitted. The Company is currently evaluating this ASU to determine whether its provisions will enhance the Company s ability to employ risk management strategies, while improving the transparency and understanding of those strategies for financial statement users.

Table of Contents

Table 1 Explanation of Non-GAAP Financial Measures

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this quarterly report on Form 10-Q includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation and calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliations of these non-GAAP financial measures to their most directly comparable GAAP financial measures are presented below.

	2018		2017		
(In thousands)	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Net interest income (GAAP)	**$ 6,317**	**6,284**	**6,275**	**6,261**	**6,101**
Tax-equivalent adjustment (a)	152	156	300	304	301
Net interest income (Tax-equivalent)	**$ 6,469**	**6,440**	**6,575**	**6,565**	**6,402**

(a) Using federal income tax rates of 21% and 34% for 2018 and 2017, respectively.

	Six Months ended June 30,	
(In thousands)	2018	2017
Net interest income (GAAP)	**$ 12,601**	**11,990**
Tax-equivalent adjustment (a)	308	601
Net interest income (Tax-equivalent)	**$ 12,909**	**12,591**

(a) Using federal income tax rates of 21% and 34% for 2018 and 2017, respectively.

Table of Contents

Table 2 - Selected Quarterly Financial Data

llars in thousands, except per share amounts)		2018 Second Quarter	2018 First Quarter	2017 Fourth Quarter	2017 Third Quarter	2017 Second Quarter
ults of Operations						
interest income (a)	$	6,469	6,440	6,575	6,565	6,4
: tax-equivalent adjustment		152	156	300	304	
interest income (GAAP)		6,317	6,284	6,275	6,261	6,
interest income		839	853	844	968	
l revenue		7,156	7,137	7,119	7,229	6,8
vision for loan losses				(400)		
interest expense		4,326	4,402	4,426	4,225	4,0
me tax expense		566	540	1,268	868	
earnings	$	2,264	2,195	1,825	2,136	1,9
share data:						
c and diluted net earnings	$	0.62	0.60	0.50	0.59	0
n dividends declared		0.24	0.24	0.23	0.23	0
ghted average shares outstanding:						
c and diluted		3,643,731	3,643,683	3,643,668	3,643,659	3,643,3
es outstanding		3,643,793	3,643,698	3,643,668	3,643,668	3,643,0
k value	$	23.53	23.36	23.85	23.75	23
mmon stock price						
n	$	50.99	39.25	40.25	37.71	37
		37.40	35.50	33.25	34.82	32
od end		49.61	39.06	38.90	35.00	36
earnings ratio		21.48x	17.44	18.09	15.70	16
book value		211%	167	163	147	
formance ratios:						
rn on average equity		10.48%	9.95	8.31	9.87	9
rn on average assets		1.10%	1.04	0.89	1.03	0
dend payout ratio		38.71%	40.00	46.00	38.98	41
et Quality:						
wance for loan losses as a % of:						
ns		1.04%	1.07	1.05	1.04	1
performing loans		430%	146	160	161	
performing assets as a % of:						
ns and other real estate owned		0.27%	0.73	0.66	0.67	0
l assets		0.15%	0.39	0.35	0.36	0

performing loans as a % of total loans	0.24%	0.73	0.66	0.65	0
ualized net (recoveries) charge-offs as a % of age loans	(0.02)%	0.02	(0.43)	0.27	(0.
ital Adequacy:					
1 risk-based capital ratio	16.40%	16.89	16.42	16.15	16
1 risk-based capital ratio	16.40%	17.46	16.98	16.71	16
l risk-based capital ratio	17.29%	18.39	17.91	17.62	17
1 leverage ratio	10.93%	10.90	10.95	10.70	10
er financial data:					
interest margin (a)	3.36%	3.29	3.37	3.32	3
ctive income tax rate	20.00%	19.74	41.00	28.89	28
iency ratio (b)	59.20%	60.36	59.66	56.09	55
cted average balances:					
urities	$ 255,877	265,626	262,171	273,280	274,4
ns, net of unearned income	448,493	451,347	453,744	443,639	436,6
l assets	820,706	841,820	823,864	831,097	831,
l deposits	728,457	744,365	726,945	735,372	737,4
g-term debt	919	3,217	3,217	3,217	3,2
l stockholders equity	86,420	88,281	87,800	86,543	84,3
cted period end balances:					
urities	$ 251,320	259,177	257,697	265,171	277,3
ns, net of unearned income	456,572	443,804	453,651	449,378	437,2
wance for loan losses	4,750	4,732	4,757	4,670	4,9
l assets	811,791	830,721	853,381	828,546	836,3
l deposits	721,005	737,332	757,659	732,648	742,4
g-term debt		3,217	3,217	3,217	3,2
l stockholders equity	85,748	85,108	86,906	86,538	85,6

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures.

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

Table of Contents

Table 3 - Selected Financial Data

(Dollars in thousands, except per share amounts)		Six Months ended June 30, 2018	2017
Results of Operations			
Net interest income (a)	$	12,909	12,591
Less: tax-equivalent adjustment		308	601
Net interest income (GAAP)		12,601	11,990
Noninterest income		1,692	1,629
Total revenue		14,293	13,619
Provision for loan losses			100
Noninterest expense		8,728	8,133
Income tax expense		1,106	1,501
Net earnings	$	4,459	3,885
Per share data:			
Basic and diluted net earnings	$	1.22	1.07
Cash dividends declared		0.48	0.46
Weighted average shares outstanding:			
Basic and diluted		3,643,707	3,643,567
Shares outstanding, at period end		3,643,793	3,643,643
Book value	$	23.53	23.36
Common stock price			
High	$	50.99	37.79
Low		35.50	30.75
Period end		49.61	36.94
To earnings ratio		21.48x	16.94
To book value		211%	158
Performance ratios:			
Return on average equity		10.22%	9.26
Return on average assets		1.07%	0.93
Dividend payout ratio		39.34%	42.99
Asset Quality:			
Allowance for loan losses as a % of:			
Loans		1.04%	1.14
Nonperforming loans		430%	220
Nonperforming assets as a % of:			
Loans and other real estate owned		0.27%	0.54
Total assets		0.15%	0.28
Nonperforming loans as a % of total loans		0.24%	0.52

Annualized net charge-offs (recoveries) as a % of average loans		%	(0.10)
Capital Adequacy:			
CET 1 risk-based capital ratio		16.40%	16.22
Tier 1 risk-based capital ratio		16.40%	16.79
Total risk-based capital ratio		17.29%	17.77
Tier 1 leverage ratio		10.93%	10.56
Other financial data:			
Net interest margin (a)		3.33%	3.23
Effective income tax rate		19.87%	27.87
Efficiency ratio (b)		59.78%	57.19
Selected average balances:			
Securities	$	260,725	266,239
Loans, net of unearned income		449,911	433,233
Total assets		831,205	833,421
Total deposits		736,415	739,720
Long-term debt		2,062	3,217
Total stockholders equity		87,297	83,884
Selected period end balances:			
Securities	$	251,320	277,363
Loans, net of unearned income		456,572	437,287
Allowance for loan losses		4,750	4,965
Total assets		811,791	836,311
Total deposits		721,005	742,456
Long-term debt			3,217
Total stockholders equity		85,748	85,099

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures.

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

Table of Contents

Table 4 - Average Balances and Net Interest Income Analysis

	Quarter ended June 30,					
	2018			2017		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Loans and loans held for sale (1)	$ 449,650	$ 5,307	4.73%	$ 437,361	$ 5,121	4.70%
Securities - taxable	185,013	1,012	2.19%	204,635	1,112	2.18%
Securities - tax-exempt (2)	70,864	724	4.10%	69,858	888	5.10%
Total securities	255,877	1,736	2.72%	274,493	2,000	2.92%
Federal funds sold	29,938	130	1.74%	29,498	79	1.07%
Interest bearing bank deposits	36,181	160	1.77%	42,196	103	0.98%
Total interest-earning assets	771,646	$ 7,333	3.81%	783,548	$ 7,303	3.74%
Cash and due from banks	13,480			13,610		
Other assets	35,580			34,029		
Total assets	$ 820,706			$ 831,187		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 130,480	$ 97	0.30%	$ 128,092	$ 64	0.20%
Savings and money market	218,798	197	0.36%	228,254	209	0.37%
Time deposits	183,757	551	1.20%	200,466	593	1.19%
Total interest-bearing deposits	533,035	845	0.64%	556,812	866	0.62%
Short-term borrowings	2,801	8	1.15%	3,743	5	0.54%
Long-term debt	919	11	4.80%	3,217	30	3.74%
Total interest-bearing liabilities	536,755	$ 864	0.65%	563,772	$ 901	0.64%
Noninterest-bearing deposits	195,422			180,652		
Other liabilities	2,109			2,194		
Stockholders equity	86,420			84,569		

Total liabilities and stockholders equity	$ 820,706		$ 831,187	
Net interest income and margin (tax-equivalent)	$ 6,469	3.36%	$ 6,402	3.28%

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.

(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using a federal income tax rate of 21% for 2018 and 34% for 2017.

Table of Contents

Table 5 - Average Balances and Net Interest Income Analysis

	Six Months ended June 30,					
	2018			2017		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
Interest-earning assets:						
Loans and loans held for sale (1)	$ 451,063	$ 10,538	4.71%	$ 434,054	$ 10,102	4.69%
Securities - taxable	189,442	2,089	2.22%	196,886	2,133	2.18%
Securities - tax-exempt (2)	71,283	1,465	4.14%	69,353	1,769	5.14%
Total securities	260,725	3,554	2.75%	266,239	3,902	2.96%
Federal funds sold	28,932	236	1.64%	35,206	156	0.89%
Interest bearing bank deposits	41,765	356	1.72%	50,238	227	0.91%
Total interest-earning assets	782,485	$ 14,684	3.78%	785,737	$ 14,387	3.69%
Cash and due from banks	13,661			13,535		
Other assets	35,059			34,149		
Total assets	$ 831,205			$ 833,421		
Interest-bearing liabilities:						
Deposits:						
NOW	$ 138,163	$ 208	0.30%	$ 126,200	$ 118	0.19%
Savings and money market	220,022	396	0.36%	231,127	421	0.37%
Time deposits	185,588	1,113	1.21%	203,189	1,189	1.18%
Total interest-bearing deposits	543,773	1,717	0.64%	560,516	1,728	0.62%
Short-term borrowings	2,888	12	0.84%	3,649	9	0.50%
Long-term debt	2,062	46	4.50%	3,217	59	3.70%
Total interest-bearing liabilities	548,723	$ 1,775	0.65%	567,382	$ 1,796	0.64%
Noninterest-bearing deposits	192,642			179,204		
Other liabilities	2,543			2,951		
Stockholders equity	87,297			83,884		

Total liabilities and stockholders equity	$	831,205		$	833,421	
Net interest income and margin (tax-equivalent)	$	12,909	3.33%	$	12,591	3.23%

(1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.

(2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using a federal income tax rate of 21% for 2018 and 34% for 2017.

Table of Contents

Table 6 - Loan Portfolio Composition

		2018			2017	
(In thousands)		Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Commercial and industrial	$	52,921	57,877	59,086	50,101	50,974
Construction and land development		42,675	35,910	39,607	47,455	46,386
Commercial real estate		246,129	234,345	239,033	232,380	220,863
Residential real estate		105,705	106,496	106,863	110,159	110,288
Consumer installment		9,824	9,685	9,588	9,877	9,409
Total loans		457,254	444,313	454,177	449,972	437,920
Less: unearned income		(682)	(509)	(526)	(594)	(633)
Loans, net of unearned income		456,572	443,804	453,651	449,378	437,287
Less: allowance for loan losses		(4,750)	(4,732)	(4,757)	(4,670)	(4,965)
Loans, net	$	451,822	439,072	448,894	444,708	432,322

Table of Contents

Table 7 - Allowance for Loan Losses and Nonperforming Assets

(Dollars in thousands)		2018 Second Quarter	2018 First Quarter	2017 Fourth Quarter	2017 Third Quarter	2017 Second Quarter
Allowance for loan losses:						
Balance at beginning of period	$	4,732	4,757	4,670	4,965	4,588
Charge-offs:						
Commercial and industrial			(52)		(449)	
Commercial real estate		(39)				
Residential real estate			(4)		(30)	
Consumer installment			(2)	(23)	(10)	(5)
Total charge-offs		(39)	(58)	(23)	(489)	(5)
Recoveries		57	33	510	194	282
Net recoveries (charge-offs)		18	(25)	487	(295)	277
Provision for loan losses				(400)		100
Ending balance	$	4,750	4,732	4,757	4,670	4,965
as a % of loans		1.04 %	1.07	1.05	1.04	1.14
as a % of nonperforming loans		430 %	146	160	161	220
Net (recoveries) charge-offs as % of avg. loans (a)		(0.02)%	0.02	(0.43)	0.27	(0.25)
Nonperforming assets:						
Nonaccrual loans	$	1,104	3,239	2,972	2,902	2,255
Other real estate owned		137			103	103
Total nonperforming assets	$	1,241	3,239	2,972	3,005	2,358
as a % of loans and other real estate owned		0.27 %	0.73	0.66	0.67	0.54
as a % of total assets		0.15 %	0.39	0.35	0.36	0.28
Nonperforming loans as a % of total loans		0.24 %	0.73	0.66	0.65	0.52
Accruing loans 90 days or more past due	$				5	42

(a) Net (recoveries) charge-offs are annualized.

Table of Contents

Table 8 - Allocation of Allowance for Loan Losses

	2018				2017					
	Second Quarter		First Quarter		Fourth Quarter		Third Quarter		Second Quarter	
(Dollars in thousands)	Amount	%*	Amount	%*	Amount	%*	Amount	%*	Amount	%*
Commercial and industrial	$ 600	11.6	$ 724	13.0	$ 653	13.0	$ 504	11.1	$ 677	11.6
Construction and land development	787	9.3	670	8.1	734	8.7	851	10.5	874	10.6
Commercial real estate	2,197	53.9	2,119	52.7	2,126	52.7	2,061	51.7	2,121	50.5
Residential real estate	1,017	23.1	1,053	24.0	1,071	23.5	1,077	24.5	1,119	25.2
Consumer installment	149	2.1	166	2.2	173	2.1	177	2.2	174	2.1
Total allowance for loan losses	$ 4,750		$ 4,732		$ 4,757		$ 4,670		$ 4,965	

* Loan balance in each category expressed as a percentage of total loans.

Table of Contents

Table 9 - CDs and Other Time Deposits of $100,000 or More

(Dollars in thousands)		**June 30, 2018**
Maturity of:		
3 months or less	$	14,918
Over 3 months through 6 months		21,917
Over 6 months through 12 months		31,381
Over 12 months		50,688
Total CDs and other time deposits of $100,000 or more	$	118,904

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information called for by ITEM 3 is set forth in ITEM 2 under the caption MARKET AND LIQUIDITY RISK MANAGEMENT and is incorporated herein by reference.

ITEM 4. CONTROLS AND PROCEDURES

The Company, with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective to allow timely decisions regarding disclosure in its reports that the Company files or submits to the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. There have been no changes in the Company s internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the normal course of its business, the Company and the Bank are, from time to time, involved in legal proceedings. The Company s and Bank s management believe there are no pending or threatened legal, governmental, or regulatory proceedings that, upon resolution, are expected to have a material adverse effect upon the Company s or the Bank s financial condition or results of operations. See also, Part I, Item 3 of the Company s Annual Report on Form 10-K for the year ended December 31, 2017.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. RISK FACTORS in the Company s Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not the only the risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and/or operating results in the future.

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

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

Table of Contents

ITEM 6. EXHIBITS

Exhibit Number	Description
3.1	Certificate of Incorporation of Auburn National Bancorporation, Inc. and all amendments thereto.*
3.2	Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007. **
31.1	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by Robert W. Dumas, President and Chief Executive Officer.
31.2	Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Executive Vice President, Chief Financial Officer.
32.1	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by Robert W. Dumas, President and Chief Executive Officer.***
32.2	Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Executive Vice President, Chief Financial Officer.***
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

* Incorporated by reference from Registrant s Form 10-Q dated June 30, 2002.

** Incorporated by reference from Registrant s Form 10-K dated March 31, 2008.

*** The certifications attached as exhibits 32.1 and 32.2 to this quarterly report on Form 10-Q are furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Table of Contents

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.

AUBURN NATIONAL BANCORPORATION, INC.
(Registrant)

Date: August 2, 2018

By: /s/ Robert W. Dumas
Robert W. Dumas
President and Chief Executive Officer

Date: August 2, 2018

By: /s/ David A. Hedges
David A. Hedges
EVP, Chief Financial Officer