

SB FINANCIAL GROUP, INC.  
Form 10-Q  
November 14, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-36785

SB FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

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Ohio 34-1395608  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

401 Clinton Street, Defiance, Ohio 43512

(Address of principal executive offices)

(Zip Code)

(419) 783-8950

(Registrant's telephone number, including area code)

N/A

(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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerate Filer    Accelerated Filer    Non-Accelerated Filer    Smaller Reporting Company

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

| <b>Title of each class</b>                        | <b>Name of each exchange on which registered</b> |
|---|--|
| Common Shares, No Par Value                       | The NASDAQ Stock Market, LLC                     |
| <b>4,852,551</b> Outstanding at November 14, 2016 | (NASDAQ Capital Market)                          |

**SB FINANCIAL GROUP, INC.**

**FORM 10-Q**

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**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements**

SB Financial Group, Inc.

Condensed Consolidated Balance Sheets  
September 30, 2016 and December 31, 2015

| (\$ in Thousands)                            | September<br>2016 | December<br>2015 |
|--|-------------------|------------------|
| (Unaudited)                                  |                   |                  |
| <b>ASSETS</b>                                |                   |                  |
| Cash and due from banks                      | \$ 25,167         | \$ 20,459        |
| Securities available for sale, at fair value | 92,689            | 89,789           |
| Other securities - FRB and FHLB Stock        | 3,748             | 3,748            |
| Total investment securities                  | 96,437            | 93,537           |
| Loans held for sale                          | 5,865             | 7,516            |
| Loans, net of unearned income                | 619,352           | 557,659          |
| Allowance for loan losses                    | (7,320 )          | (6,990 )         |
| Net loans                                    | 612,032           | 550,669          |
| Premises and equipment, net                  | 18,673            | 19,010           |
| Cash surrender value of life insurance       | 13,653            | 13,437           |
| Goodwill & other intangibles                 | 16,426            | 16,435           |
| Foreclosed assets held for sale, net         | 73                | 286              |
| Mortgage servicing rights                    | 6,887             | 7,152            |
| Accrued interest receivable                  | 1,641             | 1,260            |
| Other assets                                 | 4,946             | 3,310            |
| Total assets                                 | \$ 801,800        | \$ 733,071       |
| <b>LIABILITIES AND EQUITY</b>                |                   |                  |
| <b>Deposits</b>                              |                   |                  |
| Non interest bearing demand                  | \$ 116,976        | \$ 113,113       |
| Interest bearing demand                      | 135,729           | 126,443          |
| Savings                                      | 89,265            | 83,447           |
| Money market                                 | 126,501           | 104,412          |
| Time deposits                                | 193,673           | 159,038          |
| Total deposits                               | 662,144           | 586,453          |
| Advances from Federal Home Loan Bank         | 23,000            | 35,000           |

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|  |            |            |
|--|------------|------------|
| Repurchase agreements                  | 11,363     | 12,406     |
| Trust preferred securities             | 10,310     | 10,310     |
| Accrued interest payable               | 427        | 264        |
| Other liabilities                      | 8,293      | 7,397      |
| Total liabilities                      | 715,537    | 651,830    |
| <br>                                   |            |            |
| Commitments & Contingent Liabilities   | -          | -          |
| <br>                                   |            |            |
| Stockholders' Equity                   |            |            |
| Preferred stock, Series A              | 13,983     | 13,983     |
| Common stock                           | 12,569     | 12,569     |
| Additional paid-in capital             | 15,370     | 15,438     |
| Retained earnings                      | 44,933     | 40,059     |
| Accumulated other comprehensive income | 1,237      | 650        |
| Treasury stock, at cost                | (1,829 )   | (1,458 )   |
| Total equity                           | 86,263     | 81,241     |
| Total liabilities and equity           | \$ 801,800 | \$ 733,071 |

See notes to condensed consolidated financial statements (unaudited)

Note: The balance sheet at December 31, 2015 has been derived from the audited consolidated financial statements at that date

## SB FINANCIAL GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME - (Unaudited)

| (\$ in thousands, except share data)                | <i>Three Months<br/>Ended</i> |                           | Nine Months Ended |                   |
|---|-------------------------------|---------------------------|-------------------|-------------------|
|   | <i>September<br/>2016</i>     | <i>September<br/>2015</i> | September<br>2016 | September<br>2015 |
| Interest income                                     |                               |                           |                   |                   |
| Loans   |                               |                           |                   |                   |
| Taxable   | \$6,954                       | 6,152                     | 19,862            | 17,606            |
| Nontaxable  | 22                            | 10                        | 55                | 25                |
| Securities  |                               |                           |                   |                   |
| Taxable   | 378                           | 382                       | 1,172             | 1,149             |
| Nontaxable  | 145                           | 173                       | 450               | 525               |
| Total interest income                               | 7,499                         | 6,717                     | 21,539            | 19,305            |
| Interest expense                                    |                               |                           |                   |                   |
| Deposits  | 677                           | 492                       | 1,869             | 1,487             |
| Repurchase Agreements & Other                       | 5                             | 5                         | 14                | 14                |
| Federal Home Loan Bank advances                     | 83                            | 94                        | 266               | 280               |
| Trust preferred securities                          | 63                            | 53                        | 184               | 157               |
| Total interest expense                              | 828                           | 644                       | 2,333             | 1,938             |
| Net interest income                                 | 6,671                         | 6,073                     | 19,206            | 17,367            |
| Provision for loan losses                           | -                             | 100                       | 250               | 950               |
| Net interest income after provision for loan losses | 6,671                         | 5,973                     | 18,956            | 16,417            |
| Noninterest income                                  |                               |                           |                   |                   |
| Wealth Management Fees                              | 695                           | 636                       | 1,971             | 1,961             |
| Customer service fees                               | 692                           | 734                       | 2,052             | 2,068             |
| Gain on sale of mtg. loans & OMSR's                 | 2,503                         | 1,687                     | 6,170             | 4,892             |
| Mortgage loan servicing fees, net                   | 205                           | 98                        | (514 )            | 642               |
| Gain on sale of non-mortgage loans                  | 327                           | 296                       | 927               | 872               |
| Data service fees                                   | 223                           | 294                       | 733               | 917               |
| Net gain on sale of securities                      | 59                            | -                         | 262               | -                 |
| Gain/(loss) on sale/disposal of assets              | (31 )                         | -                         | 177               | (20 )             |
| Other income  | 342                           | 207                       | 983               | 659               |
| Total non-interest income                           | 5,015                         | 3,952                     | 12,761            | 11,991            |
| Noninterest expense                                 |                               |                           |                   |                   |
| Salaries and employee benefits                      | 4,672                         | 3,650                     | 12,765            | 11,062            |
| Net occupancy expense                               | 523                           | 481                       | 1,612             | 1,464             |
| Equipment expense                                   | 649                           | 568                       | 1,883             | 1,657             |
| Data processing fees                                | 352                           | 286                       | 996               | 796               |

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|   |         |       |        |        |
|---|---------|-------|--------|--------|
| Professional fees                                 | 380     | 416   | 1,022  | 1,282  |
| Marketing expense                                 | 123     | 146   | 493    | 437    |
| Telephone and communication                       | 101     | 96    | 302    | 284    |
| Postage and delivery expense                      | 154     | 198   | 513    | 633    |
| State, local and other taxes                      | 170     | 130   | 440    | 387    |
| Employee expense                                  | 117     | 126   | 363    | 417    |
| Intangible amortization expense                   | 3       | 54    | 9      | 163    |
| Other expenses                                    | 686     | 475   | 1,834  | 1,506  |
| Total non-interest expense                        | 7,930   | 6,626 | 22,232 | 20,088 |
| Income before income tax expense                  | 3,756   | 3,299 | 9,485  | 8,320  |
| Income tax expense                                | 1,209   | 1,035 | 3,018  | 2,569  |
| Net income  | \$2,547 | 2,264 | 6,467  | 5,751  |
| Preferred Stock Dividends                         | 244     | 244   | 731    | 712    |
| Net income available to common shareholders       | 2,303   | 2,020 | 5,736  | 5,039  |
| Basic earnings per common share                   | \$0.47  | 0.41  | 1.17   | 1.03   |
| Diluted earnings per common share                 | \$0.40  | 0.35  | 1.01   | 0.89   |
| Dividends per common share                        | \$0.060 | 0.050 | 0.175  | 0.145  |
| Average common shares outstanding (in thousands): |         |       |        |        |
| Basic:  | 4,874   | 4,884 | 4,888  | 4,882  |
| Diluted:  | 6,376   | 6,390 | 6,384  | 6,422  |

*See notes to condensed consolidated financial statements (unaudited)*



**SB Financial Group, Inc.****Condensed Consolidated Statements of Comprehensive Income (unaudited)**

| (\$'s in thousands)  | <b>Three Months<br/>Ended<br/>Sep. 30,</b> |             | <b>Nine Months<br/>Ended<br/>Sep. 30,</b> |             |
|--|--|-------------|---|-------------|
|  | <b>2016</b>                                | <b>2015</b> | <b>2016</b>                               | <b>2015</b> |
| Net income   | \$2,547                                    | \$2,264     | \$6,467                                   | \$5,751     |
| Other comprehensive income:                                |  |             |   |             |
| <u>Available-for-sale investment securities:</u>           |  |             |   |             |
| Gross unrealized holding gain (loss) arising in the period | (418 )                                     | 617         | 1,151                                     | 362         |
| Related tax (expense)/benefit                              | 142  | (210 )      | (391 )                                    | (123 )      |
| Less: Reclassification for gain realized in income         | (59 )                                      | -           | (262 )                                    | -           |
| Related tax expense  | 20   | -           | 89  | -           |
| Net effect on other comprehensive income                   | (315 )                                     | 407         | 587                                       | 239         |
| Total comprehensive income                                 | \$2,232                                    | \$2,671     | \$7,054                                   | \$5,990     |

See notes to condensed consolidated financial statements (unaudited)

**SB Financial Group, Inc.****Condensed Consolidated Statements of Shareholders' Equity (unaudited)**

| (\$'s in thousands)                                | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total     |
|--|--------------------|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
| Balance, January 1, 2016                           | \$ 13,983          | \$ 12,569       | \$ 15,438                        | \$ 40,059            | \$ 650  | \$ (1,458 )       | \$ 81,241 |
| Net Income   |                    |                 |                                  | 6,467                |   |                   | 6,467     |
| Other Comprehensive Income                         |                    |                 |                                  |                      | 587   |                   | 587       |
| Dividends on Common Stk., \$0.175<br>per share     |                    |                 |                                  | (862 )               |   |                   | (862 )    |
| Dividends on Preferred Stk., \$0.4875<br>per share |                    |                 |                                  | (731 )               |   |                   | (731 )    |
| Issuance of Restricted Stock and<br>Stock Options  |                    |                 | (154 )                           |                      |   | 253               | 99        |
| Stock Repurchase                                   |                    |                 |                                  |                      |   | (624 )            | (624 )    |
| Share based compensation expense                   |                    |                 | 86                               |                      |   |                   | 86        |
| Balance, September 30, 2016                        | \$ 13,983          | \$ 12,569       | \$ 15,370                        | \$ 44,933            | \$ 1,237  | \$ (1,829 )       | \$ 86,263 |
| Balance, January 1, 2015                           | \$ 13,983          | \$ 12,569       | \$ 15,461                        | \$ 34,379            | \$ 918  | \$ (1,627 )       | \$ 75,683 |
| Net Income   |                    |                 |                                  | 5,751                |   |                   | 5,751     |
| Other Comprehensive Income                         |                    |                 |                                  |                      | 239   |                   | 239       |
| Dividends on Common Stk., \$0.145<br>per share     |                    |                 |                                  | (713 )               |   |                   | (713 )    |
| Dividends on Preferred Stk., \$0.475<br>per share  |                    |                 |                                  | (712 )               |   |                   | (712 )    |
| Issuance of Restricted Stock and<br>Stock Options  |                    |                 | (78 )                            |                      |   | 96                | 18        |
| Stock Repurchase                                   |                    |                 |                                  |                      |   | (2 )              | (2 )      |
| Share based compensation expense                   |                    |                 | 61                               |                      |   |                   | 61        |
| Balance, September 30, 2015                        | \$ 13,983          | \$ 12,569       | \$ 15,444                        | \$ 38,705            | \$ 1,157  | \$ (1,533 )       | \$ 80,325 |

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

## Condensed Consolidated Statements of Cash Flows (Unaudited)

|   | Nine Months Ended<br>Sep. 30, |           |
|---|-------------------------------|-----------|
| (\$'s in thousands)   | 2016                          | 2015      |
| <b>Operating Activities</b>   |                               |           |
| Net Income  | \$6,467                       | \$5,751   |
| Items providing/(using) cash  |                               |           |
| Depreciation and amortization   | 892                           | 795       |
| Provision for loan losses   | 250                           | 950       |
| Expense of share-based compensation plan  | 86                            | 61        |
| Amortization of premiums and discounts on securities                                  | 688                           | 744       |
| Amortization of intangible assets   | 9                             | 163       |
| Amortization of originated mortgage servicing rights                                  | 879                           | 725       |
| Recapture of originated mortgage servicing rights impairment                          | (71 )                         | (269 )    |
| Impairment of mortgage servicing rights   | 1,236                         | 218       |
| Proceeds from sale of loans held for sale   | 249,159                       | 224,090   |
| Originations of loans held for sale   | (241,732)                     | (216,963) |
| Gain from sale of loans   | (7,098 )                      | (5,764 )  |
| (Gain)/loss on sale of assets   | (150 )                        | 20        |
| Changes in  |                               |           |
| Interest receivable   | (381 )                        | (471 )    |
| Other assets  | (2,848 )                      | (8,276 )  |
| Interest payable and other liabilities  | 1,059                         | 3,535     |
| Net cash provided by operating activities   | 8,445                         | 5,309     |
| <b>Investing Activities</b>   |                               |           |
| Purchases of available-for-sale securities  | (17,572 )                     | (25,456 ) |
| Proceeds from maturities of available-for-sale securities                             | 11,923                        | 14,830    |
| Proceeds from sales of available-for-sale securities                                  | 2,950                         | -         |
| Net change in loans   | (61,932 )                     | (25,233 ) |
| Purchase of premises and equipment and software                                       | (517 )                        | (4,846 )  |
| Proceeds from sales or disposal of premises and equipment                             | 96                            | 36        |
| Proceeds from sale of foreclosed assets   | 785                           | 110       |
| Net cash used in investing activities   | (64,267 )                     | (40,559 ) |
| <b>Financing Activities</b>   |                               |           |
| Net increase in demand deposits, money market, interest checking and savings accounts | 41,056                        | 27,018    |
| Net increase (decrease) in certificates of deposit                                    | 34,635                        | (4,356 )  |
| Net increase in securities sold under agreements to repurchase                        | (1,043 )                      | 4,171     |
| Repayment of Federal Home Loan Bank advances  | (14,000 )                     | (4,000 )  |
| Proceeds from Federal Home Loan Bank advances   | 2,000                         | 4,000     |
| Net proceeds from share based compensation plans                                      | 99                            | 18        |
| Repurchase of common stock  | (624 )                        | (2 )      |

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|  |          |          |
|--|----------|----------|
| Dividends on common stock                    | (862 )   | (713 )   |
| Dividends on preferred stock                 | (731 )   | (712 )   |
| Net cash provided by financing activities    | 60,530   | 25,425   |
| <br>   |          |          |
| Increase in Cash and Cash Equivalents        | 4,708    | (9,825 ) |
| <br>   |          |          |
| Cash and Cash Equivalents, Beginning of Year | 20,459   | 28,197   |
| Cash and Cash Equivalents, End of Period     | \$25,167 | \$18,372 |
| <br>   |          |          |
| Supplemental Cash Flows Information          |          |          |
| <br>   |          |          |
| Interest paid                                | \$2,170  | \$1,861  |
| Income taxes paid                            | \$3,479  | \$1,650  |
| Transfer of loans to foreclosed assets       | \$319    | \$35     |

See notes to condensed consolidated financial statements (unaudited)

SB FINANCIAL GROUP, INC.

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1—BASIS OF PRESENTATION**

SB Financial Group, Inc., an Ohio corporation (the “Company”) is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiaries, The State Bank and Trust Company (“State Bank”), RFCBC, Inc. (“RFCBC”), Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), and Rurban Statutory Trust II (“RST II”). In addition, State Bank owns all of the outstanding stock of Rurban Mortgage Company (“RMC”) and State Bank Insurance, LLC (“SBI”).

The consolidated financial statements include the accounts of the Company, State Bank, RFCBC, RDSI, RMC, and SBI. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements reflect all adjustments that are, in the opinion of management, necessary to fairly present the financial position, results of operations and cash flows of the Company. Those adjustments consist only of normal recurring adjustments. Results of operations for the nine months ended September 30, 2016, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2015 has been derived from the audited consolidated balance sheet of the Company as of that date.

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, 2015.

The following paragraphs summarize the impact of new accounting pronouncements:

**Accounting Standards Update (ASU) No. 2016-13: Financial Instruments – Credit Losses (Topic 326)**

This ASU replaces the current GAAP incurred impairment methodology regarding credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments in this update affect an entity to varying degrees depending on the credit quality of the assets held by the entity, their duration, and how the entity applies current GAAP. The amendments in this ASU are effective for reporting periods beginning after December 15, 2019, and management will need further study to determine the impact on the Company's consolidated financial statements.

**ASU No. 2016-09: Stock Compensation (Topic 718)**

This ASU affects all entities that issue share-based payment awards to their employees. The update is intended to simplify the accounting for these transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management will need further study to determine the impact on the Company's consolidated financial statements.

**ASU No. 2016-06: Derivatives and Hedging (Topic 815)**

This ASU clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

**ASU No. 2016-05: Derivatives and Hedging (Topic 815)**

This ASU clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedging accounting criteria continue to be met. The amendments in this ASU are effective for reporting periods beginning after December 15, 2016, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

**ASU No. 2016-02: Leases (Topic 842)**

This ASU is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this ASU are effective for reporting periods beginning after December 15, 2019, and management will need further study to determine the impact on the Company's consolidated financial statements.

**ASU No. 2016-01: Financial Instruments – Recognition and measurement of financial assets and financial liabilities (Subtopic 825-10)**

This ASU makes targeted improvements to generally accepted accounting principles. Specifically, the amendments require equity securities with readily determinable fair values be classified into different categories and require equity securities to be measured at fair value with changes in the fair value recognized through net income. The amendments in this ASU are effective for reporting periods beginning after December 15, 2017, and management does not believe this ASU will have a material impact on the Company's consolidated financial statements.

**ASU No. 2015-16: Business Combinations (Topic 805)**

This ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. Further, an entity must present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings that would have been recorded previously if the provisional amounts had been recorded as of the acquisition date. The amendments in this ASU are in effect, and they did not have a material impact on the Company's consolidated financial statements.

**ASU No. 2015-15: Interest – Imputation of Interest (Subtopic 835-30)**

This ASU requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The amendments in this ASU are in effect, and they did not have a material impact on the Company's consolidated financial statements.

**ASU No. 2015-14: Revenue from Contracts with Customers (Subtopic 606)**

This ASU defers by one year the effective date of the guidance in ASU 2014-09. The amendments in this ASU are now effective for reporting periods beginning after December 15, 2017, and management still does not believe this ASU will have a material impact on the Company's consolidated financial statements.



**NOTE 2—EARNINGS PER SHARE**

Earnings per share (EPS) have been computed based on the weighted average number of common shares outstanding during the periods presented. For the period ended September 30, 2016, share-based awards totaling 0 common shares were not considered in computing diluted EPS as they were anti-dilutive. For the period ended September 30, 2015, share-based awards totaling 50,424 common shares were not considered in computing diluted EPS as they were anti-dilutive. Included in the diluted EPS for September 30, 2016 are the impact of the full conversion of the Company's depository shares issued in December of 2014. Based upon the current conversion ratio, the 1,500,000 outstanding depository shares are convertible into an aggregate of 1,454,702 common shares. The average number of common shares used in the computation of basic and diluted earnings per share were:

|  | <b>Three Months<br/>Ended<br/>Sep. 30,</b> |             |
|--|--|-------------|
|  | <b>2016</b>                                | <b>2015</b> |
| <b>(\$ in thousands - except per share data)</b>                   |  |             |
| Distributed earnings allocated to common shares                    | \$295                                      | \$246       |
| Undistributed earnings allocated to common shares                  | 2,005                                      | 1,773       |
| Net earnings allocated to common shares                            | 2,300                                      | 2,019       |
| Net earnings allocated to participating securities                 | 3  | 1           |
| Dividends on convertible preferred shares                          | 244  | 244         |
| Net Income allocated to common shares and participating securities | \$2,547                                    | \$2,264     |
| Weighted average shares outstanding for basic earnings per share   | 4,874                                      | 4,884       |
| Dilutive effect of stock compensation                              | 47   | 55          |
| Dilutive effect of convertible shares                              | 1,455                                      | 1,451       |
| Weighted average shares outstanding for diluted earnings per share | 6,376                                      | 6,390       |
| Basic earnings per common share                                    | \$0.47                                     | \$0.41      |
| Diluted earnings per common share                                  | \$0.40                                     | \$0.35      |

|  | <b>Nine Months<br/>Ended<br/>Sep. 30,</b> |             |
|--|---|-------------|
|  | <b>2016</b>                               | <b>2015</b> |
| <b>(\$ in thousands - except per share data)</b>                   |   |             |
| Distributed earnings allocated to common shares                    | \$862                                     | \$713       |
| Undistributed earnings allocated to common shares                  | 4,868                                     | 4,322       |
| Net earnings allocated to common shares                            | 5,730                                     | 5,035       |
| Net earnings allocated to participating securities                 | 6   | 4           |
| Dividends on convertible preferred shares                          | 731                                       | 712         |
| Net Income allocated to common shares and participating securities | \$6,467                                   | \$5,751     |
| Weighted average shares outstanding for basic earnings per share   | 4,888                                     | 4,882       |
| Dilutive effect of stock compensation                              | 41  | 89          |

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|  |        |        |
|--|--------|--------|
| Dilutive effect of convertible shares                              | 1,455  | 1,451  |
| Weighted average shares outstanding for diluted earnings per share | 6,384  | 6,422  |
| Basic earnings per common share                                    | \$1.17 | \$1.03 |
| Diluted earnings per common share                                  | \$1.01 | \$0.89 |

**Note 3 - Securities**

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at September 30, 2016 and December 31, 2015 were as follows:

| (\$ in thousands)                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-Sale Securities:        |                   |                              |                               |               |
| September 30, 2016                    |                   |                              |                               |               |
| U.S. Treasury and Government agencies | \$ 13,920         | \$ 115                       | \$ (2)                        | \$ 14,033     |
| Mortgage-backed securities            | 61,882            | 905                          | (27)                          | 62,760        |
| State and political subdivisions      | 14,990            | 884                          | (1)                           | 15,873        |
| Equity securities                     | 23                | -                            | -                             | 23            |
|                                       | \$ 90,815         | \$ 1,904                     | \$ (30)                       | \$ 92,689     |

| (\$ in thousands)                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-Sale Securities:        |                   |                              |                               |               |
| December 31, 2015:                    |                   |                              |                               |               |
| U.S. Treasury and Government agencies | \$ 10,804         | \$ 101                       | \$ -                          | \$ 10,905     |
| Mortgage-backed securities            | 61,459            | 311                          | (427)                         | 61,343        |
| State and political subdivisions      | 16,519            | 999                          | -                             | 17,518        |
| Equity securities                     | 23                | -                            | -                             | 23            |
|                                       | \$ 88,805         | \$ 1,411                     | \$ (427)                      | \$ 89,789     |

The amortized cost and fair value of securities available for sale at September 30, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (\$ in thousands)                              | Available for Sale |            |
|--|--------------------|------------|
|  | Amortized Cost     | Fair Value |
| Within one year                                | \$442              | \$447      |
| Due after one year through five years          | 7,473              | 7,696      |
| Due after five years through ten years         | 6,836              | 7,143      |
| Due after ten years                            | 14,159             | 14,620     |
|  | 28,910             | 29,906     |
| Mortgage-backed securities & equity securities | 61,905             | 62,783     |
| Totals   | \$90,815           | \$92,689   |

The fair value of securities pledged as collateral, to secure public deposits and for other purposes, was \$76.6 million at September 30, 2016 and \$42.6 million at December 31, 2015. The fair value of securities delivered for repurchase agreements were \$15.8 million at September 30, 2016 and \$15.8 million at December 31, 2015.

For the nine months ended September 30, 2016, there were gross gains of \$0.26 million resulting from sales of available-for-sale securities, which was a reclassification from accumulated other comprehensive income (OCI) and was included in the net gain on sale of securities. The related \$0.09 million in tax expense was a reclassification from OCI and was included in the income tax expense line item in the income statement. There were no realized gains and losses from sales of available-for-sale securities for the nine months ended September 30, 2015.

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments was \$8.3 million at September 30, 2016, and \$37.2 million at December 31, 2015, which was approximately 9 and 34 percent, respectively, of the Company's available-for-sale investment portfolio at such dates. Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

Securities with unrealized losses, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2016 and December 31, 2015 are as follows:

| (\$ in thousands)                     | Less than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|---------------------------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|                                       | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2016                    |                     |                   |                     |                   |            |                   |
| Available-for-Sale Securities:        |                     |                   |                     |                   |            |                   |
| U.S. Treasury and Government agencies | \$2,598             | \$ (2 )           | \$-                 | \$ -              | \$2,598    | \$ (2 )           |
| Mortgage-backed securities            | \$882               | \$ (16 )          | \$4,011             | \$ (11 )          | \$4,893    | \$ (27 )          |
| State and Political subdivisions      | \$796               | \$ (1 )           | \$0                 | \$ 0              | \$796      | \$ (1 )           |
|                                       | \$4,276             | \$ (19 )          | \$4,011             | \$ (11 )          | \$8,287    | \$ (30 )          |

| (\$ in thousands)              | Less than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|--------------------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|                                | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2015              |                     |                   |                     |                   |            |                   |
| Available-for-Sale Securities: |                     |                   |                     |                   |            |                   |
| Mortgage-backed securities     | \$30,184            | \$ (253 )         | \$7,061             | \$ (174 )         | \$37,245   | \$ (427 )         |
|                                | \$30,184            | \$ (253 )         | \$7,061             | \$ (174 )         | \$37,245   | \$ (427 )         |

The total potential unrealized loss as of September 30, 2016 in the securities portfolio was \$0.03 million, which was down from the \$0.43 million unrealized loss at December 31, 2015. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. Management has determined there is no other-than-temporary-impairment on these securities.

#### NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoffs, are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Generally, all loan classes are placed on non-accrual status not later than 90 days past due, unless the loan is well-secured and in the process of collection. All interest accrued, but not collected, for loans that are placed on

non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the non-collectability of a loan balance is probable. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as new information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical charge-off experience and expected loss given default derived from the Company's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected on the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that State Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration each of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, agricultural, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent.

When State Bank moves a loan to non-accrual status, total unpaid interest accrued to date is reversed from income. Subsequent payments are applied to the outstanding principal balance with the interest portion of the payment recorded on the balance sheet as a contra-loan. Interest received on impaired loans may be realized once all contractual principal amounts are received or when a borrower establishes a history of six consecutive timely principal and interest payments. It is at the discretion of management to determine when a loan is placed back on accrual status upon receipt of six consecutive timely payments.

Large groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, State Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Categories of loans at September 30, 2016 and December 31, 2015 include:

| (\$ in thousands)            | Total Loans |           | Non-Accrual Loans |           |
|------------------------------|-------------|-----------|-------------------|-----------|
|                              | Sept. 2016  | Dec. 2015 | Sept. 2016        | Dec. 2015 |
| Commercial & Industrial      | \$100,951   | \$86,542  | 146               | 188       |
| Commercial RE & Construction | 268,408     | 242,208   | 1,393             | 5,670     |
| Agricultural & Farmland      | 54,609      | 43,835    | 5                 | 7         |
| Residential Real Estate      | 139,757     | 130,806   | 1,152             | 749       |
| Consumer & Other             | 55,333      | 54,224    | 193               | 32        |
| Total Loans                  | \$619,058   | \$557,615 | \$2,889           | \$6,646   |
| Unearned Income              | \$294       | \$44      |                   |           |

Total Loans, net of unearned income \$619,352 \$557,659

Allowance for loan losses \$(7,320 ) \$(6,990 )



The following tables present the activity in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of September 30, 2016, December 31, 2015 and September 30, 2015.

|   | <b>Commercial<br/>&amp; Industrial</b> | <b>Commercial<br/>RE &amp;<br/>Construction</b> | <b>Agricultural<br/>&amp; Farmland</b> | <b>Residential<br/>Real Estate</b> | <b>Consumer<br/>&amp; Other</b> | <b>Total</b> |
|---|--|---|--|------------------------------------|---------------------------------|--------------|
| <b>ALLOWANCE FOR LOAN AND LEASE LOSSES</b>      |  |   |  |                                    |                                 |              |
| For the Three Months Ended - September 30, 2016 |  |   |  |                                    |                                 |              |
| Beginning balance                               | \$ 1,137                               | \$ 4,126  | \$ 189                                 | \$ 1,342                           | \$ 656                          | \$ 7,450     |
| Charge Offs                                     | (42 )                                  | (30 )   | -                                      | -                                  | (64 )                           | \$(136 )     |
| Recoveries                                      | 1                                      | -   | 1                                      | 1                                  | 3                               | 6            |
| Provision                                       | 155                                    | (960 )  | 142                                    | 460                                | 203                             | -            |
| Ending Balance                                  | \$ 1,251                               | \$ 3,136  | \$ 332                                 | \$ 1,803                           | \$ 798                          | \$ 7,320     |
| For the Nine Months Ended - September 30, 2016  |  |   |  |                                    |                                 |              |
| Beginning balance                               | \$ 914                                 | \$ 3,886  | \$ 204                                 | \$ 1,312                           | \$ 674                          | \$ 6,990     |
| Charge Offs                                     | (134 )                                 | (30 )   | -                                      | -                                  | (68 )                           | \$(232 )     |
| Recoveries                                      | 248                                    | 6   | 2                                      | 1                                  | 55                              | 312          |
| Provision                                       | 223                                    | (726 )  | 126                                    | 490                                | 137                             | 250          |
| Ending Balance                                  | \$ 1,251                               | \$ 3,136  | \$ 332                                 | \$ 1,803                           | \$ 798                          | \$ 7,320     |
| Loans Receivable at September 30, 2016          |  |   |  |                                    |                                 |              |
| Allowance:                                      |  |   |  |                                    |                                 |              |
| Ending balance:                                 |  |   |  |                                    |                                 |              |
| individually evaluated for impairment           | \$ -                                   | \$ 127  | \$ -                                   | \$ 148                             | \$ 19                           | \$ 294       |
| Ending balance:                                 |  |   |  |                                    |                                 |              |
| collectively evaluated for impairment           | \$ 1,251                               | \$ 3,009  | \$ 332                                 | \$ 1,655                           | \$ 779                          | \$ 7,026     |
| Loans:  |  |   |  |                                    |                                 |              |
| Ending balance:                                 |  |   |  |                                    |                                 |              |
| individually evaluated for impairment           | \$ -                                   | \$ 1,772  | \$ -                                   | \$ 1,874                           | \$ 346                          | \$ 3,992     |
| Ending balance:                                 |  |   |  |                                    |                                 |              |
| collectively evaluated for impairment           | \$ 100,951                             | \$ 266,636                                      | \$ 54,609                              | \$ 137,883                         | \$ 54,987                       | \$ 615,066   |

| (\$'s in thousands)                   | Commercial<br>& Industrial | Commercial<br>RE &<br>Construction | Agricultural<br>& Farmland | Residential<br>Real Estate | Consumer<br>& Other | Total      |
|---------------------------------------|----------------------------|------------------------------------|----------------------------|----------------------------|---------------------|------------|
| Loans Receivable at December 31, 2015 |                            |                                    |                            |                            |                     |            |
| Allowance:                            |                            |                                    |                            |                            |                     |            |
| Ending balance:                       |                            |                                    |                            |                            |                     |            |
| individually evaluated for impairment | \$ -                       | \$ 1,759                           | \$ -                       | \$ 167                     | \$ 37               | \$ 1,963   |
| Ending balance:                       |                            |                                    |                            |                            |                     |            |
| collectively evaluated for impairment | \$ 914                     | \$ 2,127                           | \$ 204                     | \$ 1,145                   | \$ 637              | \$ 5,027   |
| Loans:                                |                            |                                    |                            |                            |                     |            |
| Ending balance:                       |                            |                                    |                            |                            |                     |            |
| individually evaluated for impairment | \$ 126                     | \$ 5,754                           | \$ -                       | \$ 1,713                   | \$ 464              | \$ 8,057   |
| Ending balance:                       |                            |                                    |                            |                            |                     |            |
| collectively evaluated for impairment | \$ 86,416                  | \$ 236,454                         | \$ 43,835                  | \$ 129,093                 | \$ 53,760           | \$ 549,558 |

| (\$'s in thousands)                             | Commercial<br>& Industrial | Commercial<br>RE &<br>Construction | Agricultural<br>& Farmland | Residential<br>Real Estate | Consumer<br>& Other | Total    |
|---|----------------------------|------------------------------------|----------------------------|----------------------------|---------------------|----------|
| ALLOWANCE FOR LOAN AND LEASE LOSSES             |                            |                                    |                            |                            |                     |          |
| For the Three Months Ended - September 30, 2015 |                            |                                    |                            |                            |                     |          |
| Beginning balance                               | \$ 1,488                   | \$ 3,066                           | \$ 261                     | \$ 1,410                   | \$ 781              | \$ 7,006 |
| Charge Offs                                     | -                          | (53 )                              | -                          | (4 )                       | (1 )                | \$(58 )  |
| Recoveries                                      | 1                          | -                                  | 1                          | 23                         | 4                   | 29       |
| Provision                                       | (621 )                     | 997                                | (40 )                      | (154 )                     | (82 )               | 100      |
| Ending Balance                                  | \$ 868                     | \$ 4,010                           | \$ 222                     | \$ 1,275                   | \$ 702              | \$ 7,076 |

For the Nine Months Ended -  
September 30, 2015

|                   |          |          |        |          |        |          |
|-------------------|----------|----------|--------|----------|--------|----------|
| Beginning balance | \$ 1,630 | \$ 2,857 | \$ 208 | \$ 1,308 | \$ 768 | \$ 6,771 |
| Charge Offs       | (309 )   | (303 )   | -      | (65 )    | (34 )  | \$(711 ) |
| Recoveries        | 22       | 3        | 3      | 28       | 10     | 66       |
| Provision         | (475 )   | 1,453    | 11     | 4        | (43 )  | 950      |
| Ending Balance    | \$ 868   | \$ 4,010 | \$ 222 | \$ 1,275 | \$ 701 | \$ 7,076 |

The risk characteristics of each loan portfolio segment are as follows:

Commercial and Agricultural

Commercial and agricultural loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may include a personal guarantee. Short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

### Commercial Real Estate including Construction

Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The characteristics of properties securing the Company's commercial real estate portfolio are diverse, but with geographic location almost entirely in the Company's market area. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. In general, the Company avoids financing single purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate versus non-owner-occupied loans.

Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews and financial analysis of the developers and property owners. Construction loans are generally based on estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

### Residential and Consumer

Residential and consumer loans consist of two segments – residential mortgage loans and personal loans. Residential mortgage loans are secured by 1-4 family residences and are generally owner-occupied, and the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer personal loans are secured by consumer personal assets, such as automobiles or recreational vehicles. Some consumer personal loans are unsecured, such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas, such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that these loans are of smaller individual amounts and spread over a large number of borrowers.

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of September 30, 2016 and December 31, 2015.

| <b><u>September 30, 2016</u></b> | <b>Commercial</b>       | <b>Commercial</b>                | <b>Agricultural</b>   | <b>Residential</b> | <b>Consumer</b>    |              |
|----------------------------------|-------------------------|----------------------------------|-----------------------|--------------------|--------------------|--------------|
| <b>(\$ in thousands)</b>         | <b>&amp; Industrial</b> | <b>RE &amp;<br/>Construction</b> | <b>&amp; Farmland</b> | <b>Real Estate</b> | <b>&amp; Other</b> | <b>Total</b> |
| 1-2                              | \$ 1,207                | \$ 44                            | \$ 40                 | \$ 338             | \$ 4               | \$1,633      |
| 3                                | 27,841                  | 84,276                           | 9,661                 | 111,581            | 52,185             | 285,544      |
| 4                                | 71,312                  | 176,270                          | 44,908                | 25,801             | 2,824              | 321,115      |
| Total Pass (1 - 4)               | 100,360                 | 260,590                          | 54,609                | 137,720            | 55,013             | 608,292      |
| Special Mention (5)              | -                       | 4,419                            | -                     | 566                | 62                 | 5,047        |
| Substandard (6)                  | 150                     | 2,006                            | -                     | 408                | 64                 | 2,628        |
| Doubtful (7)                     | 441                     | 1,394                            | -                     | 1,063              | 193                | 3,091        |
| Loss (8)                         | -                       | -                                | -                     | -                  | -                  | -            |
| Total Loans                      | \$ 100,951              | \$ 268,408                       | \$ 54,609             | \$ 139,757         | \$ 55,333          | \$619,058    |

| <b><u>December 31, 2015</u></b> | <b>Commercial</b>       | <b>Commercial</b>                | <b>Agricultural</b>   | <b>Residential</b> | <b>Consumer</b>    |              |
|---------------------------------|-------------------------|----------------------------------|-----------------------|--------------------|--------------------|--------------|
| <b>(\$ in thousands)</b>        | <b>&amp; Industrial</b> | <b>RE &amp;<br/>Construction</b> | <b>&amp; Farmland</b> | <b>Real Estate</b> | <b>&amp; Other</b> | <b>Total</b> |
| 1-2                             | \$ 709                  | \$ 767                           | \$ 47                 | \$ -               | \$ 15              | \$1,538      |
| 3                               | 23,362                  | 79,915                           | 8,195                 | 118,463            | 50,745             | 280,680      |
| 4                               | 61,799                  | 149,473                          | 35,593                | 10,418             | 3,223              | 260,506      |
| Total Pass (1 - 4)              | 85,870                  | 230,155                          | 43,835                | 128,881            | 53,983             | 542,724      |
| Special Mention (5)             | 330                     | 5,260                            | -                     | 756                | 70                 | 6,416        |
| Substandard (6)                 | 110                     | 1,072                            | -                     | 420                | 139                | 1,741        |
| Doubtful (7)                    | 232                     | 5,721                            | -                     | 749                | 32                 | 6,734        |
| Loss (8)                        | -                       | -                                | -                     | -                  | -                  | -            |
| Total Loans                     | \$ 86,542               | \$ 242,208                       | \$ 43,835             | \$ 130,806         | \$ 54,224          | \$557,615    |

The Company evaluates the loan risk grading system definitions and allowance for loan loss methodology on an ongoing basis.

### **Credit Risk Profile**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes loans individually by

classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$100 thousand and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

**Pass (grades 1 – 4):** Loans which management has determined to be performing as expected and in agreement with the terms established at the time of loan origination.

**Special Mention (5):** Assets have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company's credit position at some future date. Special mention assets are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification. Ordinarily, special mention credits have characteristics which corrective management action would remedy.

**Substandard (6):** Loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful (7):** Loans classified as doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current known facts, conditions and values, highly questionable and improbable.

**Loss (8):** Loans are considered uncollectable and of such little value that continuing to carry them as assets on the Company's financial statement is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

The following tables present the Company's loan portfolio aging analysis as of September 30, 2016 and December 31, 2015.

| (\$ in thousands)                | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>Than<br>90 Days | Total<br>Past<br>Due | Current    | Total<br>Loans<br>Receivable |
|----------------------------------|------------------------------|------------------------------|----------------------------|----------------------|------------|------------------------------|
| <b><u>September 30, 2016</u></b> |                              |                              |                            |                      |            |                              |
| Commercial & Industrial          | \$ -                         | \$-                          | \$ 110                     | \$ 110               | \$ 100,841 | \$ 100,951                   |
| Commercial RE & Construction     | 56                           | 909                          | 1,135                      | 2,100                | 266,308    | 268,408                      |
| Agricultural & Farmland          | -                            | -                            | -                          | -                    | 54,609     | 54,609                       |
| Residential Real Estate          | -                            | 55                           | 233                        | 288                  | 139,469    | 139,757                      |
| Consumer & Other                 | 17                           | 51                           | 181                        | 249                  | 55,084     | 55,333                       |
| Total Loans                      | \$ 73                        | \$ 1,015                     | \$ 1,659                   | \$ 2,747             | \$ 616,311 | \$ 619,058                   |

| (\$ in thousands)               | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>Than<br>90 Days | Total<br>Past<br>Due | Current    | Total<br>Loans<br>Receivable |
|---------------------------------|------------------------------|------------------------------|----------------------------|----------------------|------------|------------------------------|
| <b><u>December 31, 2015</u></b> |                              |                              |                            |                      |            |                              |
| Commercial & Industrial         | \$ -                         | \$ 60                        | \$ 188                     | \$ 248               | \$ 86,294  | \$ 86,542                    |
| Commercial RE & Construction    | 99                           | -                            | 5,280                      | 5,379                | 236,829    | 242,208                      |
| Agricultural & Farmland         | -                            | -                            | -                          | -                    | 43,835     | 43,835                       |
| Residential Real Estate         | 98                           | 198                          | 156                        | 452                  | 130,354    | 130,806                      |
| Consumer & Other                | 64                           | -                            | 2                          | 66                   | 54,158     | 54,224                       |
| Total Loans                     | \$ 261                       | \$ 258                       | \$ 5,626                   | \$ 6,145             | \$ 551,470 | \$ 557,615                   |

All loans past due 90 days are systematically placed on nonaccrual status.

A loan is considered impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16), when based on current information and events, it is probable State Bank will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans but also include loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.



The following tables present impaired loan information as of and for the three and nine months ended September 30, 2016 and 2015, and for the twelve months ended December 31, 2015:

| <b>Nine Months Ended<br/>September 30, 2016</b><br>(\$'s in thousands) | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|--|--------------------------------|---|------------------------------|--|---|
| With no related allowance recorded:                                    |                                |   |                              |  |   |
| Commercial & Industrial  | \$ -                           | \$ -                                    | \$ -                         | \$ -                                       | \$ -                                      |
| Commercial RE & Construction   | 637                            | 637                                     | -                            | 658  | 16  |
| Agricultural & Farmland  | -                              | -                                       | -                            | -  | -   |
| Residential Real Estate  | 987                            | 1,031                                   | -                            | 1,195                                      | 51  |
| Consumer & Other   | 20                             | 78                                      | -                            | 94   | 6   |
| All Impaired Loans < \$100,000   | 398                            | 398                                     | -                            | 398  | -   |
| With a specific allowance recorded:                                    |                                |   |                              |  |   |
| Commercial & Industrial  | -                              | -                                       | -                            | -  | -   |
| Commercial RE & Construction   | 1,135                          | 1,385                                   | 127                          | 1,404                                      | -   |
| Agricultural & Farmland  | -                              | -                                       | -                            | -  | -   |
| Residential Real Estate  | 887                            | 887                                     | 148                          | 957  | 29  |
| Consumer & Other   | 268                            | 268                                     | 19                           | 272  | 11  |
| Totals:  |                                |   |                              |  |   |
| Commercial & Industrial  | \$ -                           | \$ -                                    | \$ -                         | \$ -                                       | \$ -                                      |
| Commercial RE & Construction   | \$ 1,772                       | \$ 2,022                                | \$ 127                       | \$ 2,062                                   | \$ 16                                     |
| Agricultural & Farmland  | \$ -                           | \$ -                                    | \$ -                         | \$ -                                       | \$ -                                      |
| Residential Real Estate  | \$ 1,874                       | \$ 1,918                                | \$ 148                       | \$ 2,152                                   | \$ 80                                     |
| Consumer & Other   | \$ 346                         | \$ 346                                  | \$ 19                        | \$ 366                                     | \$ 17                                     |
| All Impaired Loans < \$100,000   | \$ 398                         | \$ 398                                  | \$ -                         | \$ 398                                     | \$ -                                      |

| <b>Three Months Ended<br/>September 30, 2016</b><br>(\$'s in thousands) | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|---|--|---|
| With no related allowance recorded:                                     |  |   |
| Commercial & Industrial   | \$ -                                       | \$ -                                      |
| Commercial RE & Construction  | 647  | 6   |
| Agricultural & Farmland   | -  | -   |
| Residential Real Estate   | 1,186                                      | 17  |
| Consumer & Other  | 89   | 2   |
| All Impaired Loans < \$100,000  | 438  | -   |
| With a specific allowance recorded:                                     |  |   |
| Commercial & Industrial   | -  | -   |
| Commercial RE & Construction  | 1,404                                      | -   |
| Agricultural & Farmland   | -  | -   |
| Residential Real Estate   | 945  | 10  |
| Consumer & Other  | 267  | 2   |
| Totals:   |  |   |
| Commercial & Industrial   | \$ -                                       | \$ -                                      |

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|                                |          |       |
|--------------------------------|----------|-------|
| Commercial RE & Construction   | \$ 2,051 | \$ 6  |
| Agricultural & Farmland        | \$ -     | \$ -  |
| Residential Real Estate        | \$ 2,131 | \$ 27 |
| Consumer & Other               | \$ 356   | \$ 4  |
| All Impaired Loans < \$100,000 | \$ 438   | \$ -  |

| <b>Twelve Months Ended<br/>December 31, 2015</b><br>(\$'s in thousands) | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|---|--------------------------------|---|------------------------------|--|---|
| With no related allowance recorded:                                     |                                |   |                              |  |   |
| Commercial & Industrial   | \$126                          | \$1,214                                 | \$-                          | \$1,388                                    | \$-                                       |
| Commercial RE & Construction  | 1,110                          | 1,110                                   | -                            | 1,206                                      | 27  |
| Agricultural & Farmland   | -                              | -                                       | -                            | -  | -   |
| Residential Real Estate   | 657                            | 657                                     | -                            | 862  | 52  |
| Consumer & Other  | 90                             | 90                                      | -                            | 107  | 9   |
| All Impaired Loans < \$100,000  | 131                            | 131                                     | -                            | 131  | -   |
| With a specific allowance recorded:                                     |                                |   |                              |  |   |
| Commercial & Industrial   | -                              | -                                       | -                            | -  | -   |
| Commercial RE & Construction  | 4,644                          | 4,893                                   | 1,759                        | 5,006                                      | 90  |
| Agricultural & Farmland   | -                              | -                                       | -                            | -  | -   |
| Residential Real Estate   | 1,056                          | 1,013                                   | 167                          | 1,084                                      | 45  |
| Consumer & Other  | 374                            | 374                                     | 37                           | 385  | 22  |
| Totals:   |                                |   |                              |  |   |
| Commercial & Industrial   | \$126                          | \$1,214                                 | \$-                          | \$1,388                                    | \$-                                       |
| Commercial RE & Construction  | \$5,754                        | \$6,003                                 | \$1,759                      | \$6,212                                    | \$117                                     |
| Agricultural & Farmland   | \$-                            | \$-                                     | \$-                          | \$-  | \$-                                       |
| Residential Real Estate   | \$1,713                        | \$1,670                                 | \$167                        | \$1,946                                    | \$97                                      |
| Consumer & Other  | \$464                          | \$464                                   | \$37                         | \$492                                      | \$31                                      |
| All Impaired Loans < \$100,000  | \$131                          | \$131                                   | \$-                          | \$131                                      | \$-                                       |

| <b>September 30, 2015</b>           | <b>Nine Months Ended</b>                   |   | <b>Three Months Ended</b>                  |   |
|-------------------------------------|--|---|--|---|
|                                     | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> |
| With no related allowance recorded: |  |   |  |   |
| Commercial & Industrial             | \$316                                      | \$ -                                      | \$316                                      | \$ -                                      |
| Commercial RE & Construction        | 704  | 25  | 797  | 6   |
| Agricultural & Farmland             | -  | -   | -  | -   |
| Residential Real Estate             | 673  | 38  | 859  | 8   |
| Consumer & Other                    | 114  | 7   | 125  | 3   |
| All Impaired Loans < \$100,000      | 344  | -   | 344  | -   |
| With a specific allowance recorded: |  |   |  |   |
| Commercial & Industrial             | 19   | -   | 1,080                                      | -   |
| Commercial RE & Construction        | 4,949                                      | 13  | 1,954                                      | 3   |
| Agricultural & Farmland             | -  | -   | -  | -   |
| Residential Real Estate             | 1,025                                      | 33  | 1,080                                      | 10  |
| Consumer & Other                    | 337  | 17  | 362  | 5   |
| Totals:                             |  |   |  |   |
| Commercial & Industrial             | \$335                                      | \$ -                                      | \$1,396                                    | \$ -                                      |
| Commercial RE & Construction        | \$5,653                                    | \$ 38                                     | \$2,751                                    | \$ 9                                      |
| Agricultural & Farmland             | \$-  | \$ -                                      | \$-  | \$ -                                      |
| Residential Real Estate             | \$1,698                                    | \$ 71                                     | \$1,939                                    | \$ 18                                     |

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|                                |       |       |       |      |
|--------------------------------|-------|-------|-------|------|
| Consumer & Other               | \$451 | \$ 24 | \$487 | \$ 8 |
| All Impaired Loans < \$100,000 | \$344 | \$ -  | \$344 | \$ - |

Impaired loans less than \$100,000 are included in groups of homogenous loans. These loans are evaluated based on delinquency status.

Interest income recognized on a cash basis does not materially differ from interest income recognized on an accrual basis.

**Troubled Debt Restructured (TDR) Loans**

TDRs are modified loans where a concession was provided to a borrower experiencing financial difficulties. Loan modifications are considered TDRs when the concessions provided are not available to the borrower through either normal channels or other sources. However, not all loan modifications are TDRs.

TDR Concession Types

The Company's standards relating to loan modifications consider, among other factors, minimum verified income requirements, cash flow analysis, and collateral valuations. Each potential loan modification is reviewed individually and the terms of the loan are modified to meet a borrower's specific circumstances at a point in time. All loan modifications, including those classified as TDRs, are reviewed and approved. The types of concessions provided to borrowers include:

**Interest rate reduction:** A reduction of the stated interest rate to a nonmarket rate for the remaining original life of the loan. The Company also may grant interest rate concessions for a limited timeframe on a case by case basis.

**Amortization or maturity date change:** A change in the amortization or maturity date beyond what the collateral supports, including a concession that does any of the following:

Lengthens the amortization period of the amortized principal beyond market terms. This concession reduces the (1) minimum monthly payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.

Reduces the amount of loan principal to be amortized. This concession also reduces the minimum monthly (2) payment and increases the amount of the balloon payment at the end of the term of the loan. Principal is generally not forgiven.

Extends the maturity date or dates of the debt beyond what the collateral supports. This concession generally (3) applies to loans without a balloon payment at the end of the term of the loan. In addition, there may be instances where renewing loans potentially require non-market terms and would then be reclassified as TDRs.

**Other:** A concession that is not categorized as one of the concessions described above. These concessions include, but are not limited to: principal forgiveness, collateral concessions, covenant concessions, and reduction of accrued interest. Principal forgiveness may result from any TDR modification of any concession type.

The following presents the activity of TDRs during the three and nine months ended September 30, 2016 and 2015.

| (\$ in thousands)          | <b>Three Months ended Sep. 30, 2016</b>                       |   |               |  |
|----------------------------|---|---|---------------|--|
|                            | <b>Pre-Modification<br/>of Recorded<br/>Loans<br/>Balance</b> | <b>Post-Modification<br/>Recorded<br/>Balance</b> |               |  |
| Residential Real Estate    | -   | \$ -  | \$ -          |  |
| Commercial                 | 1   | 309   | 309           |  |
| Consumer & Other           | -   | -   | -             |  |
| <b>Total Modifications</b> | <b>1</b>  | <b>\$ 309</b>                                     | <b>\$ 309</b> |  |

  

|                            | <b>Interest<br/>Only</b> | <b>Term</b>   | <b>Combination</b> | <b>Total<br/>Modification</b> |
|----------------------------|--------------------------|---------------|--------------------|-------------------------------|
| Residential Real Estate    | \$ -                     | \$ -          | \$ -               | \$ -                          |
| Commercial                 | -                        | 309           | -                  | 309                           |
| Consumer & Other           | -                        | -             | -                  | -                             |
| <b>Total Modifications</b> | <b>\$-</b>               | <b>\$ 309</b> | <b>\$-</b>         | <b>\$ 309</b>                 |

There was no increase in the allowance for loan losses due to TDR's in the three month period ended Sep. 30, 2016.

| (\$ in thousands)          | <b>Nine Months ended Sep. 30, 2016</b>                        |   |               |  |
|----------------------------|---|---|---------------|--|
|                            | <b>Pre-Modification<br/>of Recorded<br/>Loans<br/>Balance</b> | <b>Post-Modification<br/>Recorded<br/>Balance</b> |               |  |
| Residential Real Estate    | -   | \$ -  | \$ -          |  |
| Commercial                 | 1   | 309   | 309           |  |
| Consumer & Other           | 1   | 221   | 221           |  |
| <b>Total Modifications</b> | <b>2</b>  | <b>\$ 530</b>                                     | <b>\$ 530</b> |  |

  

|                            | <b>Interest<br/>Only</b> | <b>Term</b>   | <b>Combination</b> | <b>Total<br/>Modification</b> |
|----------------------------|--------------------------|---------------|--------------------|-------------------------------|
| Residential Real Estate    | \$ -                     | \$ -          | \$ -               | \$ -                          |
| Commercial                 | -                        | 309           | -                  | 309                           |
| Consumer & Other           | -                        | 221           | -                  | 221                           |
| <b>Total Modifications</b> | <b>\$-</b>               | <b>\$ 530</b> | <b>\$-</b>         | <b>\$ 530</b>                 |

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|                         |     |   |        |     |   |        |   |
|-------------------------|-----|---|--------|-----|---|--------|---|
| Residential Real Estate | \$  | - | \$-    | \$  | - | \$     | - |
| Commercial              | -   |   | 309    | -   |   | 309    |   |
| Consumer & Other        | -   |   | 221    | -   |   | 221    |   |
| Total Modifications     | \$- |   | \$ 530 | \$- |   | \$ 530 |   |

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There was no increase in the allowance for loan losses due to TDR's in the nine month period ended Sep. 30, 2016.

| (\$ in thousands)       | Three Months ended Sep. 30, 2015 |                                    |                                    |
|-------------------------|----------------------------------|------------------------------------|------------------------------------|
|                         | Number of Loans                  | Pre- Modification Recorded Balance | Post Modification Recorded Balance |
| Residential Real Estate | -                                | \$ -                               | \$ -                               |
| Commercial              | -                                | -                                  | -                                  |
| Consumer & Other        | -                                | -                                  | -                                  |
| Total Modifications     | -                                | \$-                                | \$-                                |

|                         | Interest Only | Term | Combination | Total Modification |
|-------------------------|---------------|------|-------------|--------------------|
| Residential Real Estate | \$-           | \$-  | \$ -        | \$ -               |
| Consumer & Other        | -             | -    | -           | -                  |
| Total Modifications     | \$-           | \$-  | \$-         | \$-                |

There was no increase in the allowance for loan losses due to TDR's in the three month period ended Sep. 30, 2015.

| (\$ in thousands)       | Nine Months ended Sep. 30, 2015 |                                    |                                    |
|-------------------------|---------------------------------|------------------------------------|------------------------------------|
|                         | Number of Loans                 | Pre- Modification Recorded Balance | Post Modification Recorded Balance |
| Residential Real Estate | 1                               | \$ 24                              | \$ 24                              |
| Consumer & Other        | -                               | -                                  | -                                  |
| Total Modifications     | 1                               | \$ 24                              | \$ 24                              |

|                         | Interest Only | Term  | Combination | Total Modification |
|-------------------------|---------------|-------|-------------|--------------------|
| Residential Real Estate | \$ -          | \$ 24 | \$ -        | \$ 24              |
| Consumer & Other        | -             | -     | -           | -                  |
| Total Modifications     | \$-           | \$ 24 | \$-         | \$ 24              |



There was no increase in the allowance for loan losses due to TDR's in the nine month period ended Sep. 30, 2015. TDR's modified in 2016 that have subsequently defaulted

| (\$ in thousands) | Number<br>of<br>Contracts | Recorded<br>Balance |
|-------------------|---------------------------|---------------------|
| Consumer & Other  | 1                         | \$ 221              |
|                   | 1                         | 221                 |

There were no TDR's modified during 2015 that have subsequently defaulted.

## NOTE 5 – DERIVATIVE FINANCIAL INSTRUMENTS AND REPURCHASE AGREEMENTS

### *Risk Management Objective of Using Derivatives*

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company manages its exposures to a wide variety of business and operational risks primarily through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing and duration of the Company's known or expected cash payments principally related to certain variable-rate assets.

### *Non-designated Hedges*

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously offset by interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2016 and December 31, 2015, the notional amount of customer-facing swaps was approximately \$30.1 million and \$17.6 million, respectively. The same amounts were offset with third party counterparties, as described above.

The Company has minimum collateral posting thresholds with its derivative counterparties. As of September 30, 2016 and December 31, 2015, the Company had posted cash as collateral in the amount of \$1.6 million and \$0.7 million, respectively.

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2016 and December 31, 2015.

**Asset Derivatives**

**Liability Derivatives**

| (\$ in thousands)                                  | September 30, 2016     |            | September 30, 2016     |            |
|--|------------------------|------------|------------------------|------------|
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives not designated as hedging instruments: |                        |            |                        |            |
| Interest rate contracts                            | Other Assets           | \$ 1,396   | Other Liabilities      | \$ 1,396   |

| (\$ in thousands)                                  | Asset Derivatives                           |            | Liability Derivatives                       |            |
|--|---|------------|---|------------|
|  | December 31, 2015<br>Balance Sheet Location | Fair Value | December 31, 2015<br>Balance Sheet Location | Fair Value |
| Derivatives not designated as hedging instruments: |   |            |   |            |
| Interest rate contracts                            | Other Assets                                | \$ 490     | Other Liabilities                           | \$ 490     |

The Company's derivative financial instruments had no net effect on the Income Statements for the three and nine months ended September 30, 2016 and 2015.

#### *Securities Sold Under Repurchase Agreements*

State Bank has retail repurchase agreements to facilitate cash management transactions with commercial customers. These obligations are secured by agency and mortgage-backed securities and such collateral is held by the Federal Home Loan Bank. The agreements mature within one month. These repurchase agreements are secured by agency securities and mortgage-backed securities with corresponding liabilities of \$5.7 million and of \$14.9 million. These securities have various maturity dates beyond 2017.

## NOTE 6 – FAIR VALUE OF ASSETS AND LIABILITIES

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

**Level 1** Quoted prices in active markets for identical assets or liabilities

**Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

**Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis, recognized in the accompanying balance sheets, as well as the general classifications of such assets pursuant to the valuation hierarchy.

### Available-for-Sale Securities

The fair values of available-for-sale securities are determined by various valuation methodologies. Level 1 securities include money market mutual funds. Level 1 inputs include quoted prices in an active market. Level 2 securities include U.S. treasury and government agencies, mortgage-backed securities, obligations of political and state subdivisions and equity securities. Level 2 inputs do not include quoted prices for individual securities in active markets; however, they do include inputs that are either directly or indirectly observable for the individual security being valued. Such observable inputs include interest rates and yield curves at commonly quoted intervals, volatilities, prepayment speeds, credit risks and default rates. Also included are inputs derived principally from or corroborated by observable market data by correlation or other means.

### Interest Rate Contracts

The fair values of interest rate contracts are based upon the estimated amount the Company would receive or pay to terminate the contracts or agreements, taking into account underlying interest rates, creditworthiness of underlying customers for credit derivatives and, when appropriate, the creditworthiness of the counterparties.

The following table presents the fair value measurements of assets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2016 and December 31, 2015.

**Fair Value Measurements Using:**

| (\$ in thousands)                     | Fair Values at | (Level | (Level   | (Level |
|---------------------------------------|----------------|--------|----------|--------|
| Available-for-Sale Securities:        | 9/30/16        | 1)     | 2)       | 3)     |
| U.S. Treasury and Government Agencies | \$ 14,033      | \$ -   | \$14,033 | \$ -   |
| Mortgage-backed securities            | 62,760         | -      | 62,760   | -      |
| State and political subdivisions      | 15,873         | -      | 15,873   | -      |
| Equity securities                     | 23             | -      | 23       | -      |
| Interest rate contracts - assets      | 1,396          | -      | 1,396    | -      |
| Interest rate contracts - liabilities | (1,396 )       | -      | (1,396 ) | -      |

**Fair Value Measurements Using:**

| (\$ in thousands)                     | Fair Values at | (Level | (Level   | (Level |
|---------------------------------------|----------------|--------|----------|--------|
| Available-for-Sale Securities:        | 12/31/2015     | 1)     | 2)       | 3)     |
| U.S. Treasury and Government Agencies | \$ 10,905      | \$ -   | \$10,905 | \$ -   |
| Mortgage-backed securities            | 61,343         | -      | 61,343   | -      |
| State and political subdivisions      | 17,518         | -      | 17,518   | -      |
| Equity securities                     | 23             | -      | 23       | -      |
| Interest rate contracts - assets      | 490            | -      | 490      | -      |
| Interest rate contracts - liabilities | (490 )         | -      | (490 )   | -      |

Level 1 – Quoted Prices in Active Markets for Identical Assets

Level 2 – Significant Other Observable Inputs

Level 3 – Significant Unobservable Inputs

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Collateral-dependent Impaired Loans, NET of ALLL

Loans for which it is probable the Company will not collect all principal and interest due according to contractual terms are measured for impairment. The estimated fair value of collateral-dependent impaired loans is based on the appraised value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy. This method requires obtaining an independent appraisal of the collateral, which is reviewed for accuracy and consistency by Credit Administration. These appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by applying a discount factor to the value based on the Company's loan review policy. All impaired loans held by the Company were collateral dependent at June 30, 2016 and December 31, 2015.

Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees; miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

**Unobservable (Level 3) Inputs**

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements.

| (\$ in thousands)<br>Description | Fair Values at<br>9/30/2016 | (Level<br>1) | (Level<br>2) | (Level<br>3) |
|----------------------------------|-----------------------------|--------------|--------------|--------------|
| Impaired loans                   | \$ 1,188                    | \$ -         | \$ -         | \$1,188      |
| Mortgage Servicing Rights        | 7,125                       | \$ -         | \$ -         | 7,125        |

| (\$ in thousands)<br>Description | Fair Values at<br>12/31/2015 | (Level<br>1) | (Level<br>2) | (Level<br>3) |
|----------------------------------|------------------------------|--------------|--------------|--------------|
| Impaired loans                   | \$ 3,011                     | \$ -         | \$ -         | \$3,011      |
| Mortgage Servicing Rights        | 2,585                        | \$ -         | \$ -         | 2,585        |

Level 1 - Quoted Prices in Active Markets for Identical Assets

Level 2 - Significant Other Observable Inputs

Level 3 - Significant Unobservable Inputs

| (\$'s in thousands)                 | Fair Value at<br>9/30/2016 | Valuation<br>Technique       | Unobservable Inputs             | Range<br>(Weighted<br>Average) |
|-------------------------------------|----------------------------|------------------------------|---------------------------------|--------------------------------|
| Collateral-dependent impaired loans | \$ 1,188                   | Market comparable properties | Comparability adjustments (%)   | Not available                  |
| Mortgage servicing rights           | 7,125                      | Discounted cash flow         | Discount Rate                   | 9.03 %                         |
|                                     |                            |                              | Constant prepayment rate        | 14.45 %                        |
|                                     |                            |                              | P&I earnings credit             | 0.53 %                         |
|                                     |                            |                              | T&I earnings credit             | 1.14 %                         |
|                                     |                            |                              | Inflation for cost of servicing | 1.50 %                         |

| (\$'s in thousands)                 | Fair Value at<br>12/31/2015 | Valuation Technique          | Unobservable Inputs           | Range<br>(Weighted<br>Average) |
|-------------------------------------|-----------------------------|------------------------------|-------------------------------|--------------------------------|
| Collateral-dependent impaired loans | \$ 3,011                    | Market comparable properties | Comparability adjustments (%) | Not available                  |



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|                           |       |                      |                                 |      |   |
|---------------------------|-------|----------------------|---------------------------------|------|---|
| Mortgage servicing rights | 2,585 | Discounted cash flow | Discount Rate                   | 9.75 | % |
|                           |       |                      | Constant prepayment rate        | 8.90 | % |
|                           |       |                      | P&I earnings credit             | 0.42 | % |
|                           |       |                      | T&I earnings credit             | 1.54 | % |
|                           |       |                      | Inflation for cost of servicing | 1.50 | % |

There were no changes in the inputs or methodologies used to determine fair value at September 30, 2016 as compared to December 31, 2015.

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying balance sheets at amounts other than fair value.

Cash and Due From Banks, Federal Reserve and Federal Home Loan Bank Stock and Accrued Interest Receivable and Payable

The carrying amount approximates the fair value.

### Loans Held for Sale

The fair value of loans held for sale is based upon quoted market prices, where available, or is determined by discounting estimated cash flows using interest rates approximating the Company's current origination rates for similar loans and adjusted to reflect the inherent credit risk.

### Loans

The estimated fair value for loans receivable is based on estimates of the rate State Bank would charge for similar loans at September 30, 2016 and December 31, 2015, applied for the time period until the loans are assumed to re-price or be paid.

### Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees, miscellaneous income and float; marginal costs of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

### Deposits, FHLB advances & Repurchase agreements

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates the fair value. The estimated fair value for fixed-maturity time deposits, as well as borrowings, is based on estimates of the rate State Bank could pay on similar instruments with similar terms and maturities at September 30, 2016 and December 31, 2015.

### Loan Commitments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The estimated fair values for other financial instruments and off-balance-sheet loan commitments approximate cost at September 30, 2016 and December 31, 2015 and are not considered significant to this presentation.

Trust Preferred Securities

The fair value for Trust Preferred Securities is estimated by discounting the cash flows using an appropriate discount rate.

The following table presents estimated fair values of the Company's other financial instruments carried at other than fair value. The fair values of certain of these instruments were calculated by discounting expected cash flows, which involves significant judgments by management and uncertainties. Fair value is the estimated amount at which financial assets or liabilities could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Because no market exists for certain of these financial instruments, and because management does not intend to sell these financial instruments, the Company does not know whether the fair values shown below represent values at which the respective financial instruments could be sold individually or in the aggregate.

|  | September 30,<br>2016<br>Carrying<br>Amount | Fair Value Measurements Using |           |           |
|--|---|-------------------------------|-----------|-----------|
|  |   | (Level 1)                     | (Level 2) | (Level 3) |
| <b>Financial assets</b>                      |   |                               |           |           |
| Cash and cash equivalents                    | \$ 25,167                                   | \$25,167                      | \$-       | \$-       |
| Loans held for sale                          | 5,865                                       | -                             | 6,053     | -         |
| Loans, net of allowance for loan losses      | 612,032                                     | -                             | -         | 612,961   |
| Federal Reserve and FHLB Bank stock          | 3,748                                       | -                             | 3,748     | -         |
| Mortgage Servicing Rights                    | 6,887                                       | -                             | -         | 6,947     |
| Accrued interest receivable                  | 1,641                                       | -                             | 1,641     | -         |
| <b>Financial liabilities</b>                 |   |                               |           |           |
| Deposits                                     | \$ 662,144                                  | \$116,976                     | \$548,360 | \$-       |
| FHLB Advances                                | 23,000                                      | -                             | 23,143    | -         |
| Short-term borrowings                        | 11,363                                      | -                             | 11,363    | -         |
| Trust preferred securities                   | 10,310                                      | -                             | 8,015     | -         |
| Accrued interest payable                     | 427   | -                             | 427       | -         |
| <br>   |   |                               |           |           |
|  | December 31,<br>2015<br>Carrying<br>Amount  | Fair Value Measurements Using |           |           |
|  |   | (Level 1)                     | (Level 2) | (Level 3) |
| <b>Financial assets</b>                      |   |                               |           |           |
| Cash and due from banks                      | \$ 20,459                                   | \$20,459                      | \$-       | \$-       |
| Loans held for sale                          | 7,516                                       | -                             | 7,779     | -         |
| Loans, net of allowance for loan losses      | 550,669                                     | -                             | -         | 548,154   |
| Federal Reserve and FHLB Bank stock, at cost | 3,748                                       | -                             | 3,748     | -         |
| Mortgage Servicing Rights                    | 7,152                                       | -                             | -         | 7,760     |
| Accrued interest receivable                  | 1,260                                       | -                             | 1,260     | -         |
| <b>Financial liabilities</b>                 |   |                               |           |           |
| Deposits                                     | \$ 586,453                                  | \$113,113                     | \$475,468 | \$-       |
| FHLB advances                                | 35,000                                      | -                             | 34,870    | -         |
| Short-term borrowings                        | 12,406                                      | -                             | 12,406    | -         |
| Trust preferred securities                   | 10,310                                      | -                             | 7,165     | -         |
| Accrued interest payable                     | 264   | -                             | 264       | -         |

**NOTE 7 – GENERAL LITIGATION**

The Company is subject to claims and lawsuits that arise primarily in the ordinary course of business. Additionally, the Company is subject to periodic examinations by various regulatory agencies. It is the opinion of management that the disposition or ultimate resolution of such claims, lawsuits and examinations will not have a material adverse effect on the consolidated financial position, results of operations and cash flow of the Company.

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

### **Cautionary Statement Regarding Forward-Looking Information**

This Quarterly Report on Form 10-Q, including Management’s Discussion and Analysis of Financial Condition and Results of Operations, contains certain forward-looking statements that are provided to assist in the understanding of anticipated future financial performance. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payment or non-payment of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our management or Board of Directors, including those relating to products or services; (c) statements of future economic performance; (d) statements regarding future customer attraction or retention; and (e) statements of assumptions underlying such statements. Words such as “anticipates”, “believes”, “plans”, “intends”, “expects”, “projects”, “estimates”, “should”, “may”, “will allow”, “will likely result”, “will continue”, “will remain”, or other similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying those statements. Forward-looking statements are based on management’s expectations and are subject to a number of risks and uncertainties. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements. Risks and uncertainties that could cause actual results to differ materially include, without limitation, risks and uncertainties inherent in the national and regional banking industry, changes in economic conditions in the market areas in which the Company and its subsidiaries operate, changes in policies by regulatory agencies, changes in accounting standards and policies, changes in tax laws, fluctuations in interest rates, demand for loans in the market areas in which the Company and its subsidiaries operate, increases in FDIC insurance premiums, changes in the competitive environment, losses of significant customers, geopolitical events and the loss of key personnel. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in Management’s Discussion and Analysis of Financial Condition and Results of Operations is available in the Company’s filings with the Securities and Exchange Commission, including the risks identified under the heading “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2015. Undue reliance should not be placed on the forward-looking statements, which speak only as of the date hereof. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect unanticipated events or circumstances after the date on which the statement is made.

### **Overview of SB Financial**

SB Financial Group, Inc. (“SB Financial” or the “Company”) is a bank holding company registered with the Federal Reserve Board. SB Financial’s wholly-owned subsidiary, The State Bank and Trust Company (“State Bank”), is an Ohio-chartered bank engaged in commercial banking. SB Financial’s technology subsidiary, Rurbanc Data Services, Inc. dba RDSI Banking Systems (“RDSI”), provides item processing services to community banks and businesses.



Rurban Statutory Trust II (“RST II”) was established in August 2005. In September 2005, RST II completed a pooled private offering of 10,000 Trust Preferred Securities with a liquidation amount of \$1,000 per security. The proceeds of the offering were loaned to the Company in exchange for junior subordinated debentures of the Company with terms substantially similar to the Trust Preferred Securities. The sole assets of RST II are the junior subordinated debentures, and the back-up obligations, in the aggregate, constitute a full and unconditional guarantee by the Company of the obligations of RST II.

RFCBC, Inc. (“RFCBC”) is an Ohio corporation and wholly-owned subsidiary of the Company that was incorporated in August 2004. RFCBC operates as a loan subsidiary in servicing and working out problem loans.

State Bank Insurance, LLC (“SBI”) is an Ohio corporation and a wholly-owned subsidiary of State Bank that was incorporated in June of 2010. SBI is an insurance company that engages in the sale of insurance products to retail and commercial customers of State Bank.

Unless the context indicates otherwise, all references herein to “we”, “us”, “our”, or the “Company” refer to SB Financial Group, Inc. and its consolidated subsidiaries.

### **Recent Regulatory Developments**

#### **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010**

The Dodd-Frank Act was enacted into law on July 21, 2010. The Dodd-Frank Act is significantly changing the regulation of financial institutions and the financial services industry. Because the Dodd-Frank Act requires various federal agencies to adopt a broad range of regulations with significant discretion, many of the details of the new law and the effects they will have on the Company will not be known for months and even years.

Among the provisions already implemented pursuant to the Dodd-Frank Act, the following provisions have or may have an effect on the business of the Company and its subsidiaries:

the CFPB has been formed with broad powers to adopt and enforce consumer protection regulations;



the federal law prohibiting the payment of interest on commercial demand deposit accounts was eliminated effective July 21, 2011;

the standard maximum amount of deposit insurance per customer was permanently increased to \$250,000;

the assessment base for determining deposit insurance premiums has been expanded from domestic deposits to average assets minus average tangible equity;

public companies in all industries are or will be required to provide shareholders the opportunity to cast a non-binding advisory vote on executive compensation;

new capital regulations for bank holding companies have been adopted, which will impose stricter requirements, and any new trust preferred securities issued after May 19, 2010, will no longer constitute Tier I capital; and

new corporate governance requirements applicable generally to all public companies in all industries require new compensation practices and disclosure requirements, including requiring companies to “claw back” incentive compensation under certain circumstances, to consider the independence of compensation advisors and to make additional disclosures in proxy statements with respect to compensation matters.

Many provisions of the Dodd-Frank Act have not yet been implemented and will require interpretation and rule making by federal regulators. As a result, the full effect of the Dodd-Frank Act on the Company cannot yet be determined. However, it is likely that the implementation of these provisions will increase compliance costs and fees paid to regulators, along with possibly restricting the operations of the Company and its subsidiaries.

### The Volcker Rule

In December 2013, five federal agencies adopted a final regulation implementing the Volcker Rule provision of the Dodd-Frank Act (the “Volcker Rule”). The Volcker Rule places limits on the trading activity of insured depository institutions and entities affiliated with a depository institution, subject to certain exceptions. The trading activity includes a purchase or sale as principal of a security, derivative, commodity future or option on any such instrument in order to benefit from short-term price movements or to realize short-term profits. The Volcker Rule exempts specified U.S. Government, agency and/or municipal obligations, and it excepts trading conducted in certain capacities, including as a broker or other agent, through a deferred compensation or pension plan, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities.

The Volcker Rule also prohibits a banking entity from having an ownership interest in, or certain relationships with, a hedge fund or private equity fund, with a number of exceptions. The Company does not engage in any of the trading activities or have any ownership interest in or relationship with any of the types of funds regulated by the Volcker Rule.

### Executive and Incentive Compensation

In June 2010, the Federal Reserve Board, the OCC and the FDIC issued joint interagency guidance on incentive compensation policies (the “Joint Guidance”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. This principles-based guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (a) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (b) be compatible with effective internal controls and risk management and (c) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors.

Pursuant to the Joint Guidance, the Federal Reserve Board will review as part of a regular, risk-focused examination process, the incentive compensation arrangements of financial institutions such as the Company. Such reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination and deficiencies will be incorporated into the institution’s supervisory ratings, which can affect the institution’s ability to make acquisitions and take other actions. Enforcement actions may be taken against an institution if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and prompt and effective measures are not being taken to correct the deficiencies.

On February 7, 2011, federal banking regulatory agencies jointly issued proposed rules on incentive-based compensation arrangements under applicable provisions of the Dodd-Frank Act (the “Proposed Rules”). The Proposed Rules generally apply to financial institutions with \$1.0 billion or more in assets that maintain incentive-based compensation arrangements for certain covered employees. The Proposed Rules (i) prohibit covered financial institutions from maintaining incentive-based compensation arrangements that encourage covered persons to expose the institution to inappropriate risk by providing the covered person with “excessive” compensation; (ii) prohibit covered financial institutions from establishing or maintaining incentive-based compensation arrangements for covered persons that encourage inappropriate risks that could lead to a material financial loss, (iii) require covered financial institutions to maintain policies and procedures appropriate to their size, complexity and use of incentive-based compensation to help ensure compliance with the Proposed Rules and (iv) require covered financial institutions to provide enhanced disclosure to regulators regarding their incentive-based compensation arrangements for covered person within 90 days following the end of the fiscal year.

Pursuant to rules adopted by the stock exchanges and approved by the SEC in January 2013 under the Dodd-Frank Act, public companies are required to implement “clawback” procedures for incentive compensation payments and to disclose the details of the procedures which allow recovery of incentive compensation that was paid on the basis of erroneous financial information necessitating a restatement due to material noncompliance with financial reporting requirements. This policy is intended to apply to compensation paid within a three-year look-back window of the restatement and would cover all executives who received incentive awards. Public company compensation committee members are also required to meet heightened independence requirements and to consider the independence of compensation consultants, legal counsel and other advisors to the compensation committee. The compensation committees must have the authority to hire advisors and to have the company fund reasonable compensation of such advisors.

### Effect of Environmental Regulation

Compliance with federal, state and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has not had a material effect upon the capital expenditures, earnings or competitive position of the Company and its subsidiaries. The Company believes that the nature of the operations of its subsidiaries has little, if any, environmental impact. The Company, therefore, anticipates no material capital expenditures for environmental control facilities for its current fiscal year or for the foreseeable future. The Company’s subsidiaries may be required to make capital expenditures for environmental control facilities related to properties which they may acquire through foreclosure proceedings in the future; however, the amount of such capital expenditures, if any, is not currently determinable.

### Regulatory Capital

The FRB has adopted risk-based capital guidelines for bank holding companies and for state member banks, such as State Bank. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk weighted assets by assigning assets and off-balance-sheet items to broad risk categories. Prior to January 1, 2015, the minimum ratio of total capital to risk-weighted assets (including certain off-balance-sheet items, such as standby letters of credit) was 8%. Of that 8%, at least 4% was required to be comprised of common shareholders’ equity (including retained earnings but excluding treasury stock), non-cumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less goodwill and certain other intangible assets (“Tier 1 capital”). The remainder of total risk-based capital (“Tier 2 capital”) may consist, among other things, of certain amounts of mandatory convertible debt securities, subordinated debt, preferred stock not qualifying as Tier 1 capital, allowance for loan and lease losses and net unrealized gains, after applicable taxes, on available-for-sale equity securities with readily determinable fair values, all subject to limitations established by the guidelines. Under the guidelines, capital is compared to the relative risk related to the balance sheet. To derive the risk included in the balance sheet, one of four risk weights (0%, 20%, 50% and 100%) is applied to different balance sheet and off-balance sheet assets, primarily based on the relative credit risk of the counterparty. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

In July 2013, the FRB and the federal banking agencies published final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and State Bank. These rules implement the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act. “Basel III” refers to various documents released by the Basel Committee on Banking Supervision.

Effective January 1, 2015, State Bank and the Company became subject to new capital regulations under BASEL III (with some provisions transitioned into full effectiveness over two to four years). The new requirements create a new required ratio for common equity Tier 1 (“CET1”) capital, increases the leverage and Tier 1 capital ratios, changes the risk-weights of certain assets for purposes of the risk-based capital ratios, creates an additional capital conservation buffer over the required capital ratios and changes what qualifies as capital for purposes of meeting these various capital requirements. These new capital requirements are as follows: leverage ratio of 4% of adjusted total assets, total capital ratio of 8% of risk-weighted assets and the Tier 1 capital ratio of 6.5% of risk-weighted assets. In addition, the Company will have to meet the new minimum CET1 capital ratio of 4.5% of risk-weighted assets. CET1 consists generally of common stock, retained earnings and accumulated other comprehensive income (AOCI), subject to certain adjustments. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Company to pay dividends, repurchase shares or pay discretionary bonuses.

Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common stock will be deducted from capital, subject to a two-year transition period. In addition, Tier 1 capital will include AOCI, which includes all unrealized gains and losses on available for sale debt and equity securities, subject to a two-year transition period. State Bank decided in the first quarter of 2015 to permanently opt-out of the inclusion of AOCI in its capital calculations to reduce the impact of market volatility on its regulatory capital levels.

The new requirements under BASEL III also include changes in the risk-weights of certain assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in nonaccrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less; a 250% risk weight (up from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk-weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, State Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital equal to 2.5% of risk-weighted assets above each of the required minimum capital levels in order to avoid limitations on paying dividends, engaging in share repurchases and paying certain discretionary bonuses. This new capital conservation buffer requirement is phased in beginning in January 2016 at 0.625% of risk-weighted assets and increasing each year until fully implemented in January 2019.

The FRB's prompt corrective action standards will change when these new capital ratios become effective. Under the new standards, in order to be considered well-capitalized, State Bank will be required to have at least a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8% (increased from 6%), a total capital ratio of 10% (unchanged) and a leverage ratio of 5% (unchanged) and not be subject to specified requirements to meet and maintain a specific capital ratio for a capital measure.

State Bank conducted a proforma analysis of the application of these new capital requirements as of June 30, 2016. Based on that analysis, State Bank determined that it meets all these new requirements, including the full 2.5% capital conservation buffer, and would remain well capitalized if these new requirements had been in effect on that date. (see Note 13) In addition, as noted above, beginning in 2016, if State Bank does not have the required capital conservation buffer, its ability to pay dividends to the Company would be limited.

In April 2015, the Federal Reserve Board issued a final rule which increased the size limitation for qualifying bank holding companies under the Federal Reserve Board's Small Bank Holding Company Policy Statement from \$500 million to \$1 billion of total consolidated assets. As a result, the Company now qualifies under the Small Bank Holding Company Policy Statement for exemption from the Federal Reserve Board's consolidated risk-based capital and leverage rules at the holding company level.

Federal Deposit Insurance Corporation (“FDIC”)

The FDIC is an independent federal agency which insures the deposits of federally-insured banks and savings associations up to certain prescribed limits and safeguards the safety and soundness of financial institutions. State Bank’s deposits are subject to the deposit insurance assessments of the FDIC. Under the FDIC’s deposit insurance assessment system, the assessment rate for any insured institution may vary according to regulatory capital levels of the institution and other factors such as supervisory evaluations.

In addition, the FDIC has proposed changing the deposit insurance premium assessment method for banks with less than \$10 billion in assets that have been insured by the FDIC for at least five years. The proposed changes would revise the financial ratios method so that it would be based on a statistical model estimating the probability of failure of a bank over three years; update the financial measures used in the financial ratios method consistent with the statistical model; and eliminate risk categories for established small banks and use the financial ratios method to determine assessment rates for all such banks (subject to minimum or maximum initial assessment rates based upon a bank's composite examination rating).

The FDIC is authorized to prohibit any insured institution from engaging in any activity that poses a serious threat to the insurance fund and may initiate enforcement actions against a bank, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may also terminate the deposit insurance of any institution that has engaged in or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, order or condition imposed by the FDIC.

### **Critical Accounting Policies**

Note 1 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015 describes the significant accounting policies used in the development and presentation of the Company's financial statements. The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The Company's financial position and results of operations can be affected by these estimates and assumptions and are integral to the understanding of reported results. Critical accounting policies are those policies that management believes are the most important to the portrayal of the Company's financial condition and results, and they require management to make estimates that are difficult, subjective, and/or complex.

**Allowance for Loan Losses** - The allowance for loan losses provides coverage for probable losses inherent in the Company's loan portfolio. Management evaluates the adequacy of the allowance for loan losses each quarter based on changes, if any, in underwriting activities, loan portfolio composition (including product mix and geographic, industry or customer-specific concentrations), trends in loan performance, regulatory guidance and economic factors. This evaluation is inherently subjective, as it requires the use of significant management estimates. Many factors can affect management's estimates of specific and expected losses, including volatility of default probabilities, rating migrations, loss severity and economic and political conditions. The allowance is increased through provisions charged to operating earnings and reduced by net charge-offs.

The Company determines the amount of the allowance based on relative risk characteristics of the loan portfolio. The allowance recorded for commercial loans is based on reviews of individual credit relationships and an analysis of the



migration of commercial loans and actual loss experience. The allowance recorded for homogeneous consumer loans is based on an analysis of loan mix, risk characteristics of the portfolio, fraud loss and bankruptcy experiences, and historical losses, adjusted for current trends, for each homogeneous category or group of loans. The allowance for credit losses relating to impaired loans is based on the loan's observable market price, the collateral for certain collateral-dependent loans, or the discounted cash flows using the loan's effective interest rate.

Regardless of the extent of the Company's analysis of customer performance, portfolio trends or risk management processes, certain inherent but undetected losses are probable within the loan portfolio. This is due to several factors, including inherent delays in obtaining information regarding a customer's financial condition or changes in their unique business conditions, the subjective nature of individual loan evaluations, collateral assessments and the interpretation of economic trends. Volatility of economic or customer-specific conditions affecting the identification and estimation of losses for larger non-homogeneous credits and the sensitivity of assumptions utilized to establish allowances for homogenous groups of loans are also factors. The Company estimates a range of inherent losses related to the existence of these exposures. The estimates are based upon the Company's evaluation of imprecise risk associated with the commercial and consumer allowance levels and the estimated impact of the current economic environment. To the extent that actual results differ from management's estimates, additional loan loss provisions may be required that could adversely impact earnings for future periods.

**Goodwill and Other Intangibles** - The Company records all assets and liabilities acquired in purchase acquisitions, including goodwill and other intangibles, at fair value as required. Goodwill is subject, at a minimum, to annual tests for impairment. Other intangible assets are amortized over their estimated useful lives using straight-line or accelerated methods, and are subject to impairment if events or circumstances indicate a possible inability to realize the carrying amount. The initial goodwill and other intangibles recorded and subsequent impairment analysis requires management to make subjective judgments concerning estimates of how the acquired asset will perform in the future. Events and factors that may significantly affect the estimates include, among others, customer attrition, changes in revenue growth trends, specific industry conditions and changes in competition. A decrease in earnings resulting from these or other factors could lead to an impairment of goodwill that could adversely impact earnings for future periods.

### **Three Months Ended September 30, 2016 compared to Three Months Ended September 30, 2015**

**Net Income:** Net income for the third quarter of 2016 was \$2.5 million compared to net income of \$2.3 million for the third quarter of 2015, an increase of 13 percent. Earnings per diluted share (EPS) of \$0.40 were up 14 percent from the \$0.35 for the third quarter of 2015.

**Provision for Loan Losses:** The third quarter provision for loan losses was \$0.0 million compared to \$0.1 million for the year-ago quarter. Net charge-offs for the quarter were \$0.13 million compared to net charge-offs of \$0.30 million for the year-ago quarter. Total delinquent loans ended the quarter at \$2.8 million, which is down \$3.7 million from the prior year or 0.17 percent of average loans.

| <b>Asset Quality Review – For the Period Ended</b> | <b>Sep.<br/>30,<br/>2016</b> | <b>Sep.<br/>30,<br/>2015</b> |
|--|------------------------------|------------------------------|
| <i>(\$'s in Thousands)</i>                         |                              |                              |
| Net charge-offs                                    | \$130                        | \$29                         |
| Non-accruing loans                                 | 2,889                        | 6,742                        |
| Accruing Trouble Debt Restructures                 | 1,588                        | 1,576                        |
| Non-accruing and restructured loans                | 4,477                        | 8,318                        |
| OREO / OAO   | 73                           | 188                          |
| Non-performing assets                              | 4,550                        | 8,506                        |
| Non-performing assets/Total assets                 | 0.57 %                       | 1.18 %                       |
| Allowance for loan losses/Total loans              | 1.18 %                       | 1.31 %                       |
| Allowance for loan losses/Non-performing loans     | 163.5 %                      | 85.1 %                       |

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$11.7 million for the third quarter of 2016, an increase of \$1.7 million, or 16.6 percent, from the \$10.0 million generated during the 2015 third quarter.

Net interest income was \$6.7 million, which is up \$0.7 million from the prior year third quarter's \$6.0 million. The Company's earning assets increased \$69.4 million, coupled with a 2 basis point increase in the yield on earning assets. The net interest margin for the third quarter of 2016 was 3.82 percent compared to 3.87 percent for the third quarter of 2015. Funding cost for interest bearing liabilities for the third quarter of 2016 were 0.56 percent compared to 0.49 percent for the prior year third quarter.

Noninterest income was \$5.0 million for the 2016 third quarter, which is up \$1.1 million from the prior year third quarter's \$4.0 million. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.3 million and gain on sale of securities was \$0.1 million. Noninterest income as a percentage of average assets for the third quarter of 2016 was 2.52 percent compared to 2.20 percent for the prior year third quarter.

State Bank originated \$117.2 million of mortgage loans for the third quarter of 2016, of which \$101.1 million was sold with the remainder in loans held for investment. This compares to \$87.0 million for the third quarter of 2015, of which \$70.1 million was sold with the remainder in loans held for investment. These third quarter 2016 originations and subsequent sales resulted in \$2.5 million of gains, up 48 percent from the gains for the third quarter of 2015. Net mortgage banking revenue was \$2.7 million for the third quarter of 2016 compared to \$1.8 million for the third quarter of 2015 due to the positive adjustment in servicing rights and higher volume. The 2016 third quarter included an \$0.1 million valuation recapture on our mortgage servicing rights, due to increased prepayment speeds in the portfolio.

**Consolidated Noninterest Expense:** Noninterest expense for the third quarter of 2016 was \$7.9 million, which is up \$1.3 million compared to \$6.6 million in the prior-year third quarter. The increase in noninterest expenses compared to the prior year was the result of higher staffing costs for our new branch facilities, merit increases, as well as additional staffing in compliance and mortgage administration.

**Income Taxes:** Income taxes for the third quarter of 2016 were \$1.2 million (effective rate 32.2 percent) compared to \$1.0 million (effective rate 31.4 percent) for the third quarter of 2015. This increase was driven by the increase in pretax income for the Company.

#### **Nine Months Ended September 30, 2016 compared to Nine Months Ended September 30, 2015**

**Net Income:** Net income for the first nine months of 2016 was \$6.5 million compared to net income of \$5.8 million for the first nine months of 2015, an increase of 12 percent. Earnings per diluted share (EPS) for the period of \$1.01 were up 13 percent from the \$0.89 for the prior year nine month period.

**Provision for Loan Losses:** The provision for loan losses for the first nine months of 2016 was \$0.25 million compared to \$0.95 million for the prior year first nine months. Net recoveries for the period were \$0.08 million compared to net charge-offs of \$0.65 million for the prior year nine month period.

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$32.0 million for the first nine months of 2016, an increase of \$2.6 million, or 8.9 percent, from the \$29.4 million generated during

the 2015 first nine months.

Net interest income was \$19.2 million, which is up \$1.8 million from the prior year first nine months \$17.4 million. The Company's earning assets increased \$65.7 million, coupled with a 2 basis point increase in the yield on earning assets. The net interest margin for the first nine months of 2016 was 3.77 percent compared to 3.78 percent for the first nine months of 2015. Funding cost for interest bearing liabilities for the first nine months of 2016 were 0.54 percent compared to 0.49 percent for the prior year first nine months.

Noninterest income was \$12.8 million for the 2016 first nine months, which is up \$0.8 million from the prior year first nine month's \$12.0 million. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.9 million and gain on sale of securities was \$0.3 million.

State Bank originated \$299.4 million of mortgage loans for the first nine months of 2016, of which \$255.57 million was sold with the remainder in loans held for investment. These levels were up 17 and 19 percent respectively for the prior year first nine months. The 2016 first nine months included a \$1.2 million valuation impairment on our mortgage servicing rights, due to increased prepayment speeds in the portfolio.

**Consolidated Noninterest Expense:** Noninterest expense for the first nine months of 2016 was \$22.2 million, which is up \$2.1 million compared to \$20.1 million in the prior-year first nine months. The increase in noninterest expenses compared to the prior year was the result of higher staffing costs for our new branch facilities and mortgage administration. In addition, higher occupancy costs related to our new branch facilities in Dublin and Findlay, Ohio have been realized.

**Income Taxes:** Income taxes for the first nine months of 2016 were \$3.0 million (effective rate 31.8 percent) compared to \$2.6 million (effective rate 30.9 percent) for the first nine months of 2015. This increase was driven by the increase in pretax income for the Company.

### **Changes in Financial Condition**

Total assets at September 30, 2016 were \$801.8 million, an increase of \$68.7 million or 9.4 percent since 2015 year end. Total loans, net of unearned income, were \$619.4 million as of September 30, 2016, up \$61.7 million from year end, an increase of 11.1 percent.

Total deposits at September 30, 2016 were \$662.1 million, an increase of \$75.7 million or 12.9 percent since 2015 year end. Borrowed funds (consisting of FHLB advances, and REPOs) totaled \$34.4 million at September 30, 2016. This is down from year end when borrowed funds totaled \$47.4 million due to a decrease in FHLB advances of \$12.0 million. Total equity for the Company of \$86.3 million now stands at 10.8 percent of total assets, which is up from the December 31, 2015 level of \$81.2 million. Total equity to assets was 11.1 percent at December 31, 2015.

The allowance for loan loss of \$7.3 million is up from the 2015 year end by 4.7 percent. This increase combined with the loan growth of 11.1 percent results in an allowance to loans of 1.18 percent. The 1.18 percent level is considered appropriate by management given the risk profile of the portfolio. The allowance to loan loss level at September 30, 2015 was 1.34 percent. The decline from the prior year was due to higher loan growth and improved asset quality.

### **Capital Resources**

As of September 30, 2016, based on the computations for the call report the Bank is classified as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain capital ratios as set forth in the table below. There are no conditions or events since September 30, 2016 that management believes have changed the Bank's capital classification.

The Bank's actual capital levels and ratios as of September 30, 2016 and December 31, 2015 are presented in the following table. Capital levels are presented for the Bank only as the Company is now exempt from quarterly reporting on capital levels at the holding company level (\$'s in thousands):

| (\$ in thousands)                                    | Actual   |         | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Procedures |        |
|--|----------|---------|-------------------------------|-------|--|--------|
|  | Amount   | Ratio   | Amount                        | Ratio | Amount   | Ratio  |
| As of September 30, 2016                             |          |         |                               |       |  |        |
| Tier I Capital to average assets                     | \$72,308 | 9.28 %  | \$31,160                      | 4.0 % | \$38,950   | 5.0 %  |
| Tier I Common equity capital to risk-weighted assets | 72,308   | 10.36 % | 35,055                        | 4.5 % | 50,635   | 6.5 %  |
| Tier I Capital to risk-weighted assets               | 72,308   | 10.36 % | 41,878                        | 6.0 % | 55,837   | 8.0 %  |
| Total Risk-based capital to risk-weighted assets     | 79,628   | 11.41 % | 55,837                        | 8.0 % | 69,796   | 10.0 % |
| As of December 31, 2015                              |          |         |                               |       |  |        |
| Tier I Capital to average assets                     | \$64,914 | 9.10 %  | \$28,534                      | 4.0 % | \$35,668   | 5.0 %  |
| Tier I Common equity capital to risk-weighted assets | 64,914   | 10.23 % | 28,545                        | 4.5 % | 41,231   | 6.5 %  |
| Tier I Capital to risk-weighted assets               | 64,914   | 10.23 % | 38,059                        | 6.0 % | 50,746   | 8.0 %  |
| Total Risk-based capital to risk-weighted assets     | 71,904   | 11.34 % | 50,746                        | 8.0 % | 63,432   | 10.0 % |

Effective January 1, 2015 new regulatory capital requirements, commonly referred to as “Basel III” were implemented and are reflected in the September 30, 2016 capital table above. Management opted out of the accumulated other comprehensive income treatment under the new requirements and, as such unrealized gains and losses from available-for-sale securities will continue to be excluded from Bank regulatory capital.

## **LIQUIDITY**

Liquidity relates primarily to the Company's ability to fund loan demand, meet deposit customers' withdrawal requirements and provide for operating expenses. Assets used to satisfy these needs consist of cash and due from banks, federal funds sold, interest-earning deposits in other financial institutions, securities available-for-sale and loans held for sale. These assets are commonly referred to as liquid assets. Liquid assets were \$123.7 million at September 30, 2016, compared to \$117.8 million at December 31, 2015.

Liquidity risk arises from the possibility that the Company may not be able to meet the Company's financial obligations and operating cash needs or may become overly reliant upon external funding sources. In order to manage this risk, the Board of Directors of the Company has established a Liquidity Policy that identifies primary sources of liquidity, establishes procedures for monitoring and measuring liquidity and quantifies minimum liquidity requirements. This policy designates the Asset/Liability Committee ("ALCO") as the body responsible for meeting these objectives. The ALCO reviews liquidity regularly and evaluates significant changes in strategies that affect balance sheet or cash flow positions. Liquidity is centrally managed on a daily basis by the Company's Chief Financial Officer and Asset Liability Manager.

The Company's commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolio of \$462.8 million at September 30, 2016 and \$416.8 million at December 31, 2015, which can and has been used to collateralize borrowings, is an additional source of liquidity. Management believes the Company's current liquidity level, without these borrowings, is sufficient to meet its liquidity needs. At September 30, 2016, all eligible commercial real estate, first mortgage residential and multi-family mortgage loans were pledged under an FHLB blanket lien.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statements for the nine months ended September 30, 2016 and 2015 follows.

The Company experienced positive cash flows from operating activities for the nine months ended September 30, 2016 and September 30, 2015. Net cash provided by operating activities was \$8.4 million for the nine months ended September 30, 2016 and \$5.3 million for the nine months ended September 30, 2015. Highlights for the current year include \$249.2 million in proceeds from the sale of loans, which is up \$25.1 million from the prior year. Originations of loans held for sale was a use of cash of \$241.7 million, which is also up from the prior year, by \$24.8 million. For the nine months ended September 30, 2016, there was a gain on sale of loans of \$7.1 million, and depreciation and amortization of \$0.9 million.



The Company experienced negative cash flows from investing activities for the nine months ended September 30, 2016 and September 30, 2015. Net cash flows used in investing activities was \$64.3 million for the nine months ended September 30, 2016 and \$40.6 million for the nine months ended September 30, 2015. Highlights for the nine months ended September 30, 2016 include \$17.6 million in purchases of available-for-sale securities. These cash payments were offset by \$11.9 million in proceeds from maturities and sales of securities, which is down \$2.9 million from the prior year nine-month period. The Company experienced a \$61.9 million increase in loans, which is up \$36.7 million from the prior year nine-month period.

The Company experienced positive cash flows from financing activities for the nine months ended September 30, 2016 and September 30, 2015. Net cash flow provided by financing activities was \$60.5 million for the nine months ended September 30, 2016 and \$25.4 million for the nine months ended September 30, 2015. Highlights for the current period include a \$41.1 million increase in transaction deposits for the nine months ended September 30, 2016, which is up from the \$27.0 million increase for the prior year nine-month period. Certificates of deposit increased by \$34.6 million in the current year compared to a decrease of \$4.4 million for the prior year.

ALCO uses an economic value of equity (“EVE”) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis calculates the net present value of the Company’s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. The likelihood of a decrease in rates as of September 30, 2016 and December 31, 2015 was considered unlikely given the current interest rate environment and therefore, only the minus 100 basis point rate change was included in this analysis. The results of this analysis are reflected in the following tables for September 30, 2016 and December 31, 2015.

### September 30, 2016

#### Economic Value of Equity

(\$’s in thousands)

| Change in Rates   | \$<br>Amount | \$<br>Change | %<br>Change |
|-------------------|--------------|--------------|-------------|
| +400 basis points | \$ 142,748   | \$ 25,778    | 22.04 %     |
| +300 basis points | 138,075      | 21,105       | 18.04       |
| +200 basis points | 131,940      | 14,971       | 12.80       |
| +100 basis points | 125,166      | 8,197        | 7.01        |
| Base Case         | 116,969      | -            | -           |
| -100 basis points | 107,970      | (9,000 )     | (7.69 )     |

### December 31, 2015

#### Economic Value of Equity

(\$’s in thousands)

| Change in Rates   | \$<br>Amount | \$<br>Change | %<br>Change |
|-------------------|--------------|--------------|-------------|
| +400 basis points | \$ 137,575   | \$ 16,287    | 13.43 %     |
| +300 basis points | 135,269      | 13,981       | 11.53       |
| +200 basis points | 131,535      | 10,247       | 8.45        |
| +100 basis points | 127,022      | 5,734        | 4.73        |
| Base Case         | 121,288      | -            | -           |
| -100 basis points | 114,630      | (6,657 )     | (5.49 )     |

#### Off-Balance-Sheet Borrowing Arrangements:

Significant additional off-balance-sheet liquidity is available in the form of FHLB advances and unused federal funds lines from correspondent banks. Management expects the risk of changes in off-balance-sheet arrangements to be immaterial to earnings.

The Company's commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolios in the aggregate amount of \$462.8 million have been pledged to meet FHLB collateralization requirements as of September 30, 2016. Based on the current collateralization requirements of the FHLB, the Company had approximately \$51.4 million of additional borrowing capacity at September 30, 2016. The Company also had \$15.9 million in unpledged securities that may be used to pledge for additional borrowings.

The Company's contractual obligations as of September 30, 2016 were comprised of long-term debt obligations, other debt obligations, operating lease obligations and other long-term liabilities. Long-term debt obligations are comprised of FHLB Advances of \$23.0 million, and Trust Preferred Securities of \$11.4 million. Total time deposits at September 30, 2016 were \$193.7 million, of which \$107.1 million matures beyond one year.

Also, as of September 30, 2016, the Company had commitments to sell mortgage loans totaling \$26.9 million. The Company believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If the Company requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

## **ASSET LIABILITY MANAGEMENT**

**Asset liability management** involves developing, executing and monitoring strategies to maintain appropriate liquidity, maximize net interest income and minimize the impact that significant fluctuations in market interest rates would have on current and future earnings. The business of the Company and the composition of its balance sheet consist of investments in interest-earning assets (primarily loans, mortgage-backed securities, and securities available for sale) which are primarily funded by interest-bearing liabilities (deposits and borrowings). With the exception of specific loans which are originated and held for sale, all of the financial instruments of the Company are for other than trading purposes. All of the Company's transactions are denominated in U.S. dollars with no specific foreign exchange exposure. In addition, the Company has limited exposure to commodity prices related to agricultural loans. The impact of changes in foreign exchange rates and commodity prices on interest rates are assumed to be insignificant. The Company's financial instruments have varying levels of sensitivity to changes in market interest rates resulting in market risk. Interest rate risk is the Company's primary market risk exposure; to a lesser extent, liquidity risk also impacts market risk exposure.

**Interest rate risk** is the exposure of a banking institution's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to the Company's earnings and capital base. Accordingly, effective risk management that maintains interest rate risks at prudent levels is essential to the Company's safety and soundness.

**Evaluating a financial institution's exposure** to changes in interest rates includes assessing both the adequacy of the management process used to control interest rate risk and the organization's quantitative level of exposure. When assessing the interest rate risk management process, the Company seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain interest rate risks at prudent levels of consistency and continuity. Evaluating the quantitative level of interest rate risk exposure requires the Company to assess the existing and potential future effects of changes in interest rates on its consolidated financial condition, including capital adequacy, earnings, liquidity and asset quality (when appropriate).

**The Federal Reserve Board** together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Company adopted a Joint Agency Policy Statement on interest rate risk effective June 26, 1996. The policy statement provides guidance to examiners and bankers on sound practices for managing interest rate risk, which will form the basis for ongoing evaluation of the adequacy of interest rate risk management at supervised institutions. The policy statement also outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest rate risk. Specifically, the guidance emphasizes the need for active board of director and senior management oversight and a comprehensive risk management process that effectively identifies, measures and controls interest rate risk.

**Financial institutions** derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Since market interest rates change over time, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest rate changes. For example, assume that an institution's assets carry intermediate or long-term fixed rates and that those assets are funded with short-term liabilities. If market interest rates rise by the time the short-term liabilities must be refinanced, the increase in the institution's interest expense on its liabilities may not be sufficiently offset if assets continue to earn at the long-term fixed rates. Accordingly, an institution's profits could decrease on existing assets because the institution will either have lower net interest income or possibly, net interest expense. Similar risks exist when assets are subject to contractual interest rate ceilings, or rate-sensitive assets are funded by longer-term, fixed-rate liabilities in a declining rate environment.

**There are several ways** an institution can manage interest rate risk including: 1) matching repricing periods for new assets and liabilities, for example, by shortening or lengthening terms of new loans, investments, or liabilities; 2) selling existing assets or repaying certain liabilities; and 3) hedging existing assets, liabilities, or anticipated transactions. An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest rate risk. Interest rate swaps, futures contracts, options on futures contracts, and other such derivative financial instruments can be used for this purpose. Because these instruments are sensitive to interest rate changes, they require management's expertise to be effective. The Company does not currently utilize any derivative financial instruments to manage interest rate risk. As market conditions warrant, the Company may implement various interest rate risk management strategies, including the use of derivative financial instruments.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Management believes there has been no material change in the Company's market risk from the information contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2015.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

With the participation of the President and Chief Executive Officer (the principal executive officer) and the Executive Vice President and Chief Financial Officer (the principal financial officer) of the Company, the Company's management has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Company's President and Chief Executive Officer and the Company's Executive Vice President and Chief Financial Officer have concluded that:

information required to be disclosed by the Company in this Quarterly Report on Form 10-Q and other reports which the Company files or submits under the Exchange Act would be accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure;

information required to be disclosed by the Company in this Quarterly Report on Form 10-Q and other reports which the Company files or submits under the Exchange Act would be recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms; and

the Company's disclosure controls and procedures were effective as of the end of the quarterly period covered by this Quarterly Report on Form 10-Q.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended September 30, 2016, 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 ordinary course of our business, the Company and its subsidiaries are parties to various legal actions which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these legal actions cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

### **Item 1A. Risk Factors**

There are certain risks and uncertainties in our business that could cause our actual results to differ materially from those anticipated. A detailed discussion of our risk factors is included in “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. There have been no material changes to the risk factors as presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

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

(a) Not Applicable

(b) Not Applicable

(c) Repurchases of Common Shares

During the three and nine months ended September 30, 2016, the Company purchased shares of its common stock as detailed in the table below:

| <b>Common<br/>Shares<br/>Repurchased</b> | <b>Average<br/>Price</b> |
|--|--------------------------|
|--|--------------------------|



|                    |        |          |
|--------------------|--------|----------|
| Three months ended |        |          |
| 9/30/2016          | 39,258 | \$ 11.77 |

|                   |        |          |
|-------------------|--------|----------|
| Nine months ended |        |          |
| 9/30/2016         | 54,756 | \$ 11.41 |

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

Exhibits

- 31.1 Rule 13a-14(a)/15d-14(a) Certification (Principal Executive Officer)
- 31.2 Rule 13a-14(a)/15d-14(a) Certification (Principal Financial Officer)
- 32.1 Section 1350 Certification (Principal Executive Officer)
- 32.2 Section 1350 Certification (Principal Financial Officer)

**SIGNATURES**

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

SB FINANCIAL GROUP, INC.

Date: November 14, 2016 By: /s/ Mark A. Klein  
Mark A. Klein  
Chairman, President & CEO

By: /s/ Anthony V. Cosentino  
Anthony V. Cosentino  
Executive Vice President &  
Chief Financial Officer