

SB FINANCIAL GROUP, INC.  
Form 10-Q  
May 09, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2018

OR

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

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

Commission file number 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  
incorporation or organization) Identification No.)

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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

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

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Shares, No Par Value <b>6,485,876</b> Outstanding at May 9, 2018	The NASDAQ Stock Market, LLC (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

	March 2018 (unaudited)	December 2017 (audited)
(\$ in Thousands)		
<b>ASSETS</b>		
Cash & due from banks	\$ 48,329	\$ 26,616
Securities available for sale, at fair value	91,987	82,790
Other securities - FRB and FHLB Stock	3,748	3,748
Loans held for sale	8,893	3,940
Loans, net of unearned income	707,207	696,615
Allowance for loan losses	(8,219 )	(7,930 )
Premises and equipment, net	21,776	21,277
Cash surrender value of life insurance	16,567	16,479
Goodwill & other intangibles	16,409	16,411
Foreclosed assets held for sale, net	70	26
Mortgage servicing rights	10,196	9,907
Accrued interest receivable	1,925	1,825
Other assets	6,753	4,923
<b>Total assets</b>	<b>\$ 925,641</b>	<b>\$ 876,627</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Deposits</b>		
Non interest bearing demand	\$ 132,919	\$ 135,592
Interest bearing demand	137,893	131,079
Savings	116,820	103,267
Money market	143,679	141,844
Time deposits	217,484	217,818
<b>Total deposits</b>	<b>748,795</b>	<b>729,600</b>
Repurchase agreements	14,505	15,082
Advances from Federal Home Loan Bank	18,500	18,500

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Trust preferred securities	10,310	10,310
Accrued interest payable	633	592
Other liabilities	9,999	8,543
Total liabilities	802,742	782,627
Commitments & Contingent Liabilities	-	-
Stockholders' Equity		
Preferred stock, Series A	13,983	13,983
Common stock	40,481	12,569
Additional paid-in capital	15,189	15,405
Retained earnings	57,162	55,439
Accumulated other comprehensive income	(941 )	(141 )
Treasury stock, at cost	(2,975 )	(3,255 )
Total stockholders' equity	122,899	94,000
Total liabilities and stockholders' equity	\$ 925,641	\$ 876,627

See notes to condensed consolidated financial statements (unaudited)

Note: The balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements at that date

SB Financial Group, Inc.

**Condensed Consolidated Income Statement (unaudited)**

(\$ in thousands, except per share data)	Three Months	
	March 2018	March 2017
Interest income		
Loans		
Taxable	\$8,140	\$6,800
Tax exempt	21	20
Securities		
Taxable	573	461
Tax exempt	117	133
Total interest income	8,851	7,414
Interest expense		
Deposits	975	748
Repurchase agreements & other	10	4
Federal Home Loan Bank advances	79	86
Trust preferred securities	87	70
Total interest expense	1,151	908
Net interest income	7,700	6,506
Provision for loan losses	300	-
Net interest income after provision for loan losses	7,400	6,506
Noninterest income		
Wealth management fees	739	667
Customer service fees	644	640
Gain on sale of mortgage loans & OMSR's	1,100	1,250
Mortgage loan servicing fees, net	471	383
Gain on sale of non-mortgage loans	660	430
Data service fees	-	193
Gain/(loss) on sale/disposal of assets	(39 )	2
Other income	668	237
Total noninterest income	4,243	3,802
Noninterest expense		
Salaries and employee benefits	4,939	4,386
Net occupancy expense	649	560
Equipment expense	829	641
Data processing fees	438	370
Professional fees	419	363
Marketing expense	221	195

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Telephone and communications	122	116
Postage and delivery expense	74	174
State, local and other taxes	186	167
Employee expense	166	145
Other expenses	584	265
Total noninterest expense	8,627	7,382
Income before income tax expense	3,016	2,926
Income tax expense	563	933
Net income	\$2,453	\$1,993
Preferred Stock Dividends	244	244
Net income available to common shareholders	\$2,209	\$1,749
Common share data:		
Basic earnings per common share	\$0.40	\$0.36
Diluted earnings per common share	\$0.35	\$0.31
Average common shares outstanding (in thousands):		
Basic:	5,519	4,855
Diluted:	7,055	6,387

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



SB Financial Group, Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(\$'s in thousands)	Three Months Ended Mar. 31,	
	2018	2017
Net income	\$2,453	\$1,993
Other comprehensive income:		
Available-for-sale investment securities:		
Unrealized holding gain (loss) arising in the period	(1,013)	129
Related tax (expense) benefit	213	(44 )
Net effect on other comprehensive income	(800 )	85
Total comprehensive income	\$1,653	\$2,078

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

Condensed Consolidated Statements of Shareholders' Equity (unaudited)

(\$ in thousands - except per share data)	Preferred	Common	Additional	Retained	Accumulated	Treasury	Total
	Stock	Stock	Paid-in Capital	Earnings	Other Comprehensive Income	Stock	
Balance, January 1, 2018	\$ 13,983	\$ 12,569	\$ 15,405	\$ 55,439	\$ (141 )	\$ (3,255 )	\$ 94,000
Net income				2,453			2,453
Common stock issuance (1,666,666 shares)		27,912					27,912
Other comprehensive loss					(800 )		(800 )
Dividends on common, \$0.075 per share				(486 )			(486 )
Dividends on preferred, \$0.1625 per share				(244 )			(244 )
Restricted stock vesting			(257 )			257	-
Stock options exercised			(41 )			81	40
Stock buyback						(58 )	(58 )
Share based compensation expense			82				82
Balance, March 31, 2018	\$ 13,983	\$ 40,481	\$ 15,189	\$ 57,162	\$ (941 )	\$ (2,975 )	\$ 122,899
Balance, January 1, 2017	\$ 13,983	\$ 12,569	\$ 15,362	\$ 46,688	\$ 51	\$ (2,105 )	\$ 86,548
Net income				1,993			1,993
Other comprehensive income					85		85
Dividends on common, \$0.065 per share				(319 )			(319 )
Dividends on preferred, \$0.1625 per share				(244 )			(244 )
Restricted stock vesting			(163 )			163	-
Stock options exercised			(66 )			395	329
Stock buyback						(455 )	(455 )
Share based compensation expense			91				91
Balance, March 31, 2017	\$ 13,983	\$ 12,569	\$ 15,224	\$ 48,118	\$ 136	\$ (2,002 )	\$ 88,028

See notes to condensed consolidated financial statements (unaudited)



SB Financial Group, Inc.

## Condensed Consolidated Statements of Cash Flows (unaudited)

	Three Months Ended Mar. 31,	
	2018	2017
<b>(\$'s in thousands)</b>		
<b>Operating Activities</b>		
Net Income	\$2,453	\$1,993
Items providing/(using) cash		
Depreciation and amortization	409	367
Provision for loan losses	300	-
Expense of share-based compensation plan	82	91
Amortization of premiums and discounts on securities	86	169
Amortization of intangible assets	2	3
Amortization of originated mortgage servicing rights	246	218
Recovery of mortgage servicing rights	(92 )	(35 )
Proceeds from sale of loans held for sale	43,412	46,352
Originations of loans held for sale	(41,720)	(46,364)
Gain from sale of loans	(1,760 )	(1,680 )
Changes in		
Interest receivable	(100 )	50
Other assets	(1,438 )	181
Interest payable and other liabilities	1,472	(743 )
Net cash provided by operating activities	3,352	602
<b>Investing Activities</b>		
Purchases of available-for-sale securities	(13,149)	(23,307)
Proceeds from maturities of available-for-sale securities	2,853	5,459
Net change in loans	(16,874)	17,664
Purchase of premises and equipment and software	(406 )	(1,147 )
Proceeds from sale of equipment	133	-
Proceeds from sale of foreclosed assets	22	40
Net cash used in investing activities	(27,421)	(1,291 )
<b>Financing Activities</b>		
Net increase in demand deposits, money market, interest checking and savings accounts	19,530	25,511
Net increase in certificates of deposit	(335 )	14,331
Net increase in securities sold under agreements to repurchase	(577 )	1,264
Repayment of Federal Home Loan Bank advances	-	(11,000)
Share repurchase	(58 )	(455 )
Exercise of Stock Options	40	329

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Issuance of Common Stock	27,912	-
Dividends on Common Stock	(486 )	(319 )
Dividends on Preferred Stock	(244 )	(244 )
Net cash provided by financing activities	45,782	29,417
Increase in Cash and Cash Equivalents	21,713	28,728
Cash and Cash Equivalents, Beginning of Year	26,616	17,012
Cash and Cash Equivalents, End of Period	\$48,329	\$45,740
Supplemental Cash Flows Information		
Interest paid	\$1,110	\$866
Income taxes paid	\$220	\$203
Transfer of loans to foreclosed assets	\$70	\$-

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”). Effective January 1, 2018 the Company completed the sale of the customer contracts and certain other assets of RDSI’s remaining processing business operated through its Diverse Computer Marketers (DCM) division. As part of the transaction, the Company entered into a 180 day transition agreement, which will allow the buyer to effectively convert the DCM clients to an alternative processing platform. The transaction had a minimal positive impact to the Company’s financial statements in the first quarter of 2018.

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 three months ended March 31, 2018, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2017 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, 2017.

The following paragraphs summarize the impact of new accounting pronouncements:

**Accounting Standards Update (ASU) No. 2017-04: Intangibles – Goodwill and Other (Topic 350)**

This ASU simplifies the test for goodwill impairment. Specifically, these amendments eliminate Step 2 from the goodwill impairment test, and also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments in this ASU are effective for annual goodwill impairment tests in fiscal years beginning after December 15, 2019, and management does not believe the changes will have a material effect on the Company's accounting and disclosures.

**ASU No. 2016-15: Statement of Cash Flows (Topic 230)**

This ASU provides specific guidance for eight cash flow classifications. The intention is to ensure that this ASU will eliminate any current or future diversity in classification and reporting. The amendments in this ASU are effective for the Company for reporting periods beginning after December 15, 2017 and did not have a significant impact on the consolidated financial statements.

**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. The Company implemented a process to track required data by utilizing accounting software in preparation for compliance.

The adoption of ASU 2016-13 is likely to result in an increase in the allowance for loan losses as a result of changing from an “incurred loss” model, which encompasses allowances for current known and inherent losses within the portfolio, to an “expected loss” model, which encompasses allowances for losses expected to be incurred over the life of the portfolio. Furthermore, ASU 2016-13 will necessitate that we establish an allowance for expected credit losses on debt securities. While we are currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption will be significantly influenced by the composition, characteristics and quality of our loan and securities portfolios as well as the prevailing economic conditions and forecasts as of the adoption date. We anticipate being fully prepared for implementation by December 15, 2019.

**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, 2018. The Company has little leasing activity and management has determined that the impact on the Company’s consolidated financial statements will be immaterial.

**ASU No. 2016-01: Recognition and Measurement of Financial Assets and Liabilities (Topic 825)**

This ASU has a number of provisions including the requirements that public business entities use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, a separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e. securities or loans receivables), and eliminating the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at



amortized cost. The amendment is effective for the Company in the first quarter of 2018 and did not have a significant impact on the consolidated financial statements or on fair value and other required disclosures.

**ASU No. 2014-09: Revenue from Contracts with Customers (Topic 606)**

This ASU implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of the amendment is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. ASU 2014-09 establishes a five-step model which entities must follow to recognize revenue and removes inconsistencies and weaknesses in existing guidance. The majority of our revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as our loans, letters of credit, derivatives and investment securities, as well as revenue related to our mortgage servicing activities, as these activities are subject to other GAAP discussed elsewhere within our disclosures. ASU 2014-09 became effective on January 1, 2018 and had no material effect on how we recognize revenue or to our consolidated financial statements and disclosures. **Interest Income** – The largest source of revenue for the Company is interest income which is primarily recognized on an accrual basis according to nondiscretionary formulas in written contracts, such as loan and lease agreements or investment securities contracts. **Noninterest Income** – The Company earns noninterest income through a variety of financial and transaction services provided to corporate and consumer clients such as Wealth Management, deposit account, debit card and mortgage banking. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed. In certain circumstances, noninterest income is reported net of associated expenses.

**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. Included in the diluted EPS for March 31, 2018 are the impact of the full conversion of the Company's depository shares. Based upon the current conversion price of \$10.2374, the 1,500,000 outstanding depository shares are convertible into an aggregate of 1,465,222 common shares. There were no anti-dilutive shares in 2018 or 2017. The average number of common shares used in the computation of basic and diluted earnings per share were:

(\$ in thousands - except per share data)	Three Months Ended Mar., 31	
	2018	2017
Distributed earnings allocated to common shares	\$486	\$319
Undistributed earnings allocated to common shares	1,720	1,427
Net earnings allocated to common shares	2,206	1,746
Net earnings allocated to participating securities	3	3
Dividends on convertible preferred shares	244	244
Net Income allocated to common shares and participating securities	\$2,453	\$1,993
Weighted average shares outstanding for basic earnings per share	5,519	4,855
Dilutive effect of stock compensation	72	74
Dilutive effect of convertible shares	1,464	1,458
Weighted average shares outstanding for diluted earnings per share	7,055	6,387
Basic earnings per common share	\$0.40	\$0.36
Diluted earnings per common share	\$0.35	\$0.31

**Note 3 – Securities**

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at March 31, 2018 and December 31, 2017 were as follows:

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
March 31, 2018				
U.S. Treasury and Government agencies	\$ 14,299	\$ 42	\$ (175 )	\$ 14,166
Mortgage-backed securities	66,068	57	(1,394 )	64,731
State and political subdivisions	12,812	309	(31 )	13,090
	\$ 93,179	\$ 408	\$ (1,600 )	\$ 91,987

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
December 31, 2017:				
U.S. Treasury and Government agencies	\$ 12,715	\$ 62	\$ (69 )	\$ 12,708
Mortgage-backed securities	57,355	97	(690 )	56,762
State and political subdivisions	12,829	439	(18 )	13,250
Equity securities	70	-	-	70
	\$ 82,969	\$ 598	\$ (777 )	\$ 82,790

The amortized cost and fair value of securities available for sale at March 31, 2018, 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	\$ 1,560	\$ 1,578

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Due after one year through five years	9,194	9,214
Due after five years through ten years	10,990	10,990
Due after ten years	5,367	5,474
	27,111	27,256
Mortgage-backed securities	66,068	64,731
Totals	\$93,179	\$91,987

The fair value of securities pledged as collateral, to secure public deposits and for other purposes, was \$45.7 million at March 31, 2018 and \$38.9 million at December 31, 2017. The fair value of securities delivered for repurchase agreements was \$19.2 million at March 31, 2018 and \$19.1 million at December 31, 2017.

There were no realized gains and losses from sales of available-for-sale securities for the three months ended March 31, 2018 or March 31, 2017.

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 \$72.8 million at March 31, 2018, and \$59.3 million at December 31, 2017, which was approximately 79 and 72 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 March 31, 2018 and December 31, 2017 are as follows:

(\$ in thousands) March 31, 2018	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$7,424	\$ (121 )	\$2,546	\$ (54 )	\$9,970	\$ (175 )
Mortgage-backed securities	47,336	(894 )	13,953	(500 )	61,289	(1,394 )
State and Political subdivisions	1,206	(12 )	320	(19 )	1,526	(31 )
	\$55,966	\$ (1,027 )	\$16,819	\$ (573 )	\$72,785	\$ (1,600 )

(\$ in thousands) December 31, 2017	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$5,675	\$ (27 )	\$2,559	\$ (42 )	\$8,234	\$ (69 )
Mortgage-backed securities	35,205	(319 )	14,673	(371 )	49,878	(690 )
State and political subdivisions	905	(4 )	326	(14 )	1,231	(18 )
	\$41,785	\$ (350 )	\$17,558	\$ (427 )	\$59,343	\$ (777 )

The total potential unrealized loss as of March 31, 2018 in the securities portfolio was \$1.60 million, compared to a \$0.78 million unrealized loss at December 31, 2017. 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 nonclassified 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 March 31, 2018 and December 31, 2017 include:

(\$ in thousands)	Total Loans		Non-Accrual Loans	
	Mar. 2018	Dec. 2017	Mar. 2018	Dec. 2017
Commercial & Industrial	\$107,078	\$101,554	35	121
Commercial RE & Construction	338,586	332,154	487	1,322
Agricultural & Farmland	50,266	51,947	-	-
Residential Real Estate	151,820	150,854	1,714	1,123
Consumer & Other	58,956	59,619	85	138
Total Loans	\$706,706	\$696,128	\$2,321	\$2,704
Net deferred costs	\$501	\$487		
Total Loans, net deferred costs	\$707,207	\$696,615		
Allowance for loan losses	\$(8,219 )	\$(7,930 )		

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 March 31, 2018, December 31, 2017 and March 31, 2017.

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
<b>ALLOWANCE FOR LOAN AND LEASE LOSSES</b>						
For the Three Months Ended - March 31, 2018						
Beginning balance	\$ 823	\$ 3,779	\$ 505	\$ 2,129	\$ 694	\$7,930
Charge Offs	-	(19 )	-	-	(1 )	\$(20 )
Recoveries	-	3	-	1	5	9
Provision	155	(90 )	12	229	(6 )	300
Ending Balance	\$ 978	\$ 3,673	\$ 517	\$ 2,359	\$ 692	\$8,219

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
Loans Receivable at March 31, 2018						
Allowance:						
Ending balance:						

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individually evaluated for impairment	\$ -	\$ -	\$ -	\$ 170	\$ 4	\$ 174
Ending balance:						
collectively evaluated for impairment	\$ 978	\$ 3,673	\$ 517	\$ 2,189	\$ 688	\$ 8,045
Loans:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 548	\$ -	\$ 2,367	\$ 190	\$ 3,105
Ending balance:						
collectively evaluated for impairment	\$ 107,078	\$ 338,038	\$ 50,266	\$ 149,453	\$ 58,766	\$ 703,601

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
Loans Receivable at December 31, 2017						
Allowance:						
Ending balance: individually evaluated for impairment	\$ -	\$ 146	\$ -	\$ 178	\$ 5	\$ 329
Ending balance: collectively evaluated for impairment	\$ 823	\$ 3,633	\$ 505	\$ 1,951	\$ 689	\$ 7,601
Loans:						
Ending balance: individually evaluated for impairment	\$ -	\$ 1,385	\$ -	\$ 1,830	\$ 197	\$ 3,412
Ending balance: collectively evaluated for impairment	\$ 101,554	\$ 330,769	\$ 51,947	\$ 149,024	\$ 59,422	\$ 692,716

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Three Months Ended - March 31, 2017						
Beginning balance	\$ 1,204	\$ 3,321	\$ 347	\$ 1,963	\$ 890	\$ 7,725
Charge Offs	-	-	-	(22 )	(29 )	\$(51 )
Recoveries	1	-	1	-	3	5
Provision	(207 )	(125 )	121	72	139	-
Ending Balance	\$ 998	\$ 3,196	\$ 469	\$ 2,013	\$ 1,003	\$ 7,679

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 March 31, 2018 and December 31, 2017.

<u>March 31, 2018</u> (\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
1-2	\$ 19	\$ 9	\$ -	\$ 828	\$ 1	\$ 857
3	18,237	92,736	7,741	112,491	56,656	287,861
4	84,804	243,601	42,064	36,370	2,065	408,904
Total Pass (1 - 4)	103,060	336,346	49,805	149,689	58,722	697,622
Special Mention (5)	3,395	1,474	461	-	61	5,391
Substandard (6)	88	438	-	2,094	173	2,793
Doubtful (7)	535	328	-	37	-	900
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 107,078	\$ 338,586	\$ 50,266	\$ 151,820	\$ 58,956	\$ 706,706

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<u>December 31, 2017</u>	Commercial	Commercial RE	Agricultural	Residential	Consumer	
(\$ in thousands)	& Industrial	& Construction	& Farmland	Real Estate	& Other	Total
1-2	\$ 96	\$ 13	\$ -	\$ 832	\$ 1	\$942
3	19,883	93,222	8,080	114,130	57,204	292,519
4	80,448	236,217	43,735	34,271	2,151	396,822
Total Pass (1 - 4)	100,427	329,452	51,815	149,233	59,356	690,283
Special Mention (5)	512	1,100	132	-	66	1,810
Substandard (6)	7	580	-	1,583	197	2,367
Doubtful (7)	608	1,022	-	38	-	1,668
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 101,554	\$ 332,154	\$ 51,947	\$ 150,854	\$ 59,619	\$696,128

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 warranted. 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 March 31, 2018 and December 31, 2017.

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
<u>March 31, 2018</u>						
Commercial & Industrial	\$ 209	\$ 20	\$ 3	\$ 232	\$ 106,846	\$ 107,078
Commercial RE & Construction	47	-	255	302	338,284	338,586
Agricultural & Farmland	-	-	-	-	50,266	50,266
Residential Real Estate	375	10	975	1,360	150,460	151,820
Consumer & Other	196	126	60	382	58,574	58,956
Total Loans	\$ 827	\$ 156	\$ 1,293	\$ 2,276	\$ 704,430	\$ 706,706

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
<u>December 31, 2017</u>						
Commercial & Industrial	\$ 85	\$ -	\$ 88	\$ 173	\$ 101,381	\$ 101,554
Commercial RE & Construction	110	-	1,086	1,196	330,958	332,154
Agricultural & Farmland	-	-	-	-	51,947	51,947
Residential Real Estate	484	379	433	1,296	149,558	150,854
Consumer & Other	182	21	103	306	59,313	59,619
Total Loans	\$ 861	\$ 400	\$ 1,710	\$ 2,971	\$ 693,157	\$ 696,128

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 months ended March 31, 2018 and 2017, and for the twelve months ended December 31, 2017:



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Three Months Ended <u>March 31, 2018</u> (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial RE & Construction	548	575	-	725	6
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,301	1,344	-	2,005	20
Consumer & Other	105	104	-	118	2
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	-	-	-	-	-
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,066	1,085	170	613	7
Consumer & Other	85	85	4	86	1
Totals:					
Commercial & Industrial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial RE & Construction	\$ 548	\$ 575	\$ -	\$ 725	\$ 6
Agricultural & Farmland	\$ -	\$ -	\$ -	\$ -	\$ -
Residential Real Estate	\$ 2,367	\$ 2,429	\$ 170	\$ 2,618	\$ 27
Consumer & Other	\$ 190	\$ 189	\$ 4	\$ 204	\$ 3

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Twelve Months Ended <u>December 31, 2017</u> (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$-	\$-	\$-	\$-	\$-
Commercial RE & Construction	696	722	-	756	34
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	752	795	-	1,460	67
Consumer & Other	110	110	-	128	9
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	689	689	146	713	-
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,078	1,097	178	628	25
Consumer & Other	87	87	5	91	5
Totals:					
Commercial & Industrial	\$-	\$-	\$-	\$-	\$-
Commercial RE & Construction	\$1,385	\$1,411	\$146	\$1,469	\$34
Agricultural & Farmland	\$-	\$-	\$-	\$-	\$-
Residential Real Estate	\$1,830	\$1,892	\$178	\$2,088	\$92
Consumer & Other	\$197	\$197	\$5	\$219	\$14

Three Months Ended <u>March 31, 2017</u> (\$'s in thousands)	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:		
Commercial & Industrial	\$-	\$-
Commercial RE & Construction	644	12
Agricultural & Farmland	-	-
Residential Real Estate	1,355	18
Consumer & Other	139	2
With a specific allowance recorded:		
Commercial & Industrial	-	-
Commercial RE & Construction	788	(2 )
Agricultural & Farmland	-	-
Residential Real Estate	637	7
Consumer & Other	167	1
Totals:		
Commercial & Industrial	\$-	\$-
Commercial RE & Construction	\$1,432	\$10
Agricultural & Farmland	\$-	\$-
Residential Real Estate	\$1,992	\$25
Consumer & Other	\$306	\$3

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.

During the first three months of 2018 and 2017, there was no TDR activity.

TDRs modified in the past twelve-month period that have subsequently defaulted

(\$ in thousands)	Number of Contracts	Recorded Balance
Residential Real Estate	1	\$ 61
Commercial Real Estate	1	159
Total Modifications	2	\$ 220

**NOTE 5 – MORTGAGE SERVICING RIGHTS**

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balance of mortgage loans serviced for others approximated \$1.0 billion at March 31, 2018 and \$994.9 million at December 31, 2017. Contractually specified servicing fees of approximately \$0.6 million and \$0.6 million were included in mortgage loan servicing fees in the income statement for the periods ending March 31, 2018 and 2017, respectively.

The following table summarizes mortgage servicing rights capitalized and related amortization, along with activity in the related valuation allowance:

(\$ in thousands)	2018	2017
Carrying amount, January 1	\$9,907	\$8,422
Mortgage servicing rights capitalized during the year	502	488
Mortgage servicing rights amortization during the year	(246 )	(218 )
Net change in valuation allowance	92	35
Carrying amount, March 31	\$10,255	\$8,727
Valuation allowance:		
January 1	\$151	\$228
Increase/(reduction)	(92 )	(35 )
March 31	\$59	\$193

**NOTE 6 – 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 March 31, 2018 and December 31, 2017, the notional amount of customer-facing swaps was approximately \$49.0 million and \$39.3 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 March 31, 2018 and December 31, 2017, the Company had no posted cash as collateral with correspondents. At March 31, 2018, we had cash from correspondents as collateral of \$0.9 million.

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 March 31, 2018 and December 31, 2017.

(\$ in thousands)	Asset Derivatives		Liability Derivatives	
	March 31, 2018		March 31, 2018	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$1,144	Other Liabilities	\$1,144

(\$ in thousands)	Asset Derivatives		Liability Derivatives	
	December 31, 2017		December 31, 2017	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 698	Other Liabilities	\$ 698

The Company's derivative financial instruments had no net effect on the condensed consolidated Income Statements for the three months ended March 31, 2018 and 2017.

#### *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 \$5.0 million and of \$14.2 million. These securities have various maturity dates beyond 2020.

#### **NOTE 7 – 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 March 31, 2018 and December 31, 2017.

(\$ in thousands)	Fair Values at March 31, 2018	(Level 1)	(Level 2)	(Level 3)
Available-for-Sale Securities:				
U.S. Treasury and Government Agencies	\$ 14,166	\$ -	\$14,166	\$ -
Mortgage-backed securities	64,731	-	64,731	-
State and political subdivisions	13,090	-	13,090	-
Interest rate contracts - assets	1,144	-	1,144	-
Interest rate contracts - liabilities	(1,144)	)	(1,144)	-

Fair Value Measurements Using:

(\$ in thousands)	Fair Values at December 31, 2017	(Level 1)	(Level 2)	(Level 3)
Available-for-Sale Securities:				
U.S. Treasury and Government Agencies	\$ 12,708	\$ -	\$12,708	\$ -
Mortgage-backed securities	56,762	-	56,762	-
State and political subdivisions	13,250	-	13,250	-
Equity securities	70	-	70	-
Interest rate contracts - assets	698	-	698	-
Interest rate contracts - liabilities	(698 )	-	(698 )	-

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 March 31, 2018 and December 31, 2017.

#### 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.

(\$ in thousands) Description	Fair Values at March 31, 2018	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 237	\$ -	\$ -	\$ 237
Mortgage Servicing Rights	754	-	-	754

(\$ in thousands) Description	Fair Values at December 31, 2017	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 982	\$ -	\$ -	\$ 982
Mortgage Servicing Rights	1,490	-	-	1,490

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 March 31, 2018	Valuation Technique	Unobservable Inputs	Range
Collateral-dependent impaired loans	\$ 237	Market comparable properties	Comparability adjustments (%)	20 %
Mortgage servicing rights	754	Discounted cash flow	Discount Rate	10.15 %
			Constant prepayment rate	6.39 %
			P&I earnings credit	1.88 %
			T&I earnings credit	2.62 %
			Inflation for cost of servicing	1.50 %

(\$'s in thousands)	Fair Value at December 31, 2017	Valuation Technique	Unobservable Inputs	Range
Collateral-dependent impaired loans	\$ 982	Market comparable properties	Comparability adjustments (%)	Not available
Mortgage servicing rights	1,490	Discounted cash flow	Discount Rate	9.65 %
			Constant prepayment rate	7.51 %
			P&I earnings credit	1.56 %
			T&I earnings credit	2.13 %
			Inflation for cost of servicing	1.50 %

### Unobservable (Level 3) Inputs

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

There were no changes in the inputs or methodologies used to determine fair value at March 31, 2018 as compared to December 31, 2017.

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 of loans as of March 31, 2018 follows the guidance in ASU 2016-01, which prescribes an "exit price" approach in estimating and disclosing fair value of financial instruments. The fair value calculation at that date discounted estimated future cash flows using rates that incorporated discounts for credit, liquidity, and marketability factors. The fair value estimate shown as of December 31, 2017 used an "entry price" approach. The fair value calculation for that date discounted estimated future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Consequently, the fair value disclosures for March 31, 2018 and December 31, 2017 are not directly comparable.

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, 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 March 31, 2018 and December 31, 2017.

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 March 31, 2018 and December 31, 2017 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.

	March 31, 2018	Carrying Amount	Fair Value Measurements Using (Level 1)	(Level 2)	(Level 3)
(\$ in thousands)					
Financial assets					

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Cash and cash equivalents	\$48,329	\$48,329	\$-	\$-
Loans held for sale	8,893	-	9,058	-
Loans, net of allowance for loan losses	698,988	-	-	684,348
Federal Reserve and FHLB Bank stock	3,748	-	3,748	-
Accrued interest receivable	1,925	-	1,925	-

Financial liabilities

Deposits	\$748,795	\$531,391	\$215,158	\$-
Repurchase agreements	14,505	-	14,505	-
FHLB advances	18,500	-	18,319	-
Trust preferred securities	10,310	-	9,446	-
Accrued interest payable	633	-	633	-

December 31,  
2017

Carrying Amount      Fair Value Measurements Using  
(Level 1)    (Level 2)    (Level 3)

(\$ in thousands)

Financial assets

Cash and due from banks	\$ 26,616	\$26,616	\$-	\$-
Loans held for sale	3,940	-	4,041	-
Loans, net of allowance for loan losses	688,685	-	-	686,940
Federal Reserve and FHLB Bank stock, at cost	3,748	-	3,748	-
Accrued interest receivable	1,825	-	1,825	-

Financial liabilities

Deposits	\$ 729,600	\$511,782	\$220,823	\$-
Repurchase agreements	15,082	-	15,082	-
FHLB advances	18,500	-	18,385	-
Trust preferred securities	10,310	-	9,673	-
Accrued interest payable	592	-	592	-

**NOTE 8 – SHARE BASED COMPENSATION**

In April 2017, the shareholders approved a new share-based incentive compensation plan, the SB Financial Group, Inc. 2017 Stock Incentive Plan (the "2017 Plan"), which replaced the Company's 2008 Stock Incentive Plan. This plan permits the grant or award of incentive stock options, nonqualified stock options, stock appreciation rights ("SAR's"), restricted stock, and restricted stock units ("RSU's") for up to 500,000 Common Shares of the Company.

The 2008 Plan, which was approved by the shareholders in April 2008, permits the grant or award of incentive stock options, nonqualified stock options, stock appreciation rights ("SARs"), and restricted stock for up to 250,000 Common Shares of the Company.

The 2008 and 2017 Plans are intended to advance the interests of the Company and its shareholders by offering employees, directors and advisory board members of the Company and its subsidiaries an opportunity to acquire or increase their ownership interest in the Company through grants of equity-based awards. The Plans permit equity-based awards to be used to attract, motivate, reward and retain highly competent individuals upon whose judgment, initiative, leadership and efforts are key to the success of the Company by encouraging those individuals to become shareholders of the Company.

Option awards are granted with an exercise price equal to the market price of the Company's stock at the date of grant and those option awards vest based on 5 years of continuous service and have 10-year contractual terms. The fair value of each option award was estimated on the date of grant using the Black-Scholes valuation model. No options were granted in the first three months of 2018.

A summary of incentive option activity under the Company's plans as of March 31, 2018 and changes during the quarter then ended, is presented below:

(\$ in thousands - except per share data)	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Term	Aggregate Intrinsic Value
Outstanding, December 31, 2017	92,500	\$ 6.97		
Granted	-	-		
Exercised	(5,750)	6.98		
Forfeited	-	-		
Expired	-	-		

Outstanding, March 31, 2018	86,750	\$	6.97	1.87	\$ 1,001
Exercisable, March 31, 2018	86,750	\$	6.97	1.87	\$ 1,001

During 2018, the 5,750 option shares exercised had a total intrinsic value of \$0.06 million and the cash received from these exercised options was \$0.04 million. The tax benefit from these transactions was immaterial. As of March 31, 2018, there was no unrecognized compensation cost related to incentive option share-based compensation arrangements granted under the 2008 Plan.

On February 5, 2013, the Company adopted a Long Term Incentive (LTI) Plan. The Plan awards restricted stock in the Company to certain key executives under the 2008 Plan. These restricted stock awards vest over a four-year period and are intended to assist the Company in retention of key executives. During 2017, the Company met certain performance targets and restricted stock awards were approved and issued in February of 2018. The compensation cost charged against income for the Long Term Incentive (LTI) Plan was \$0.08 million, with a total income tax benefit recognized in the income statement of \$0.03 million.

As of March 31, 2018, there was \$0.70 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements related to the restricted stock awards under the 2008 and 2017 Plans which were granted in accordance with the Long Term Incentive (LTI) plan. That cost is expected to be recognized over a weighted-average period of 1.9 years.

A summary of restricted stock activity under the Company's plans as of March 31, 2018 and changes during the quarter then ended, is presented below:

	Shares	Weighted-Average Value per Share
Nonvested, December 31, 2017	52,258	\$ 14.91
Granted	15,268	17.60
Vested	(21,632)	13.95
Forfeited	-	-
Nonvested, March 31, 2018	45,894	\$ 16.26

In April, 2017, the Company's shareholders approved a new equity-based incentive compensation plan, the 2017 Stock Incentive Plan (the "2017"). The 2017 Plan permits the company to grant stock options, restricted stock and other equity-based awards and cash-based awards to employees and directors of the Company and its subsidiaries. A total of 500,000 common shares of the Company are available for grants of awards under the 2017 Plan. As of March 31, 2018, 17,268 shares had been granted under the 2017 Plan.

#### **NOTE 9 – EQUITY CAPITAL**

On February 9, 2018, the Company closed a common share capital raise, pursuant to which the Company issued and sold an aggregate of 1,666,666 common shares in a public offering registered with the Securities and Exchange Commission at a price of \$18.00 per share, resulting in gross proceeds of \$30.0 million. After fees and transaction expenses, the Company realized net proceeds of \$27.9 million. The Company intends to use the net proceeds from this offering for general corporate purposes, which may include (a) capital contributions to its bank subsidiary to increase regulatory capital and/or (b) investments at the holding company level.

#### **NOTE 10 – 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, 2017. 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 an Ohio corporation and 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 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.

### **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, 2017 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 March 31, 2018 compared to Three Months Ended March 31, 2017**

**Net Income:** Net income for the first quarter of 2018 was \$2.5 million compared to net income of \$2.0 million for the first quarter of 2017, an increase of 23 percent. Earnings per diluted share (EPS) of \$0.35 were up 13 percent from the \$0.31 for the first quarter of 2017. The EPS for the quarter includes the average impact of the common capital raise completed in February 2018, which added 1.67 million shares.

**Provision for Loan Losses:** The first quarter provision for loan losses was \$0.3 million compared to \$0.0 million for the year-ago quarter. Net charge-offs for the quarter were \$0.01 million compared to \$0.05 million for the year-ago quarter. Total delinquent loans ended the quarter at \$2.3 million, or 0.32 percent of total loans, which was up \$0.1 million from the prior year.

Asset Quality Review – For the Period Ended (\$'s in Thousands)	Mar. 31, 2018	Mar. 31, 2017
Net charge-offs	\$10	\$46
Nonaccruing loans	2,321	2,382
Accruing Trouble Debt Restructures	1,115	1,383
Nonaccruing and restructured loans	3,436	3,765
OREO / OAO	70	950
Nonperforming assets	3,506	4,715
Nonperforming assets/Total assets	0.38 %	0.56 %
Allowance for loan losses/Total loans	1.16 %	1.23 %
Allowance for loan losses/Nonperforming loans	239.2 %	204.0 %

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$11.9 million for the first quarter of 2018, an increase of \$1.6 million, or 16 percent, from the \$10.3 million generated during the 2017 first quarter.

Net interest income was \$7.7 million, which is up \$1.2 million from the prior year first quarter's \$6.5 million. The Company's earning assets increased \$68.0 million, coupled with a 37 basis point increase in the yield on earning assets. The net interest margin for the first quarter of 2018 was 3.86 percent compared to 3.59 percent for the first quarter of 2017. Funding cost for interest bearing liabilities for the first quarter of 2018 were 0.71 percent compared to 0.60 percent for the prior year first quarter.

Noninterest income was \$4.2 million for the 2018 first quarter, which is up \$0.4 million from the prior year first quarter's \$3.8 million. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.7 million and wealth management revenue was \$0.7 million. The completed the sale of DCM in the first quarter of 2018, resulting in total revenue of \$0.4 million. Noninterest income as a percentage of average assets for the first quarter of 2018 was 1.87 percent compared to 1.84 percent for the prior year first quarter.

State Bank originated \$58.5 million of mortgage loans for the first quarter of 2018, of which \$43.4 million was sold with the remainder in loans held for investment. This compares to \$56.7 million for the first quarter of 2017, of which \$46.4 million was sold with the remainder in loans held for investment. These first quarter 2018 originations and subsequent sales resulted in \$1.1 million of gains, down \$0.2 million from the gains for the first quarter of 2017. Net mortgage banking revenue was \$1.6 million for the first quarter of 2018 compared to \$1.6 million for the first quarter of 2017. The 2018 first quarter included an \$0.09 million positive valuation impairment on our mortgage servicing rights, due to decreased prepayment speeds in the portfolio.

**Consolidated Noninterest Expense:** Noninterest expense for the first quarter of 2018 was \$8.6 million, which is up \$1.2 million compared to \$7.4 million in the prior-year first quarter. The first quarter of 2018 included higher commission on SBA sales (of \$0.1 million), expenses related to the sale of DCM (of \$0.2 million) and several of the previously announced tax initiatives (of \$0.2 million).

**Income Taxes:** Income taxes for the first quarter of 2018 were \$0.6 million (effective rate 18.7 percent) compared to \$0.9 million (effective rate 31.9 percent) for the first quarter of 2017. The lower tax level was driven by a slightly higher pretax income, which was well offset by the new rates under the Tax Cuts and Jobs Act.

### **Changes in Financial Condition**

Total assets at March 31, 2018 were \$925.6 million, an increase of \$49.0 million or 5.6 percent since 2017 year end. Total loans, net of unearned income, were \$707.2 million as of March 31, 2018, up \$10.5 million from year-end, an increase of 1.5 percent.

Total deposits at March 31, 2018 were \$748.8 million, an increase of \$19.2 million or 2.6 percent since 2017 year end. Borrowed funds (consisting of FHLB advances, and REPOs) totaled \$33.0 million at March 31, 2018. This is down from year-end when borrowed funds totaled \$33.6 million due to a decrease in REPO balances. Total equity for the Company of \$122.9 million now stands at 13.3 percent of total assets, which is up from the December 31, 2017 level of \$94.0 million and 10.7 percent of total assets. Equity balances were higher due to the common capital raise completed by the Company in the first quarter of 2018 as detailed in Note 9.

The allowance for loan loss of \$8.2 million is up from the 2017 year end by 3.6 percent. This increase combined with the loan increase of 1.4 percent results in an allowance to loans of 1.16 percent. The 1.16 percent level is considered appropriate by management given the risk profile of the portfolio.

### **Capital Resources**

As of March 31, 2018, 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, State Bank must maintain capital ratios as set forth in the table below. There are no conditions or events since March 31, 2018 that management believes have changed State Bank's capital classification.



State Bank's actual capital levels and ratios as of March 31, 2018 and December 31, 2017 are presented in the following table. Capital levels are presented for State 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 March 31, 2018						
Tier I Capital to average assets	\$99,840	11.25 %	\$35,502	4.0 %	\$44,378	5.0 %
Tier I Common equity capital to risk-weighted assets	99,840	12.23 %	36,721	4.5 %	53,042	6.5 %
Tier I Capital to risk-weighted assets	99,840	12.23 %	48,962	6.0 %	65,282	8.0 %
Total Risk-based capital to risk-weighted assets	108,059	13.24 %	65,282	8.0 %	81,603	10.0 %
As of December 31, 2017						
Tier I Capital to average assets	\$83,807	9.72 %	\$34,477	4.0 %	\$43,097	5.0 %
Tier I Common equity capital to risk-weighted assets	83,807	10.54 %	35,786	4.5 %	51,691	6.5 %
Tier I Capital to risk-weighted assets	83,807	10.54 %	47,715	6.0 %	63,620	8.0 %
Total Risk-based capital to risk-weighted assets	91,737	11.54 %	63,620	8.0 %	79,524	10.0 %

Effective January 1, 2015, new regulatory capital requirements commonly referred to as "Basel III" were implemented and are reflected in the March 31, 2018 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 State Banks 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 \$149.7 million at March 31, 2018, compared to \$113.3 million at December 31, 2017.

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 \$477.2 million at March 31, 2018 and \$535.0 million at December 31, 2017, 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 March 31, 2018, 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 three months ended March 31, 2018 and 2017 follows.



The Company experienced positive cash flows from operating activities for the three months ended March 31, 2018 and March 31, 2017. Net cash provided by operating activities was \$3.4 million for the three months ended March 31, 2018 and \$0.6 million for the three months ended March 31, 2017. Highlights for the current year include \$43.4 million in proceeds from the sale of loans, which is down \$3.0 million from the prior year. Originations of loans held for sale was a use of cash of \$41.7 million, which is also down from the prior year, by \$4.7 million. For the three months ended March 31, 2018, there was a gain on sale of loans of \$1.8 million, and depreciation and amortization of \$0.4 million.

The Company experienced negative cash flows from investing activities for the three months ended March 31, 2018 and March 31, 2017. Net cash flows used in investing activities was \$27.4 million for the three months ended March 31, 2018 and \$1.3 million for the three months ended March 31, 2017. Highlights for the three months ended March 31, 2018 include \$13.1 million in purchases of available-for-sale securities. These cash payments were offset by \$2.9 million in proceeds from maturities and sales of securities, which is down \$2.6 million from the prior three-month period. The Company experienced a \$16.9 million increase in loans, which is up \$34.6 million from the prior year three-month period.

The Company experienced positive cash flows from financing activities for the three months ended March 31, 2018 and March 31, 2017. Net cash flow provided by financing activities was \$45.8 million for the three months ended March 31, 2018 and \$29.4 million for the three months ended March 31, 2017. Highlights for the current period include a \$19.5 million increase in transaction deposits for the three months ended March 31, 2018, which is down from the \$25.5 million increase in transaction deposits for the three months ended March 31, 2017. Certificates of deposit decreased by \$0.3 million in the current year compared to an increase of \$14.3 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 March 31, 2018 and December 31, 2017 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 March 31, 2018 and December 31, 2017.

### **March 31, 2018**

#### **Economic Value of Equity**

**(\$’s in thousands)**

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	\$212,726	\$23,704	12.54 %
+300 basis points	208,287	19,265	10.19
+200 basis points	203,333	14,311	7.57
+100 basis points	196,836	7,814	4.13
Base Case	189,022	-	-
-100 basis points	179,688	(9,334 )	(4.94 )

**December 31, 2017****Economic Value of Equity****(\$'s in thousands)**

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	\$182,859	\$27,297	17.55 %
+300 basis points	177,619	22,058	14.18
+200 basis points	171,759	16,197	10.41
+100 basis points	164,348	8,786	5.65
Base Case	155,562	-	-
-100 basis points	145,678	(9,884 )	(6.35 )

**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 total amount of \$477.2 million were pledged to meet FHLB collateralization requirements as of March 31, 2018. Based on the current collateralization requirements of the FHLB, the Company had approximately \$75.6 million of additional borrowing capacity at March 31, 2018. The Company also had \$27.0 million in unpledged securities to pledge for additional borrowings.

The Company's contractual obligations as of March 31, 2018 were comprised of long-term debt obligations, other debt obligations, operating lease obligations and other long-term liabilities. Long-term debt obligations were comprised of FHLB Advances of \$18.5 million and Trust Preferred Securities of \$10.3 million. Total time deposits at March 31, 2018 were \$217.5 million, of which \$113.8 million mature beyond one year.

In addition, as of March 31, 2018, the Company had commitments to sell mortgage loans totaling \$25.8 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, 2017.

### **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 March 31, 2018, 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, 2017. 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, 2017.

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

(a) Not Applicable

(b) Not Applicable

(c) Repurchases of Common Shares

There were no purchases of the Company's common stock for the quarter ended March 31, 2018.

### **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)~~

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**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: May 9, 2018 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