

FIRST BANCSHARES INC /MS/  
Form 10-Q  
August 09, 2018

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 June 30, 2018

Commission file number: 000-22507

**THE FIRST BANCSHARES, INC.**

(Exact name of Registrant as specified in its charter)

Mississippi 64-0862173  
(State of Incorporation) (IRS Employer Identification No)

6480 U.S. Highway 98 West, Suite A, Hattiesburg, Mississippi 39402  
(Address of principal executive offices) (Zip Code)

(601) 268-8998

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company, or an emerging growth company.

|  |   |
|--|---|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/>   | Smaller Reporting Company <input type="checkbox"/>    |
| (Do not check if a smaller reporting company)    |   |
| Emerging growth company <input type="checkbox"/> |   |

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

Common stock, \$1.00 par value, 13,092,447 shares issued and 13,065,953 outstanding as of August 2, 2018.



The First Bancshares, Inc.

Form 10-Q

Quarter Ended June 30, 2018

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**PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****THE FIRST BANCSHARES, INC.****CONSOLIDATED BALANCE SHEETS**

(\$ In Thousands)

|   | <b>(Unaudited)<br/>June 30,<br/>2018</b> | <b>(Audited)<br/>December 31,<br/>2017</b> |
|---|--|--|
| <b>ASSETS</b>                                     |  |  |
| Cash and due from banks                           | \$ 97,554                                | \$ 42,980                                  |
| Interest-bearing deposits with banks              | 20,792                                   | 48,466                                     |
| Federal funds sold                                | 2,079                                    | 475  |
| Total cash and cash equivalents                   | 120,425                                  | 91,921                                     |
| Securities held-to-maturity, at amortized cost    | 6,000                                    | 6,000                                      |
| Securities available-for-sale, at fair value      | 437,011                                  | 356,893                                    |
| Other securities                                  | 10,320                                   | 9,969                                      |
| Total securities                                  | 453,331                                  | 372,862                                    |
| Loans held for sale                               | 5,914                                    | 4,790                                      |
| Loans   | 1,710,271                                | 1,225,306                                  |
| Allowance for loan losses                         | (9,512 )                                 | (8,288 )                                   |
| Loans, net  | 1,706,673                                | 1,221,808                                  |
| Interest receivable                               | 8,493                                    | 6,705                                      |
| Premises and equipment                            | 62,289                                   | 46,426                                     |
| Cash surrender value of bank-owned life insurance | 36,634                                   | 27,054                                     |
| Goodwill  | 54,944                                   | 19,960                                     |
| Other real estate owned                           | 7,890                                    | 7,158                                      |
| Other assets                                      | 31,010                                   | 19,344                                     |

|   |             |              |
|---|-------------|--------------|
| TOTAL ASSETS  | \$2,481,689 | \$ 1,813,238 |
| LIABILITIES AND STOCKHOLDERS' EQUITY  |             |              |
| LIABILITIES:  |             |              |
| Deposits:   |             |              |
| Noninterest-bearing   | \$ 459,402  | \$ 301,989   |
| Interest-bearing  | 1,637,833   | 1,168,576    |
| TOTAL DEPOSITS  | 2,097,235   | 1,470,565    |
| Interest payable  | 1,186       | 353          |
| Borrowed funds  | 10,516      | 104,072      |
| Subordinated debentures   | 75,192      | 10,310       |
| Other liabilities   | 11,734      | 5,470        |
| TOTAL LIABILITIES   | 2,195,863   | 1,590,770    |
| STOCKHOLDERS' EQUITY:   |             |              |
| Common stock, par value \$1 per share, 20,000,000 shares authorized; 13,092,447 shares issued at June 30, 2018, and 11,192,401 shares issued at December 31, 2017, respectively | 13,092      | 11,192       |
| Additional paid-in capital  | 216,310     | 158,456      |
| Retained earnings   | 61,369      | 53,722       |
| Accumulated other comprehensive loss  | (4,481 )    | (438 )       |
| Treasury stock, at cost, 26,494 shares at June 30, 2018 and at December 31, 2017  | (464 )      | (464 )       |
| TOTAL STOCKHOLDERS' EQUITY  | 285,826     | 222,468      |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY  | \$2,481,689 | \$ 1,813,238 |

See Notes to Consolidated Financial Statements

**THE FIRST BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF INCOME**

(\$ In Thousands, except earnings and dividends per share)

|   | <b>(Unaudited)</b>        |               | <b>(Unaudited)</b>      |               |
|---|---------------------------|---------------|-------------------------|---------------|
|   | <b>Three Months Ended</b> |               | <b>Six Months Ended</b> |               |
|   | <b>June 30,</b>           |               | <b>June 30,</b>         |               |
|   | <b>2018</b>               | <b>2017</b>   | <b>2018</b>             | <b>2017</b>   |
| <b>INTEREST INCOME:</b>   |                           |               |                         |               |
| Interest and fees on loans  | \$ 21,714                 | \$ 14,170     | \$ 37,699               | \$ 27,670     |
| Interest and dividends on securities:                                       |                           |               |                         |               |
| Taxable interest and dividends  | 2,423                     | 1,605         | 4,409                   | 3,141         |
| Tax exempt interest   | 758                       | 592           | 1,433                   | 1,185         |
| Interest on federal funds sold and interest bearing deposits in other banks | 142                       | 97            | 254                     | 221           |
| <b>TOTAL INTEREST INCOME</b>  | <b>25,037</b>             | <b>16,464</b> | <b>43,795</b>           | <b>32,217</b> |
| <b>INTEREST EXPENSE:</b>  |                           |               |                         |               |
| Interest on deposits  | 2,547                     | 1,303         | 4,387                   | 2,461         |
| Interest on borrowed funds  | 921                       | 326           | 1,459                   | 753           |
| <b>TOTAL INTEREST EXPENSE</b>   | <b>3,468</b>              | <b>1,629</b>  | <b>5,846</b>            | <b>3,214</b>  |
| <b>NET INTEREST INCOME</b>  | <b>21,569</b>             | <b>14,835</b> | <b>37,949</b>           | <b>29,003</b> |
| <b>PROVISION FOR LOAN LOSSES</b>  | <b>857</b>                | <b>248</b>    | <b>1,134</b>            | <b>294</b>    |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>                  | <b>20,712</b>             | <b>14,587</b> | <b>36,815</b>           | <b>28,709</b> |
| <b>OTHER INCOME:</b>  |                           |               |                         |               |
| Service charges on deposit accounts   | 1,341                     | 922           | 2,368                   | 1,790         |
| Other service charges and fees  | 4,291                     | 2,835         | 6,723                   | 5,358         |
| <b>TOTAL OTHER INCOME</b>   | <b>5,632</b>              | <b>3,757</b>  | <b>9,091</b>            | <b>7,148</b>  |
| <b>OTHER EXPENSES:</b>  |                           |               |                         |               |
| Salaries and employee benefits  | 9,502                     | 7,762         | 17,291                  | 15,743        |
| Occupancy and equipment   | 2,034                     | 1,348         | 3,680                   | 2,718         |
| Acquisition and integration charges   | 3,838                     | 2,682         | 5,596                   | 6,280         |
| Other   | 4,306                     | 3,278         | 7,710                   | 6,424         |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| TOTAL OTHER EXPENSES                          | 19,680   | 15,070   | 34,277   | 31,165   |
| INCOME BEFORE INCOME TAXES                    | 6,664    | 3,274    | 11,629   | 4,692    |
| INCOME TAXES                                  | 1,419    | 908      | 2,427    | 1,204    |
| NET INCOME APPLICABLE TO COMMON STOCKHOLDERS  | \$ 5,245 | \$ 2,366 | \$ 9,202 | \$ 3,488 |
| NET INCOME APPLICABLE TO COMMON STOCKHOLDERS: |          |          |          |          |
| BASIC   | \$ 0.40  | \$ 0.26  | \$ 0.75  | \$ 0.38  |
| DILUTED                                       | 0.40     | 0.26     | 0.74     | 0.38     |
| DIVIDENDS PER SHARE – COMMON                  | 0.05     | 0.0375   | 0.10     | 0.075    |

See Notes to Consolidated Financial Statements



**THE FIRST BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(\$ In Thousands)

|   | <b>(Unaudited)<br/>Three Months<br/>Ended<br/>June 30,<br/>2018</b> |             | <b>(Unaudited)<br/>Six Months Ended<br/>June 30,<br/>2018</b> |             |
|---|---|-------------|---|-------------|
|   | <b>2018</b>   | <b>2017</b> | <b>2018</b>   | <b>2017</b> |
| Net income per consolidated statements of income  | \$ 5,245  | \$ 2,366    | \$ 9,202  | \$ 3,488    |
| Other Comprehensive Income:   |   |             |   |             |
| Unrealized holding gains/ (losses) arising during period on available-for sale securities | (926 )  | 2,904       | (5,410 )  | 5,259       |
| Less reclassification adjustment for gains included in net income                         | -   | -           | -   | -           |
| Unrealized holding gains/ (losses) arising during period on available-for-sale securities | (926 )  | 2,904       | (5,410 )  | 5,259       |
| Income tax benefit(expense)   | 234   | (1,230 )    | 1,367   | (2,030 )    |
| Other comprehensive income (loss)   | (692 )  | 1,674       | (4,043 )  | 3,229       |
| Comprehensive Income  | \$ 4,553  | \$ 4,040    | \$ 5,159  | \$ 6,717    |

See Notes to Consolidated Financial Statements

## THE FIRST BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(\$ In Thousands, unaudited)

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Compre-<br>hensive<br>Income(Loss) | Treasury<br>Stock | Total      |
|---|-----------------|----------------------------------|----------------------|--|-------------------|------------|
| Balance, January 1, 2017                                      | \$ 9,018        | \$ 102,574                       | \$ 44,477            | \$ (1,078 )  | \$ (464 )         | \$ 154,527 |
| Net income  | -               | -                                | 3,488                | -  | -                 | 3,488      |
| Other comprehensive income                                    | -               | -                                | -                    | 3,229  | -                 | 3,229      |
| Dividends on common stock, \$0.0375 per share                 | -               | -                                | (686 )               | -  | -                 | (686 )     |
| Issuance of 89,591 common shares for GCCB acquisition         | 89              | 2,160                            | -                    | -  | -                 | 2,249      |
| Repurchase of restricted stock for payment of taxes           | (12 )           | (318 )                           | -                    | -  | -                 | (330 )     |
| Restricted stock grant  | 84              | (84 )                            | -                    | -  | -                 | -          |
| Compensation expense  | -               | 402                              | -                    | -  | -                 | 402        |
| Balance, June 30, 2017  | \$ 9,179        | \$ 104,734                       | \$ 47,279            | \$ 2,151   | \$ (464 )         | \$ 162,879 |
| Balance, January 1, 2018                                      | \$ 11,192       | \$ 158,456                       | \$ 53,722            | \$ (438 )  | \$ (464 )         | \$ 222,468 |
| Net income  | -               | -                                | 9,202                | -  | -                 | 9,202      |
| Other comprehensive income                                    | -               | -                                | -                    | (4,043 )   | -                 | (4,043 )   |
| Dividends on common stock, \$0.10 per share                   | -               | -                                | (1,206 )             | -  | -                 | (1,206 )   |
| Issuance of 1,134,010 common shares for Southwest acquisition | 1,134           | 34,871                           | -                    | -  | -                 | 36,005     |
| Issuance of 726,461 common shares for Sunshine acquisition    | 726             | 22,702                           | -                    | -  | -                 | 23,428     |
| Restricted stock grant  | 52              | (52 )                            | -                    | -  | -                 | -          |
| Restricted stock grants forfeited                             | (12 )           | 12                               | -                    | -  | -                 | -          |
| Expenses associated with common stock issuance                | -               | (237 )                           | -                    | -  | -                 | (237 )     |
| Compensation expense  | -               | 558                              | -                    | -  | -                 | 558        |
| ASU 2016-01 implementation                                    | -               | -                                | (349 )               | -  | -                 | (349 )     |
| Balance, June 30, 2018  | \$ 13,092       | \$ 216,310                       | \$ 61,369            | \$ (4,481 )  | \$ (464 )         | \$ 285,826 |

See Notes to Consolidated Financial Statements

**THE FIRST BANCSHARES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(\$ In Thousands)

|   | <b>(Unaudited)</b>      |                  |
|---|-------------------------|------------------|
|   | <b>Six Months Ended</b> |                  |
|   | <b>June 30,</b>         |                  |
|   | <b>2018</b>             | <b>2017</b>      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                         |                  |
| NET INCOME  | \$9,202                 | \$3,488          |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                         |                  |
| Depreciation, amortization and accretion  | 2,121                   | 2,312            |
| Provision for loan losses   | 1,134                   | 294              |
| Loss on sale/writedown of ORE   | 52                      | 404              |
| Restricted stock expense  | 558                     | 402              |
| Increase in cash value of life insurance  | (411 )                  | (354 )           |
| Federal Home Loan Bank stock dividends  | (64 )                   | (42 )            |
| Changes in:   |                         |                  |
| Interest receivable   | (17 )                   | 272              |
| Loans held for sale, net  | (1,121 )                | (24 )            |
| Interest payable  | 696                     | (69 )            |
| Other, net  | (269 )                  | 544              |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                      | <b>11,881</b>           | <b>7,227</b>     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                         |                  |
| Maturities, calls and paydowns of available- for-sale and held-to-maturity securities | 30,021                  | 34,734           |
| Proceeds from sales of securities available-for-sale                                  | 18,573                  | -                |
| Purchases of available-for-sale securities  | (57,039 )               | (62,555 )        |
| Redemptions (Purchases) of other securities   | 2,436                   | (1,796 )         |
| Net increase in loans   | (48,042 )               | (83,942 )        |
| Net increase in premises and equipment  | (2,424 )                | (2,415 )         |
| Purchase of bank-owned life insurance   | -                       | (469 )           |
| Proceeds from sale of other real estate owned   | 985                     | 5,759            |
| Cash received in excess of cash paid for acquisitions                                 | 29,901                  | 3,413            |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>  | <b>(25,589 )</b>        | <b>(107,271)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                         |                  |
| Increase in deposits  | 117,435                 | 156,060          |
| Net decrease in borrowed funds  | (138,664)               | (24,539 )        |
| Dividends paid on common stock  | (1,188 )                | (670 )           |
| Repurchase of restricted stock for payment of taxes                                   | -                       | (330 )           |
| Expenses associated with capital raise  | (237 )                  | -                |
| Issuance of subordinated debt, net  | 64,866                  | -                |

|  |            |           |
|--|------------|-----------|
| NET CASH PROVIDED BY FINANCING ACTIVITIES        | 42,212     | 130,521   |
| NET INCREASE IN CASH                             | 28,504     | 30,477    |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 91,921     | 62,119    |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD       | \$ 120,425 | \$ 92,596 |

SUPPLEMENTAL DISCLOSURES:

|   |        |       |
|---|--------|-------|
| CASH PAYMENTS FOR INTEREST  | 4,964  | 3,366 |
| CASH PAYMENTS FOR INCOME TAXES  | 816    | 650   |
| LOANS TRANSFERRED TO OTHER REAL ESTATE                                | 985    | 755   |
| ISSUANCE OF RESTRICTED STOCK GRANTS                                   | 52     | 84    |
| STOCK ISSUED IN CONNECTION WITH GULF COAST COMMUNITY BANK ACQUISITION | -      | 2,249 |
| STOCK ISSUED IN CONNECTION WITH SOUTHWEST ACQUISITION                 | 36,005 | -     |
| STOCK ISSUED IN CONNECTION WITH SUNSHINE ACQUISITION                  | 23,428 | -     |

Also see Note 4 regarding non-cash transactions included in the acquisitions.

See Notes to Consolidated Financial Statements

**THE FIRST BANCSHARES, INC.**

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

**June 30, 2018**

**NOTE 1 — BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and the instructions to Form 10-Q of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. However, in the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, please refer to the consolidated financial statements and footnotes thereto included in the Company's Form 10-K for the fiscal year ended December 31, 2017.

**NOTE 2 — SUMMARY OF ORGANIZATION**

The First Bancshares, Inc., Hattiesburg, Mississippi (the "Company"), was incorporated June 23, 1995, under the laws of the State of Mississippi for the purpose of operating as a bank holding company. The Company's primary asset is its interest in its wholly-owned subsidiary, The First, A National Banking Association (the "Bank" or "The First").

At June 30, 2018, the Company had approximately \$2.5 billion in assets, \$1.7 billion in net loans, \$2.1 billion in deposits, and 0.3 billion in stockholders' equity. For the six months ended June 30, 2018, the Company reported net income of \$9.2 million. After tax merger related costs of \$4.3 million were expensed during the six months ended June 30, 2018.

On May 22, 2018, the Company paid a cash dividend in the amount of \$0.05 per share to shareholders of record as of the close of business on Monday, May 7, 2018.

On February 22, 2018, the Company paid a cash dividend in the amount of \$0.05 per share to shareholders of record as of the close of business on Friday, February 5, 2018.

### NOTE 3 — RECENT ACCOUNTING PRONOUNCEMENTS

In June 2018, the FASB issued ASU No. 2018-07, *Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*. ASU 2018-07 has been issued as part of a simplification initiative which will expand the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees and expands the scope through the amendments to address and improve aspects of the accounting for non-employee share-based payment transactions. The amendments will be effective for interim and annual reporting periods beginning after December 15, 2018. The Company is currently evaluating the provisions of ASU 2018-07 to determine the potential impact the new standard will have on its Consolidated Financial Statements.

In January 2016, the FASB issued ASU No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments by making targeted improvements to GAAP as follows: (1) require equity investments (except those accounted for under the equity method of accounting for those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (4) eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (5) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (6) require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (7) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (8) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. ASU 2016-01 is effective for interim and annual reporting periods beginning after December 15, 2017. Starting with the first quarter of 2018, the Company began using an exit price notion when measuring the fair value of its loan portfolio, excluding loans held for sale, for disclosure purposes. The new guidance did not materially impact the Company's Consolidated Financial Statements.

In February, 2018, the FASB issued ASU No. 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. ASU No. 2018-02 allows for the reclassification from other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (the Act). ASU 2018-02 also allows an accounting policy election to reclassify other stranded tax effects that relate to the Act but are not directly related to the change in federal tax rate. ASU 2018-02 is



effective in the first quarter of 2019. Early adoption is permitted for reporting periods for which financial statements have not yet been issued. The Company adopted ASU 2018-02 in the fourth quarter of 2017 by retrospective application. Upon adoption, the Company made a policy election to reclassify stranded tax effects of approximately \$76 thousand from Accumulated Other Comprehensive Income to retained earnings using the specific identification method.

In May 2017, the FASB issued ASU No. 2017-09, “*Stock Compensation, Scope of Modification Accounting.*” ASU 2017-09 clarifies when changes to the terms of conditions of a share-based payment award must be accounted for as modifications. Companies will apply the modification accounting guidance if any change in the value, vesting conditions or classification of the award occurs. The new guidance should reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications, as the guidance will allow companies to make certain non-substantive changes to awards without accounting for them as modifications. It does not change the accounting for modifications. ASU 2017-09 is effective for interim and annual reporting periods beginning after December 15, 2017. ASU 2017-09 did not have a material impact on the Company’s Consolidated Financial Statements.

In March 2017, the FASB issued ASU No. 2017-08, “*Premium Amortization on Purchased Callable Debt Securities.*” ASU 2017-08 shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. Currently, entities generally amortize the premium as an adjustment of yield over the contractual life of the security. ASU 2017-08 does not change the accounting for purchased callable debt securities held at a discount as the discount will continue to be accreted to maturity. ASU 2017-08 is effective for interim and annual reporting periods beginning after December 15, 2018; early adoption is permitted. The guidance calls for a modified retrospective transition approach under which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period in which ASU 2017-08 is adopted. The Company is currently evaluating the provisions of ASU 2017-08 to determine the potential impact the new standard will have on its Consolidated Financial Statements.

In January 2017, the FASB issued ASU No. 2017-04, “*Simplifying the Test for Goodwill Impairment.*” ASU 2017-04 removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. Under the amended guidance, a goodwill impairment charge will now be recognized for the amount by which the carrying value of a reporting unit exceeds its fair value, not to exceed the carrying amount of goodwill. This guidance is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted for any impairment tests performed after January 1, 2017. The Company is currently assessing the impact of ASU 2017-04 on its Consolidated Financial Statements.

In August 2016, the FASB issued ASU No. 2016-15, “*Classification of Certain Cash Receipts and Cash Payments.*” Current GAAP is unclear or does not include specific guidance on how to classify certain transactions in the statement of cash flows. ASU 2016-15 is intended to reduce diversity in practice in how eight particular transactions are classified in the statement of cash flows. ASU 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017. Entities were required to apply the guidance retrospectively unless it would have been impracticable to do, in which case the amendments could have been applied prospectively. The Company applied the guidance retrospectively. As this guidance only affects the classification within the statement of cash flows, ASU 2016-15 did not have a material impact on the Company’s Consolidated Financial Statements.

In June 2016, the Financial Accounting Standards Board (FASB) issued ASU No. 2016-13, “*Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*”. ASU 2016-13 requires a new impairment model known as the current expected credit loss (“CECL”) which significantly changes the way impairment of financial instruments is recognized by requiring immediate recognition of estimated credit losses expected to occur over the remaining life of financial instruments. The main provisions of ASU 2016-13 include (1) replacing the “incurred loss” approach under current GAAP with an “expected loss” model for instruments measured at amortized cost, (2) requiring entities to record an allowance for credit losses related to available-for-sale debt securities rather than a direct write-down of the carrying amount of the investments, as is required by the other-than-temporary-impairment model under current GAAP, and (3) a simplified accounting model for purchased credit-impaired debt securities and loans. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019, although early adoption is permitted. The Company is currently working with a third party to assess the impact of the adoption of ASU 2016-13 on its Consolidated Financial Statements. While we are currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption could be influenced by the composition, characteristics and quality of our loan portfolio as well as the prevailing economic conditions and forecasts as of the adoption date. As part of our evaluation process, we have established a working group that includes individuals from various functional areas to assess processes, portfolio segmentation, systems requirements and needed resources to implement this new accounting standard.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company adopted the amendments effective January 1, 2017. The Company has a stock-based compensation plan for which the ASU 2016-09 guidance results in the associated excess tax benefits or deficiencies being recognized as tax expense or benefit in the income statement instead of the previous accounting treatment, which requires excess tax benefits to be recognized as an adjustment to additional paid-in capital and excess tax deficiencies to be recognized as either an offset to accumulated excess tax benefits, if any, or to the income statement. In addition, such amounts are now classified as an operating activity in the statement of cash flows instead of the current accounting treatment, which required it to be classified as both an operating and a financing activity. The Company's stock based compensation plan has not historically generated material amounts of excess tax benefits or deficiencies and, therefore, the Company has not experienced a material change in the Company's financial position or results of operation as a result of the adoption and implementation of ASU 2016-09.

In February 2016, the FASB issued ASU No. 2016-02 "*Leases (Topic 842)*." ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If neither risks and rewards nor control is conveyed, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is currently assessing the impact of ASU 2016-02 on Consolidated Financial Statements.

#### **NOTE 4 – BUSINESS COMBINATIONS**

##### Acquisitions

##### **Sunshine Financial, Inc.**

On April 1, 2018, the Company completed its acquisition of Sunshine Financial, Inc., ("Sunshine"), and immediately thereafter merged its wholly-owned subsidiary, Sunshine Community Bank, with and into The First. The Company

paid a total consideration of approximately \$30.5 million to the Sunshine shareholders as consideration in the merger which included 726,461 shares of Company common stock and approximately \$7 million in cash.

In connection with the acquisition, preliminarily, the Company recorded approximately \$10.0 million of goodwill and \$2.8 million of core deposit intangible. The core deposit intangible will be expensed over 10 years.

The Company acquired the \$173.1 million loan portfolio at an estimated fair value discount of \$2.2 million. The discount represents expected credit losses, adjusted for market interest rates and liquidity adjustments.

Expenses associated with the acquisition were \$1.2 million for the six month period ended June 30, 2018. These costs included charges associated with due diligence as well as legal and consulting expenses, which have been expensed as incurred.

The preliminary amounts of the acquired identifiable assets and liabilities as of the acquisition date were as follows:

**(\$ In Thousands)**

|                                     |          |
|-------------------------------------|----------|
| Purchase price:                     |          |
| Cash and stock                      | \$30,461 |
| Total purchase price                | 30,461   |
| Identifiable assets:                |          |
| Cash and due from banks             | 16,099   |
| Investments                         | 13,812   |
| Loans                               | 170,843  |
| Bank owned life insurance           | 3,284    |
| Core deposit intangible             | 2,831    |
| Personal and real property          | 4,121    |
| Other assets                        | 2,576    |
| Total assets                        | 213,566  |
| Liabilities and equity:             |          |
| Deposits                            | 151,973  |
| Borrowed funds                      | 38,250   |
| Other liabilities                   | 2,920    |
| Total liabilities                   | 193,143  |
| Net assets acquired                 | 20,423   |
| Goodwill resulting from acquisition | \$10,038 |

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2018, are as follows (\$ In Thousands):

|                               |           |
|-------------------------------|-----------|
| Outstanding principal balance | \$168,958 |
| Carrying amount               | 166,463   |

**Southwest Banc Shares, Inc.**

On March 1, 2018, the Company completed its acquisition of Southwest Banc Shares, Inc., (“Southwest”), and immediately thereafter merged its wholly-owned subsidiary, First Community Bank, with and into The First. The Company paid a total consideration of approximately \$60.0 million to the Southwest shareholders as consideration in the merger which included 1,134,010 shares of Company common stock and \$24 million in cash.

In connection with the acquisition, preliminarily, the Company recorded approximately \$24.8 million of goodwill and \$4.2 million of core deposit intangible. The core deposit intangible will be expensed over 10 years.

The Company acquired the \$274.7 million loan portfolio at an estimated fair value discount of \$8.4 million. The discount represents expected credit losses, adjusted for market interest rates and liquidity adjustments.

Expenses associated with the acquisition were \$4.0 million for the six month period ended June 30, 2018. These costs included systems conversions and integrating operations charges, as well as legal and consulting expenses, which have been expensed as incurred.

The preliminary amounts of the acquired identifiable assets and liabilities as of the acquisition date were as follows:

**(\$ In Thousands)**

|                                     |          |
|-------------------------------------|----------|
| Purchase price:                     |          |
| Cash and stock                      | \$60,005 |
| Total purchase price                | 60,005   |
| Identifiable assets:                |          |
| Cash and due from banks             | 44,836   |
| Investments                         | 66,940   |
| Loans                               | 266,307  |
| Bank owned life insurance           | 5,885    |
| Core deposit intangible             | 4,177    |
| Personal and real property          | 10,500   |
| Other assets                        | 3,226    |
| Total assets                        | 401,871  |
| Liabilities and equity:             |          |
| Deposits                            | 357,221  |
| Borrowed funds                      | 6,858    |
| Other liabilities                   | 2,561    |
| Total liabilities                   | 366,640  |
| Net assets acquired                 | 35,231   |
| Goodwill resulting from acquisition | \$24,774 |

During the quarter, adjustments were made to the acquired identifiable assets and liabilities which included adjustments to fair values, reclassifications of balances and break out of bank owned life insurance. Loans were



adjusted down by \$3.6 million to reflect the sales price of acquired loans that were subsequently sold. Deferred tax assets increased \$0.7 million and various other assets increased \$0.4 million. As a result of these changes and the confirmation of \$5.9 million bank owned life insurance, total assets acquired increased \$3.4 million and total liabilities increased \$0.5 million, resulting in a decrease to goodwill of \$2.9 million.

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2018, are as follows (\$ In Thousands):

|                               |           |
|-------------------------------|-----------|
| Outstanding principal balance | \$240,831 |
| Carrying amount               | 237,603   |

The following unaudited pro-forma financial information for the six months ended June 30, 2018 and June 30, 2017 gives effect to the acquisitions of Southwest Banc Shares and Sunshine Financial as if the acquisitions had occurred on January 1, 2018 and 2017. The pro-forma financial information is not necessarily indicative of the results of operations had the acquisitions been effective as of this date.

**(\$ In Thousands)**

|                            | Pro-Forma<br>June 30,<br>2018<br>(unaudited) | Pro-Forma<br>June 30,<br>2017<br>(unaudited) |
|----------------------------|--|--|
| Net interest income        | 42,355                                       | 39,309                                       |
| Non-interest income        | 9,868  | 9,581  |
| Total revenue              | 52,223                                       | 48,890                                       |
| Income before income taxes | 18,575                                       | 13,501                                       |

Supplemental pro-forma earnings were adjusted to exclude acquisition costs incurred.

**Iberville Bank**

On January 1, 2017, the Company completed its acquisition of 100% of the common stock of Iberville Bank, Plaquemine, Louisiana, from A. Wilbert's Sons Lumber and Shingle Co. ("Iberville Parent"), and immediately thereafter merged Iberville Bank ("Iberville"), the wholly-owned subsidiary of Iberville Parent, with and into The First. The Company paid a total of \$31.1 million in cash. Approximately \$2.5 million of the purchase price was held in escrow as contingency for flood-related losses in the loan portfolio incurred due to flooding in Iberville's market area in the fall of 2016. The Company received \$498,207 from the escrow for settlement of flood-related loans. Goodwill at June 30, 2018, reflects the escrow settlement.

In connection with the acquisition, the Company recorded \$5.1 million of goodwill and \$2.7 million of core deposit intangible. The core deposit intangible will be amortized to expense over 10 years.

The Company acquired Iberville's \$149.4 million loan portfolio at an estimated fair value discount of \$0.8 million. The discount represents expected credit losses, adjusted for market interest rates and liquidity adjustments.

Expenses associated with the acquisition were \$0 and \$3.5 million for the six months ended June 30, 2018 and 2017, respectively. These costs included system conversion and integrating operations charges, as well as legal and consulting expenses, which have been expensed as incurred.

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2018, are as follows:

**(\$ In Thousands)**

|                               |           |
|-------------------------------|-----------|
| Outstanding principal balance | \$101,862 |
| Carrying amount               | 101,267   |

**Gulf Coast Community Bank**

Also on January 1, 2017, the Company completed the merger of Gulf Coast Community Bank (“GCCB”), Pensacola, Florida, with and into The First. The Company issued to GCCB’s shareholders shares of the Company’s common stock which, for purposes of the GCCB acquisition, were valued through averaging the trading price of the Company’s common stock price over a 30 day trading period ending on the fifth business day prior to the closing of the acquisition. Fractional shares were acquired with cash. The consideration totaled \$2.3 million.

In connection with the acquisition, the Company recorded \$1.1 million of goodwill and \$1.0 million of core deposit intangible. The core deposit intangible will be amortized to expense over 10 years.

The Company acquired GCCB's \$91.0 million loan portfolio at a fair value discount of approximately \$2.2 million. The discount represents expected credit losses, adjusted for market interest rates and liquidity adjustments.

Expenses associated with the acquisition were \$0 and \$2.8 million for the six months ended June 30, 2018 and 2017, respectively. These costs included systems conversion and integrating operations charges, as well as legal and consulting expenses, which have been expensed as incurred.

On March 3, 2017, \$5.0 million of loans acquired in the acquisition were sold. In connection with the sale, the acquisition credit mark was decreased by \$2.2 million, the amount of which was included in the credit mark at acquisition.

The outstanding principal balance and the carrying amount of these loans included in the consolidated balance sheet at June 30, 2018, are as follows:

**(\$ In Thousands)**

|                               |          |
|-------------------------------|----------|
| Outstanding principal balance | \$48,365 |
| Carrying amount               | 48,251   |

Loans acquired in the four acquisitions discussed in Note 4 – Business Combinations were accounted for in accordance with ASC 310-20, *Receivables-Nonrefundable Fees and Other Costs*. No loans were identified as purchased credit impaired loans.

**NOTE 5 — EARNINGS APPLICABLE TO COMMON STOCKHOLDERS**

Basic per share data is calculated based on the weighted-average number of common shares outstanding during the reporting period. Diluted per share data includes any dilution from potential common stock outstanding, such as restricted stock grants. There were no antidilutive common stock equivalents excluded in the calculations.

**For the Three Months Ended  
June 30, 2018**

**Shares Per**

**Net  
Income  
(Numerator)(Denominator) Share Data**

Basic earnings per share \$5,245,000 13,065,953 \$ 0.40

Effect of dilutive shares:

Restricted stock grants 102,016

Diluted earnings per share \$5,245,000 13,167,969 \$ 0.40

**For the Six Months Ended  
June 30, 2018**

**Net  
Income  
(Numerator)(Denominator) Share Data**

Basic earnings per share \$9,202,000 12,311,460 \$ 0.75

Effect of dilutive shares:

Restricted stock grants 102,016

Diluted earnings per share \$9,202,000 12,413,476 \$ 0.74

**For the Three Months Ended  
June 30, 2017**

|   | <b>Net<br/>Income<br/>(Numerator)</b> | <b>Shares<br/>(Denominator)</b> | <b>Per<br/>Share<br/>Data</b> |
|---|---------------------------------------|---------------------------------|-------------------------------|
| Basic earnings per share                              | \$2,366,000                           | 9,145,179                       | \$ 0.26                       |
| Effect of dilutive shares:<br>Restricted stock grants |                                       | 61,199                          |                               |
| Diluted earnings per share                            | \$2,366,000                           | 9,206,378                       | \$ 0.26                       |

**For the Six Months Ended  
June 30, 2017**

|   | <b>Net<br/>Income<br/>(Numerator)</b> | <b>Shares<br/>(Denominator)</b> | <b>Per<br/>Share<br/>Data</b> |
|---|---------------------------------------|---------------------------------|-------------------------------|
| Basic earnings per share                              | \$3,488,000                           | 9,134,225                       | \$0.38                        |
| Effect of dilutive shares:<br>Restricted stock grants |                                       | 61,199                          |                               |
| Diluted earnings per share                            | \$3,488,000                           | 9,195,424                       | \$0.38                        |

The Company granted 51,851 shares of restricted stock in the first quarter of 2018 and 73,827 shares of restricted stock in the first quarter of 2017. There were no grants of restricted stock in the second quarter of 2018 and 9,709 shares granted during the second quarter of 2017.

**NOTE 6 – COMPREHENSIVE INCOME**

As presented in the Consolidated Statements of Comprehensive Income, comprehensive income includes net income and other comprehensive income. The Company's sources of other comprehensive income are unrealized gains and losses on available-for-sale investment securities. Gains or losses on investment securities that had previously been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose were realized and reflected in net income of the current period, and as a result are considered to be reclassification adjustments that are excluded from other comprehensive income in the current period.

**NOTE 7 – FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK**

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. At June 30, 2018, and December 31, 2017, these financial instruments consisted of the following:

| (\$ In Thousands)            | June 30, 2018 | December 31, 2017 |
|------------------------------|---------------|-------------------|
| Commitments to extend credit | \$ 241,238    | \$ 281,381        |
| Standby letters of credit    | 9,061         | 8,207             |

#### **NOTE 8 – FAIR VALUE DISCLOSURES AND REPORTING, THE FAIR VALUE OPTION AND FAIR VALUE MEASUREMENTS**

FASB's standards on financial instruments, and on fair value measurements and disclosures, require all entities to disclose in their financial statement footnotes the estimated fair values of financial instruments for which it is practicable to estimate fair values. In addition to disclosure requirements, FASB's standard on investments requires that our debt securities which are classified as available-for-sale and our equity securities that have readily determinable fair values be measured and reported at fair value in our Consolidated Financial Statements. Certain impaired loans are also reported at fair value, as explained in greater detail below, and foreclosed assets are carried at the lower of cost or fair value. FASB's standard on financial instruments permits companies to report certain other financial assets and liabilities at fair value, but we have not elected the fair value option for any of those financial instruments.

Fair value measurement and disclosure standards also establish a framework for measuring fair values. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants on the measurement date. Further, the standards establish a fair value hierarchy that encourages an entity to maximize the use of observable inputs and limit the use of unobservable inputs when measuring fair values. The standards describe three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the factors that market participants would likely consider in pricing an asset or liability.

Fair value estimates are made at a specific point in time based on relevant market data and information about the financial instruments. The estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the



value of anticipated future business related to the instruments. In addition, the tax ramifications related to realized gains and losses could have a significant effect on fair value estimates but have not been considered in those estimates. Because no active market exists for a significant portion of our financial instruments, fair value disclosures are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. The estimates are subjective and involve uncertainties and matters of significant judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly alter the fair values presented. The following methods and assumptions were used by the Company to estimate its financial instrument fair values disclosed at June 30, 2018 and December 31, 2017:

Cash and cash equivalents and fed funds sold: The carrying amount is estimated to be fair value.

Securities (available-for-sale, held-to-maturity and other): Fair values are determined by obtaining quoted prices on nationally recognized securities exchanges or by matrix pricing, which is a mathematical technique used widely in the industry to value debt securities by relying on their relationship to other benchmark quoted securities when quoted prices for specific securities are not readily available.

Loans and leases: ASU 2016-1, *Recognition and Measurement of Financial Assets and Financial Liabilities*, requires the Company to use the exit price notion when measuring fair value of financial instruments for disclosure purposes effective January 1, 2018, therefore the fair value presented in the following table may not be comparable to prior period. For performing loans, the fair value is determined based on a discounted cash flow analysis. The discounted cash flow was based on contractual maturity of the loan and market indications of rates, prepayment speeds, defaults and credit risk. For non-performing loans, the fair value is determined based on the estimated values of the underlying collateral or individual analysis of receipts. At December 31, 2017, the fair values of loans, excluding loans held for sale, were estimated as follows: for variable rate loans that reprice frequently and with no significant change in credit risk, fair values were based on carrying values. Fair values for other loans were estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest receivable approximates its fair value.

Loans held for sale: Since loans designated by the Company as available-for-sale are typically sold shortly after making the decision to sell them, realized gains or losses are usually recognized within the same period and fluctuations in fair values are not relevant for reporting purposes. If available-for-sale loans are held on our books for an extended period of time, the fair value of those loans is determined using quoted secondary-market prices.

Collateral-dependent impaired loans: Collateral-dependent impaired loans are carried at fair value when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the original loan agreement and the loan has been written down to the fair value of its underlying collateral, net of expected disposition costs where applicable.

Accrued interest receivable: The carrying amount of accrued interest receivable approximates fair value and is classified as level 2 for accrued interest receivable related to investment securities and Level 3 for accrued interest receivable related to loans.

Deposits (noninterest-bearing and interest-bearing): Fair values for non-maturity deposits are equal to the amount payable on demand at the reporting date, which is the carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a cash flow analysis, discounted at interest rates being offered at each reporting date by the Bank for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

FHLB and other borrowings: Current carrying amounts are used as an approximation of fair values for federal funds purchased, overnight advances from the Federal Home Loan Bank (“FHLB”), borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days of the reporting dates. Fair values of other short-term borrowings are estimated by discounting projected cash flows at the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

Long-term borrowings: Fair values are estimated using projected cash flows discounted at the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Subordinated debentures: Fair values are determined based on the current market value for like instruments of a similar maturity and structure.

Accrued interest payable: The carrying amount of accrued interest payable approximates fair value resulting in a Level 2 classification.

Off-balance sheet instruments: Fair values of off-balance sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value until such commitments are funded or closed. Management has determined that these instruments do not have a distinguishable fair value and no fair value has been assigned.

Estimated fair values for the Company's financial instruments are as follows, as of the dates noted:

As of June 30, 2018  
(\$ In Thousands)

|   | Carrying Amount | Estimated Fair Value | Fair Value Measurements |   |   |
|---|-----------------|----------------------|-------------------------|---|---|
|   |                 |                      | Quoted Prices (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Instruments:                  |                 |                      |                         |   |   |
| Assets:                                 |                 |                      |                         |   |   |
| Cash and cash equivalents               | \$ 120,425      | \$ 120,425           | \$ 120,425              | \$ -  | \$ -                                      |
| Securities available-for-sale:          |                 |                      |                         |   |   |
| Obligations of U.S. Government Agencies | 21,263          | 21,263               | -                       | 21,263  | -   |
| Municipal securities                    | 156,453         | 156,453              | -                       | 156,453                                       | -   |
| Mortgage-backed securities              | 248,652         | 248,652              | -                       | 248,652                                       | -   |
| Corporate obligations                   | 10,643          | 10,643               | -                       | 8,075   | 2,568                                     |
| Securities held-to-maturity             | 6,000           | 7,183                | -                       | 7,183   | -   |
| Other securities                        | 10,320          | 10,320               | n/a                     | n/a   | n/a                                       |
| Loans, net                              | 1,706,673       | 1,720,284            | -                       | -   | 1,720,284                                 |
| Accrued interest receivable             | 8,493           | 8,493                | -                       | -   | -   |
| Liabilities:                            |                 |                      |                         |   |   |
| Noninterest-bearing deposits            | \$ 459,402      | \$ 459,402           | \$ -                    | \$ 459,402                                    | \$ -                                      |

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|                           |           |           |   |           |        |
|---------------------------|-----------|-----------|---|-----------|--------|
| Interest-bearing deposits | 1,637,833 | 1,597,218 | - | 1,597,218 | -      |
| Subordinated debentures   | 75,192    | 75,394    | - | -         | 75,394 |
| FHLB and other borrowings | 10,516    | 10,516    | - | 10,516    | -      |
| Accrued interest payable  | 1,186     | 1,186     | - | 1,186     | -      |

As of December 31, 2017

(\$ In Thousands)

|                               | Carrying<br>Amount | Estimated<br>Fair Value | Fair Value Measurements          |   |  |
|-------------------------------|--------------------|-------------------------|----------------------------------|---|--|
|                               |                    |                         | Quoted<br>Prices<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Financial Instruments:        |                    |                         |                                  |   |  |
| Assets:                       |                    |                         |                                  |   |  |
| Cash and cash equivalents     | \$91,921           | \$91,921                | \$91,921                         | \$ -  | \$ -   |
| Securities available-for-Sale | 356,893            | 356,893                 | 920                              | 353,404   | 2,569  |
| Securities held-to-maturity   | 6,000              | 7,398                   | -                                | 7,398   | -  |
| Other securities              | 9,969              | 9,969                   | n/a                              | n/a   | n/a  |
| Loans, net                    | 1,221,808          | 1,238,525               | -                                | -   | 1,238,525  |
| Accrued interest receivable   | 6,705              | 6,705                   | -                                | 2,287   | 4,418  |
| Liabilities:                  |                    |                         |                                  |   |  |
| Noninterest-bearing deposits  | \$301,989          | \$301,989               | \$ -                             | \$ 301,989  | \$ -   |
| Interest-Bearing deposits     | 1,168,576          | 1,165,682               | -                                | 1,165,682   | -  |
| Subordinated debentures       | 10,310             | 10,310                  | -                                | -   | 10,310   |
| FHLB and other borrowings     | 104,072            | 104,072                 | -                                | 104,072   | -  |
| Accrued interest payable      | 353                | 353                     | -                                | 353   | -  |

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, securities are classified within Level 2 of the valuation hierarchy, and fair values are estimated by using pricing models, quoted prices of securities with similar characteristics, or discounted cash flow. Level 2 securities include U. S. agency securities, mortgage-backed securities, obligations of states and political subdivisions and certain corporate, asset-backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy.

Assets measured at fair value on a recurring basis are summarized below:

June 30, 2018

(\$ In Thousands)

|  | Fair Value | Fair Value Measurements Using                                  |   |   |
|--|------------|--|---|---|
|  |            | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Obligations of U. S. Government Agencies | \$21,263   | \$ -   | \$ 21,263                                     | \$ -                                      |
| Municipal securities                     | 156,453    | -  | 156,453                                       | -   |
| Mortgage-backed securities               | 248,652    | -  | 248,652                                       | -   |
| Corporate obligations                    | 10,643     | -  | 8,075   | 2,568                                     |
| Total                                    | \$437,011  | \$ -   | \$ 434,443                                    | \$ 2,568                                  |

December 31, 2017

(\$ In Thousands)

|  | Fair Value | Fair Value Measurements Using                                  |   |   |
|--|------------|--|---|---|
|  |            | Quoted Prices in Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Obligations of U. S. Government Agencies | \$ 4,992   | \$ -   | \$ 4,992                                      | \$ -                                      |
| Municipal securities                     | 138,584    | -  | 138,584                                       | -   |
| Mortgage-backed securities               | 196,578    | -  | 196,578                                       | -   |
| Corporate obligations                    | 15,819     | -  | 13,250  | 2,569                                     |

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|       |            |        |            |          |
|-------|------------|--------|------------|----------|
| Other | 920        | 920    | -          | -        |
| Total | \$ 356,893 | \$ 920 | \$ 353,404 | \$ 2,569 |

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The following is a reconciliation of activity for assets measured at fair value based on significant unobservable (non-market) information.

| (\$ In Thousands)  | Bank-Issued<br>Trust<br>Preferred<br>Securities |         |
|--|---|---------|
|  | 2018  | 2017    |
| Balance, January 1   | \$2,569   | \$2,241 |
| Transfers into Level 3   | -   | -       |
| Transfers out of Level 3   | -   | -       |
| Other-than-temporary impairment loss included in earnings (loss) | -   | -       |
| Unrealized gain (loss) included in comprehensive income          | (1 )  | 328     |
| Balance at June 30, 2018 and December 31, 2017                   | \$2,568   | \$2,569 |

The following table presents quantitative information about recurring Level 3 fair value measurements (in thousands):

| Trust Preferred<br>Securities | Fair<br>Value | Valuation<br>Technique | Significant<br>Unobservable<br>Inputs | Range of<br>Inputs |
|-------------------------------|---------------|------------------------|---------------------------------------|--------------------|
| June 30, 2018                 | \$2,568       | Discounted cash flow   | Probability of default                | 2.88% - 4.58%      |
| December 31, 2017             | \$2,569       | Discounted cash flow   | Probability of default                | 2.07% - 3.77%      |

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

#### *Impaired Loans*

Loans for which it is probable that the Company will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for estimating fair value include using the fair value of the collateral for collateral dependent loans or, where a loan is determined not to be collateral dependent, using the discounted cash flow method.

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a 10 percent discount factor to the value. If the impaired loan is determined not to be collateral dependent, then the discounted cash flow method is used. This method requires the impaired loan to be recorded at the present value of expected future cash flows discounted at the loan's effective interest rate. The effective interest rate of a loan is the contractual interest rate adjusted for any net deferred loan fees or costs, or premium or discount existing at origination or acquisition of the loan. Impaired loans are classified within Level 3 of the fair value hierarchy.

*Other Real Estate Owned*

Other real estate owned acquired through loan foreclosure is initially recorded by obtaining a current independent appraisal of the collateral and applying a 10 percent discount factor to the value. The adjustment at the time of foreclosure is recorded through the allowance for loan losses. Due to the subjective nature of establishing the fair value, the actual fair value of the other real estate owned or foreclosed asset could differ from the original estimate. If it is determined the fair value declines subsequent to foreclosure, a valuation allowance is recorded through non-interest expense. Operating costs associated with the assets are also recorded as non-interest expense. Gains and losses on the disposition of other real estate owned and foreclosed assets are netted and posted to other non-interest expense. Other real estate owned measured at fair value on a non-recurring basis at June 30, 2018, amounted to \$7.9 million. Other real estate owned is classified within Level 3 of the fair value hierarchy.

The following table presents the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fell at June 30, 2018 and December 31, 2017.

(\$ In Thousands)

June 30, 2018

|                         |            | Fair Value Measurements Using |             |              |
|-------------------------|------------|-------------------------------|-------------|--------------|
|                         |            | Quoted                        |             |              |
|                         |            | Prices                        |             |              |
|                         |            | in                            | Significant | Significant  |
|                         |            | Active                        | Other       | Unobservable |
|                         |            | Markets                       | Observable  | Inputs       |
|                         |            | For                           | Inputs      |              |
|                         |            | Identical                     |             |              |
|                         |            | Assets                        |             |              |
|                         | Fair Value | (Level                        | (Level 2)   | (Level 3)    |
|                         |            | 1)                            |             |              |
| Impaired loans          | \$ 13,547  | \$ -                          | \$ -        | \$ 13,547    |
| Other real estate owned | \$ 7,890   | -                             | -           | \$ 7,890     |

December 31, 2017

|                         |            | Fair Value Measurements Using |             |              |
|-------------------------|------------|-------------------------------|-------------|--------------|
|                         |            | Quoted                        |             |              |
|                         |            | Prices                        |             |              |
|                         |            | in                            | Significant | Significant  |
|                         |            | Active                        | Other       | Unobservable |
|                         |            | Markets                       | Observable  | Inputs       |
|                         |            | For                           | Inputs      |              |
|                         |            | Identical                     |             |              |
|                         |            | Assets                        |             |              |
|                         | Fair Value | (Level                        | (Level 2)   | (Level 3)    |
|                         |            | 1)                            |             |              |
| Impaired loans          | \$ 9,614   | \$ -                          | \$ -        | \$ 9,614     |
| Other real estate owned | 7,158      | -                             | -           | 7,158        |

**NOTE 9 - SECURITIES**

The following disclosure of the estimated fair value of financial instruments is made in accordance with authoritative guidance. The estimated fair value amounts have been determined using available market information and valuation methodologies that management believes are appropriate. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

A summary of the amortized cost and estimated fair value of available-for-sale securities and held-to-maturity securities at June 30, 2018 and December 31, 2017, follows:

**(\$ In Thousands)**

|   | <b>June 30, 2018</b>      |                                       |  |                                     |
|---|---------------------------|---------------------------------------|--|-------------------------------------|
|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
| Available-for-sale securities:  |                           |                                       |  |                                     |
| Obligations of U.S. Government agencies                                 | \$21,664                  | -                                     | \$ 401                                 | \$ 21,263                           |
| Tax-exempt and taxable obligations of states and municipal subdivisions | 156,891                   | 1,117                                 | 1,555                                  | 156,453                             |
| Mortgage-backed securities  | 253,071                   | 187                                   | 4,606                                  | 248,652                             |
| Corporate obligations   | 11,383                    | 10                                    | 750                                    | 10,643                              |
|   | \$443,009                 | \$ 1,314                              | \$ 7,312                               | \$ 437,011                          |
| Held-to-maturity securities:  |                           |                                       |  |                                     |
| Taxable obligations of states and municipal subdivisions                | \$6,000                   | \$ 1,183                              | \$ -                                   | \$ 7,183                            |
|   |                           |                                       |  |                                     |
|   | <b>December 31, 2017</b>  |                                       |  |                                     |
|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
| Available-for-sale securities:  |                           |                                       |  |                                     |
| Obligations of U.S. Government agencies                                 | \$4,996                   | \$ -                                  | \$ 4                                   | \$ 4,992                            |
| Tax-exempt and taxable obligations of states and municipal subdivisions | 137,281                   | 2,028                                 | 725                                    | 138,584                             |

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|  |           |          |          |            |
|--|-----------|----------|----------|------------|
| Mortgage-backed securities                               | 197,346   | 785      | 1,554    | 196,578    |
| Corporate obligations                                    | 16,599    | 21       | 801      | 15,819     |
| Other  | 1,256     | -        | 335      | 920        |
|  | \$357,478 | \$ 2,834 | \$ 3,419 | \$ 356,893 |
| Held-to-maturity securities:                             |           |          |          |            |
| Taxable obligations of states and municipal subdivisions | \$6,000   | \$ 1,398 | \$ -     | \$ 7,398   |

The scheduled maturities of securities at June 30, 2018 and December 31, 2017 were as follows:

| (\$ In Thousands)                      | June 30, 2018                           |                            | Held-to-Maturity  |                            |
|--|---|----------------------------|-------------------|----------------------------|
|  | Available-for-Sale<br>Amortized<br>Cost | Estimated<br>Fair<br>Value | Amortized<br>Cost | Estimated<br>Fair<br>Value |
| Due less than one year                 | \$ 19,499                               | \$ 19,466                  | \$ -              | \$ -                       |
| Due after one year through five years  | 57,467                                  | 57,923                     | -                 | -                          |
| Due after five years through ten years | 69,611                                  | 69,010                     | 6,000             | 7,183                      |
| Due greater than ten years             | 43,361                                  | 41,988                     | -                 | -                          |
| Mortgage-backed securities             | 253,071                                 | 248,624                    | -                 | -                          |
| Total                                  | \$ 443,009                              | \$ 437,011                 | \$ 6,000          | \$ 7,183                   |

| (\$ In Thousands)                      | December 31, 2017                       |                            | Held-to-Maturity  |                            |
|--|---|----------------------------|-------------------|----------------------------|
|  | Available-for-Sale<br>Amortized<br>Cost | Estimated<br>Fair<br>Value | Amortized<br>Cost | Estimated<br>Fair<br>Value |
| Due less than one year                 | \$ 14,048                               | \$ 14,062                  | \$ -              | \$ -                       |
| Due after one year through five years  | 49,519                                  | 49,776                     | -                 | -                          |
| Due after five years through ten years | 57,713                                  | 58,589                     | 6,000             | 7,398                      |
| Due greater than ten years             | 38,852                                  | 37,889                     | -                 | -                          |
| Mortgage-backed securities             | 197,346                                 | 196,577                    | -                 | -                          |
| Total                                  | \$ 357,478                              | \$ 356,893                 | \$ 6,000          | \$ 7,398                   |

Actual maturities can differ from contractual maturities because the obligations may be called or prepaid with or without penalties.

The details concerning securities classified as available-for-sale with unrealized losses as of June 30, 2018 and December 31, 2017 were as follows:

| (\$ In Thousands)  | June 30, 2018      |                         |                       |                         |            |                         |
|--|--------------------|-------------------------|-----------------------|-------------------------|------------|-------------------------|
|  | Losses < 12 Months |                         | Losses 12 Months or > |                         | Total      |                         |
|  | Fair Value         | Gross Unrealized Losses | Fair Value            | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Obligations of U.S. government agencies                                | \$ 19,339          | \$ 344                  | \$ 1,397              | \$ 57                   | \$ 20,736  | \$ 401                  |
| Tax-exempt and taxable obligations of state and municipal subdivisions | 76,098             | 1,096                   | 11,706                | 459                     | 87,804     | 1,555                   |
| Mortgage-backed securities   | 187,711            | 3,333                   | 34,917                | 1,273                   | 222,628    | 4,606                   |
| Corporate obligations  | 5,063              | 48                      | 3,178                 | 702                     | 8,241      | 750                     |
|  | \$ 288,211         | \$ 4,821                | \$ 51,198             | \$ 2,491                | \$ 339,409 | \$ 7,312                |

| (\$ In Thousands)  | December 31, 2017  |                         |                       |                         |            |                         |
|--|--------------------|-------------------------|-----------------------|-------------------------|------------|-------------------------|
|  | Losses < 12 Months |                         | Losses 12 Months or > |                         | Total      |                         |
|  | Fair Value         | Gross Unrealized Losses | Fair Value            | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Obligations of U.S. government agencies                                | \$ 4,992           | \$ 4                    | \$ -                  | \$ -                    | \$ 4,992   | \$ 4                    |
| Tax-exempt and taxable obligations of state and municipal subdivisions | 40,559             | 501                     | 8,723                 | 224                     | 49,282     | 725                     |
| Mortgage-backed securities   | 89,313             | 807                     | 33,287                | 747                     | 122,600    | 1,554                   |
| Corporate obligations  | 5,666              | 9                       | 3,156                 | 792                     | 8,822      | 801                     |
| Other  | -                  | -                       | 920                   | 335                     | 920        | 335                     |
|  | \$ 140,530         | \$ 1,321                | \$ 46,086             | \$ 2,098                | \$ 186,616 | \$ 3,419                |

At June 30, 2018 and December 31, 2017, the Company security portfolio consisted of 450 and 235, securities, respectively, that were in an unrealized loss position. The Company reviews its investment portfolio quarterly for indications of other-than-temporary impairment (“OTTI”), with attention given to securities in a continuous loss position of at least ten percent for over twelve months. Management believes that none of the losses on available-for-sale securities noted above constitute an OTTI. The noted losses are considered temporary due to market fluctuations in available interest rates. Management considers the issuers of the securities to be financially sound, the corporate bonds are investment grade, and the collectability of all contractual principal and interest payments is reasonably expected. No OTTI losses were recognized during the six months ended June 30, 2018 or the year ended December 31, 2017.

**NOTE 10 – LOANS**

Generally, the Company will place a delinquent loan in nonaccrual status when the loan becomes 90 days or more past due. At the time a loan is placed in nonaccrual status, all interest which has been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. The following tables summarize by class our loans classified as past due in excess of 30 days or more in addition to those loans classified as non-accrual:

|  | <b>June 30, 2018</b>          |  |                    |                                       |                     |
|--|-------------------------------|--|--------------------|---------------------------------------|---------------------|
|  | <b>(\$ In thousands)</b>      |  |                    |                                       |                     |
|  | <b>Past Due 30 to 89 Days</b> | <b>Past Due 90 Days or More and Still Accruing</b> | <b>Non-Accrual</b> | <b>Total Past Due and Non-Accrual</b> | <b>Total Loans</b>  |
| Real Estate-construction               | \$432                         | \$ 12  | \$ 322             | \$ 766                                | \$229,164           |
| Real Estate-mortgage                   | 4,570                         | 90   | 4,970              | 9,630                                 | 546,118             |
| Real Estate-non farm non-residential   | 1,086                         | 810  | 1,715              | 3,611                                 | 658,098             |
| Commercial                             | 169                           | -  | 1,325              | 1,494                                 | 228,584             |
| Lease Financing Rec.                   | -                             | -  | -                  | -                                     | 2,476               |
| Obligations of states and subdivisions | -                             | -  | -                  | -                                     | 10,627              |
| Consumer                               | 233                           | 28   | 108                | 369                                   | 35,204              |
| <b>Total</b>                           | <b>\$6,490</b>                | <b>\$ 940</b>                                      | <b>\$ 8,440</b>    | <b>\$ 15,870</b>                      | <b>\$ 1,710,271</b> |

|  | <b>December 31, 2017</b>      |  |                    |                                       |                     |
|--|-------------------------------|--|--------------------|---------------------------------------|---------------------|
|  | <b>(\$ In Thousands)</b>      |  |                    |                                       |                     |
|  | <b>Past Due 30 to 89 Days</b> | <b>Past Due 90 Days or More and Still Accruing</b> | <b>Non-Accrual</b> | <b>Total Past Due and Non-Accrual</b> | <b>Total Loans</b>  |
| Real Estate-construction               | \$192                         | \$ 27  | \$ 92              | \$ 311                                | \$183,328           |
| Real Estate-mortgage                   | 2,656                         | 176  | 2,692              | 5,524                                 | 385,099             |
| Real Estate-non farm non-residential   | 1,487                         | 82   | 1,724              | 3,293                                 | 467,484             |
| Commercial                             | 393                           | -  | 1,120              | 1,513                                 | 165,780             |
| Lease Financing Rec.                   | -                             | -  | -                  | -                                     | 2,450               |
| Obligations of states and subdivisions | -                             | -  | -                  | -                                     | 3,109               |
| Consumer                               | 57                            | -  | 46                 | 103                                   | 18,056              |
| <b>Total</b>                           | <b>\$4,785</b>                | <b>\$ 285</b>                                      | <b>\$ 5,674</b>    | <b>\$ 10,744</b>                      | <b>\$ 1,225,306</b> |





In connection with our acquisition of BCB Holding Company, Inc. in 2014, we acquired loans with deteriorated credit quality. These loans were recorded at estimated fair value at the acquisition date with no carryover of the related allowance for loan losses. The acquired loans were segregated as of the acquisition date between those considered to be performing (acquired non-impaired loans) and those with evidence of credit deterioration (acquired impaired loans). Acquired loans are considered impaired if there is evidence of credit deterioration and if it is probable, at acquisition, all contractually required payments will not be collected.

Total outstanding acquired impaired loans were \$2.0 million as of June 30, 2018 and \$2.0 million as of December 31, 2017. The outstanding balance of these loans is the undiscounted sum of all amounts, including amounts deemed principal, interest, fees, penalties, and other under the loans, owed at the reporting date, whether or not currently due and whether or not any such amounts have been charged off.

Changes in the carrying amount and accretable yield for acquired impaired loans were as follows at June 30, 2018 and December 31, 2017:

(\$ In Thousands)

|                                | <b>June 30, 2018</b>        |   | <b>December 31, 2017</b>    |   |
|--------------------------------|-----------------------------|---|-----------------------------|---|
|                                | <b>Accretable<br/>Yield</b> | <b>Carrying<br/>Amount of<br/>Loans</b> | <b>Accretable<br/>Yield</b> | <b>Carrying<br/>Amount of<br/>Loans</b> |
| Balance at beginning of period | \$ 836                      | \$ 1,185                                | \$ 894                      | \$ 1,305                                |
| Accretion                      | (25 )                       | 25                                      | (58 )                       | 58                                      |
| Payments received, net         |                             | (43 )                                   | -                           | (178 )                                  |
| Charge-off                     | (10 )                       | (10 )                                   | -                           | -                                       |
| Balance at end of period       | \$ 801                      | \$ 1,157                                | \$ 836                      | \$ 1,185                                |

The following tables provide additional detail of impaired loans broken out according to class as of June 30, 2018 and December 31, 2017. The recorded investment included in the following tables represents customer balances net of any partial charge-offs recognized on the loans, net of any deferred fees and costs. As nearly all of our impaired loans at June 30, 2018 are on nonaccrual status, recorded investment excludes any insignificant amount of accrued interest receivable on loans 90-days or more past due and still accruing. The unpaid balance represents the recorded balance prior to any partial charge-offs.

#### June 30, 2018

(\$ In Thousands)

|   | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment<br/>YTD</b> | <b>Interest<br/>Income<br/>Recognized<br/>YTD</b> |
|---|--------------------------------|---------------------------|------------------------------|--|---|
| Impaired loans with no related allowance: |                                |                           |                              |  |   |
| Commercial installment                    | \$ 283                         | \$283                     | \$ -                         | \$ 275   | \$ 2  |
| Commercial real estate                    | 3,762                          | 3,884                     | -                            | 3,902  | 54  |
| Consumer real estate                      | 5,795                          | 6,044                     | -                            | 3,354  | 62  |
| Consumer installment                      | 138                            | 145                       | -                            | 64   | 3   |
| Total                                     | \$ 9,978                       | \$10,356                  | \$ -                         | \$ 7,595   | \$ 121  |
| Impaired loans with a related allowance:  |                                |                           |                              |  |   |
| Commercial installment                    | \$ 1,043                       | \$1,043                   | \$ 435                       | \$ 979   | \$ -  |
| Commercial real estate                    | 2,658                          | 2,658                     | 193                          | 2,580  | 70  |
| Consumer real estate                      | 1,041                          | 1,058                     | 124                          | 679  | 9   |
| Consumer installment                      | 28                             | 28                        | 28                           | 22   | -   |
| Total                                     | \$ 4,770                       | \$4,787                   | \$ 780                       | \$ 4,260   | \$ 79   |
| Total Impaired Loans:                     |                                |                           |                              |  |   |
| Commercial installment                    | \$ 1,326                       | \$1,326                   | \$ 435                       | \$ 1,253   | \$ 2  |
| Commercial real estate                    | 6,420                          | 6,542                     | 193                          | 6,482  | 124   |
| Consumer real estate                      | 6,836                          | 7,102                     | 124                          | 4,033  | 71  |
| Consumer installment                      | 166                            | 173                       | 28                           | 87   | 3   |
| Total Impaired Loans                      | \$ 14,748                      | \$15,143                  | \$ 780                       | \$ 11,855  | \$ 200  |

As of June 30, 2018, the Company had \$1.3 million of foreclosed residential real estate property obtained by physical possession and \$0.3 million of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions.

December 31, 2017

(\$ In Thousands)

|   | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Average<br/>Recorded<br/>Investment<br/>YTD</b> | <b>Interest<br/>Income<br/>Recognized<br/>YTD</b> |
|---|--------------------------------|---------------------------|------------------------------|--|---|
| Impaired loans with no related allowance: |                                |                           |                              |  |   |
| Commercial installment                    | \$ 270                         | \$270                     | \$ -                         | \$ 90  | \$ 1  |
| Commercial real estate                    | 4,080                          | 4,176                     | -                            | 3,502  | 101   |
| Consumer real estate                      | 2,180                          | 2,424                     | -                            | 1,897  | 83  |
| Consumer installment                      | 29                             | 29                        | -                            | 17   | -   |
| Total                                     | \$ 6,559                       | \$6,899                   | \$ -                         | \$ 5,506   | \$ 185  |
| Impaired loans with a related allowance:  |                                |                           |                              |  |   |
| Commercial installment                    | \$ 850                         | \$850                     | \$ 267                       | \$ 262   | \$ 14   |
| Commercial real estate                    | 2,638                          | 2,638                     | 234                          | 2,756  | 112   |
| Consumer real estate                      | 504                            | 504                       | 137                          | 493  | 15  |
| Consumer installment                      | 23                             | 23                        | 23                           | 24   | -   |
| Total                                     | \$ 4,015                       | \$4,015                   | \$ 661                       | \$ 3,535   | \$ 141  |
| Total Impaired Loans:                     |                                |                           |                              |  |   |
| Commercial installment                    | \$ 1,120                       | \$1,120                   | \$ 267                       | \$ 352   | \$ 15   |
| Commercial real estate                    | 6,718                          | 6,814                     | 234                          | 6,258  | 213   |
| Consumer real estate                      | 2,684                          | 2,928                     | 137                          | 2,390  | 98  |
| Consumer installment                      | 52                             | 52                        | 23                           | 41   | -   |
| Total Impaired Loans                      | \$ 10,574                      | \$10,914                  | \$ 661                       | \$ 9,041   | \$ 326  |

The following table is a summary of interest recognized and cash-basis interest earned on impaired loans:

| (\$ In Thousands)                            | <b>Three Months<br/>Ended<br/>June 30, 2018</b> | <b>Six Months<br/>Ended<br/>June 30, 2018</b> |
|--|---|---|
| Interest income recognized during impairment | \$ 99   | \$ 161  |
| Cash-basis interest income recognized        | 99  | 200   |

The gross interest income that would have been recorded in the period that ended if the nonaccrual loans had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the three months and six months ended June 30, 2018 was \$143,000 and \$230,000, respectively. The Company had no loan commitments to borrowers in non-accrual status at June 30, 2018 and December 31, 2017.

If the Company grants a concession to a borrower in financial difficulty, the loan is classified as a troubled debt restructuring (“TDR”).

There were no TDRs modified during the three month and six month periods ended June 30, 2018. There were 5 and 0 TDRs modified during the three months and six months ended June 30, 2017, respectively. The balance of TDRs was \$9.1 million at June 30, 2018 and \$6.9 million at December 31, 2017, respectively. The increase of \$2.2 million is attributable to the acquisitions. There was \$0.2 million allocated in specific reserves established with respect to these loans as of June 30, 2018. As of June 30, 2018, the Company had no additional amount committed on any loan classified as TDR.

The following tables set forth the amounts and past due status for the Bank TDRs at June 30, 2018 and December 31, 2017:

(\$ In Thousands)

**June 30, 2018**

| <b>Current<br/>Loans</b> | <b>Past Due<br/>30-89</b> | <b>Past Due<br/>90 days<br/>and still<br/>accruing</b> | <b>Non-<br/>accrual</b> | <b>Total</b> |
|--------------------------|---------------------------|--|-------------------------|--------------|
|--------------------------|---------------------------|--|-------------------------|--------------|

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|                           |         |    |   |    |   |         |         |
|---------------------------|---------|----|---|----|---|---------|---------|
| Commercial installment    | \$15    | \$ | - | \$ | - | \$-     | \$15    |
| Commercial real estate    | 3,608   |    | - |    | - | 1,230   | 4,838   |
| Consumer real estate      | 2,567   |    | - |    | - | 1,562   | 4,129   |
| Consumer installment      | 119     |    | - |    | - | 33      | 152     |
| Total                     | \$6,309 | \$ | - | \$ | - | \$2,825 | \$9,134 |
| Allowance for loan Losses | \$158   | \$ | - | \$ | - | \$19    | \$177   |

30

(\$ In Thousands)

|                           | December 31, 2017 |                   |  |                 | Total   |
|---------------------------|-------------------|-------------------|--|-----------------|---------|
|                           | Current<br>Loans  | Past Due<br>30-89 | Past Due<br>90 days<br>and still<br>accruing | Non-<br>accrual |         |
| Commercial installment    | \$-               | \$ -              | \$ -   | \$ -            | \$-     |
| Commercial real estate    | 3,702             | 92                | -  | 1,025           | 4,819   |
| Consumer real estate      | 1,012             | 89                | -  | 987             | 2,088   |
| Consumer installment      | -                 | -                 | 5  | 18              | 23      |
| Total                     | \$4,714           | \$ 181            | \$ 5   | \$ 2,030        | \$6,930 |
| Allowance for loan losses | \$ 100            | \$ 22             | \$ 5   | \$ 27           | \$ 154  |

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms. There was 1 loan which totaled \$86,000 and 2 loans which totaled \$283,000 that were modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the quarter ending June 30, 2018 and June 30, 2017, respectively. There were 3 loans which totaled \$381,000 and 2 loans which totaled \$283,000 that were modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the six months ending June 30, 2018 and June 30, 2017, respectively.

#### Internal Risk Ratings

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 uses the following definitions for risk ratings, which are consistent with the definitions used in supervisory guidance:

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

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

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

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.



As of June 30, 2018 and December 31, 2017, and based on the most recent analysis performed, the risk categories of loans by class of loans (excluding mortgage loans held for sale) were as follows:

June 30, 2018

(\$ In Thousands)

|                                 | <b>Real<br/>Estate</b> | <b>Real<br/>Estate</b> | <b>Installment<br/>and<br/>Other</b> | <b>Commercial,<br/>Financial and<br/>Agriculture</b> | <b>Total</b> |
|---------------------------------|------------------------|------------------------|--------------------------------------|--|--------------|
|                                 | <b>Commercial</b>      | <b>Mortgage</b>        |                                      |  |              |
| Pass                            | \$ 1,039,742           | \$ 344,592             | \$ 54,329                            | \$ 225,908   | \$ 1,664,571 |
| Special Mention                 | 14,305                 | 2,142                  | -                                    | 2,864  | 19,311       |
| Substandard                     | 17,777                 | 6,722                  | 551                                  | 1,765  | 26,815       |
| Doubtful                        | 90                     | -                      | -                                    | 454  | 544          |
| Subtotal                        | \$ 1,071,914           | \$ 353,456             | \$ 54,880                            | \$ 230,991   | \$ 1,711,241 |
| Less:                           |                        |                        |                                      |  |              |
| Unearned discount               | 970                    | -                      | -                                    | -  | 970          |
| Loans, net of unearned discount | \$ 1,070,944           | \$ 353,456             | \$ 54,880                            | \$ 230,991   | \$ 1,710,271 |

December 31, 2017

(\$ In Thousands)

|                                 | <b>Real<br/>Estate</b> | <b>Real<br/>Estate</b> | <b>Installment<br/>and<br/>Other</b> | <b>Commercial,<br/>Financial and<br/>Agriculture</b> | <b>Total</b> |
|---------------------------------|------------------------|------------------------|--------------------------------------|--|--------------|
|                                 | <b>Commercial</b>      | <b>Mortgage</b>        |                                      |  |              |
| Pass                            | \$ 763,572             | \$ 226,178             | \$ 28,482                            | \$ 166,819   | \$ 1,185,051 |
| Special Mention                 | 15,987                 | 680                    | -                                    | 2,908  | 19,575       |
| Substandard                     | 14,979                 | 4,622                  | 80                                   | 1,905  | 21,586       |
| Doubtful                        | 94                     | -                      | -                                    | 23   | 117          |
| Subtotal                        | 794,632                | 231,480                | 28,562                               | 171,655  | 1,226,329    |
| Less:                           |                        |                        |                                      |  |              |
| Unearned discount               | 710                    | 65                     | -                                    | 248  | 1,023        |
| Loans, net of unearned discount | \$ 793,922             | \$ 231,415             | \$ 28,562                            | \$ 171,407   | \$ 1,225,306 |

Activity in the allowance for loan losses for the period was as follows:

| (\$ In Thousands)                           | <b>Three Months<br/>Ended<br/>June 30, 2018</b> | <b>Six Months<br/>Ended<br/>June 30, 2018</b> |
|---|---|---|
| Balance at beginning of period              | \$ 8,659  | \$ 8,288                                      |
| Loans charged-off:                          |   |   |
| Real Estate                                 | (13 )   | (17 )   |
| Installment and Other                       | (13 )   | (32 )   |
| Commercial, Financial and Agriculture       | (5 )  | (5 )  |
| Total                                       | (31 )   | (54 )   |
| Recoveries on loans previously charged-off: |   |   |
| Real Estate                                 | 41  | 63  |
| Installment and Other                       | (24 )   | 63  |
| Commercial, Financial and Agriculture       | 10  | 18  |
| Total                                       | 27  | 144   |
| Net recoveries (charge-off)                 | (4 )  | 90  |
| Provision for Loan Losses                   | 857   | 1,134   |
| Balance at end of period                    | \$ 9,512  | \$ 9,512                                      |

The following tables represent how the allowance for loan losses is allocated to a particular loan type, as well as the percentage of the category to total loans at June 30, 2018 and December 31, 2017.

The following tables provide the ending balances in the Company's loans (excluding mortgage loans held for sale) and allowance for loan losses, broken down by portfolio segment as of June 30, 2018 and December 31, 2017. The tables also provide additional detail as to the amount of our loans and allowance that correspond to individual versus collective impairment evaluation. The impairment evaluation corresponds to the Company's systematic methodology for estimating its Allowance for Loan Losses. See Item 2. – “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Provision for Loan and Lease Losses” for a description of our methodology.

### June 30, 2018

(\$ In thousands)

|                                  | <b>Real Estate</b>  | <b>Installment<br/>and<br/>Other</b> | <b>Commercial<br/>Financial<br/>and<br/>Agriculture</b> | <b>Total</b>        |
|----------------------------------|---------------------|--------------------------------------|---|---------------------|
| <b>Loans</b>                     |                     |                                      |   |                     |
| Individually evaluated           | \$ 13,256           | \$ 165                               | \$ 1,327  | \$ 14,748           |
| Collectively evaluated           | 1,419,213           | 35,659                               | 240,651   | 1,695,523           |
| <b>Total</b>                     | <b>\$ 1,432,469</b> | <b>\$ 35,824</b>                     | <b>\$ 241,978</b>                                       | <b>\$ 1,710,271</b> |
| <b>Allowance for Loan Losses</b> |                     |                                      |   |                     |
| Individually evaluated           | \$ 318              | \$ 28                                | \$ 435  | \$ 781              |
| Collectively evaluated           | 6,999               | 155                                  | 1,577   | 8,731               |
| <b>Total</b>                     | <b>\$ 7,317</b>     | <b>\$ 183</b>                        | <b>\$ 2,012</b>   | <b>\$ 9,512</b>     |

### December 31, 2017

(\$ In thousands)

|                                  | <b>Real Estate</b>  | <b>Installment<br/>and<br/>Other</b> | <b>Commercial,<br/>Financial<br/>and<br/>Agriculture</b> | <b>Total</b>        |
|----------------------------------|---------------------|--------------------------------------|--|---------------------|
| <b>Loans</b>                     |                     |                                      |  |                     |
| Individually evaluated           | \$ 9,402            | \$ 52                                | \$ 1,120   | \$ 10,574           |
| Collectively evaluated           | 1,015,934           | 28,511                               | 170,287  | 1,214,732           |
| <b>Total</b>                     | <b>\$ 1,025,336</b> | <b>\$ 28,563</b>                     | <b>\$ 171,407</b>  | <b>\$ 1,225,306</b> |
| <b>Allowance for Loan Losses</b> |                     |                                      |  |                     |
| Individually evaluated           | \$ 371              | \$ 23                                | \$ 267   | \$ 661              |
| Collectively evaluated           | 5,952               | 334                                  | 1,341  | 7,627               |

|       |         |        |          |         |
|-------|---------|--------|----------|---------|
| Total | \$6,323 | \$ 357 | \$ 1,608 | \$8,288 |
|-------|---------|--------|----------|---------|

## NOTE 11 – REVENUE FROM CONTRACTS WITH CUSTOMERS

On January 1, 2018, the Company adopted ASU No. 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 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 or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract; (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation.

The Company concluded that there was no change to the timing and pattern of revenue recognition for its current revenue streams or the presentation of revenue as gross versus net. No adjustment to retained earnings was required on the adoption date. Because there was no change to the timing and pattern of revenue recognition, there were no material changes to the Company's processes and internal controls.

All of the Company's revenue from contracts with customers within the scope of ASC 606 is recognized within noninterest income. The guidance does not apply to revenue associated with financial instruments, including loans and investment securities that are accounted for under other GAAP, which comprise a significant portion of our revenue stream. A description of the Company's revenue streams accounted for under ASC 606 is as follows:

Service Charges on Deposit Accounts: The Company earns fees from deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed at the point in the time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Interchange Income: The Company earns interchange fees from debit and credit card holder transaction conducted through various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided by the cardholder.

Gains/Losses on Sales of OREO: The Company records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether the collectability of the transaction prices is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The following table presents the Company's sources of non-interest income for the three months ended June 30, 2018 and 2017 and six months ended June 30, 2018 and 2017. Items outside the scope of ASC 606 are noted as such.

|                             | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2018</b> | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2017</b> | <b>Six<br/>Months<br/>Ended<br/>June 30,<br/>2018</b> | <b>Six<br/>Months<br/>Ended<br/>June 30,<br/>2017</b> |
|-----------------------------|---|---|---|---|
| Non-interest income         |   |   |   |   |
| Service charges on Deposits |   |   |   |   |
| Overdraft fees              | \$ 711  | \$ 550  | \$ 1,338  | \$ 1,119  |
| Other                       | 630   | 372   | 1,030   | 671   |
| Interchange income          | 1,500   | 959   | 2,540   | 1,862   |
| Investment brokerage Fees   | 10  | 4   | 26  | 8   |
| Loan servicing fees         | -   | -   | -   | -   |
| Net losses on securities    | (5 )  | (1 )  | (5 )  | (9 )  |
| Other                       | 2,786   | 1,873   | 4,162   | 3,497   |
| Total non-interest income   | \$ 5,632  | \$ 3,757  | \$ 9,091  | \$ 7,148  |

**NOTE 12 – SUBSEQUENT EVENTS/OTHER**

Subsequent events have been evaluated by management through the date the financial statements were issued.

**FMB Banking Corporation**

On July 24, 2018, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with FMB Banking Corporation, a Florida corporation (“FMB”), whereby FMB will be merged with and into the Company. Pursuant to and simultaneously with entering into the Merger Agreement, The First, and FMB’s wholly owned subsidiary bank, Farmers & Merchants Bank, entered into a Plan of Bank Merger whereby Farmers & Merchants Bank will be merged with and into The First immediately following the merger of FMB with and into the Company with a purchase price of approximately \$80.0 million. At June 30, 2018, FMB had total assets of approximately \$480.7 million.

**NOTE 13 – RECLASSIFICATION**

Certain amounts in the 2017 financial statements have been reclassified for comparative purposes to conform to the current period financial statement presentation.





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

### FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as “expects,” “will,” “intends,” “anticipates,” “plans,” “believes,” “seeks,” “estimates,” and “may” and variations of such words and similar expressions are intended to identify such forward-looking statements. Such statements are based on currently available information and are subject to various risks and uncertainties that could cause actual results to differ materially from the Company’s present expectations. Factors that might cause such differences include, but are not limited to: competitive pressures among financial institutions increasing significantly; economic conditions, either nationally or locally, in areas in which the Company conducts operations being less favorable than expected; interest rate risk; legislation or regulatory changes which adversely affect the ability of the consolidated Company to conduct business combinations or new operations; and risks related to the acquisitions of Southwest Banc Shares, Inc., Sunshine Financial, Inc. and FMB, including the risk that anticipated benefits from the transactions are not realized in the time frame anticipated or at all as a result of changes in general economic and market conditions or other unexpected factors or events.

Potential risks and uncertainties that could cause our actual results to differ materially from those anticipated in any forward-looking statements include, but are not limited to, the following:

- reduced earnings due to higher credit losses generally and specifically because losses in the sectors of our loan portfolio secured by real estate are greater than expected due to economic factors, including declining real estate values, increasing interest rates, increasing unemployment, or changes in payment behavior or other factors;
- general economic conditions, either nationally or regionally and especially in our primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;
- adverse changes in asset quality and resulting credit risk-related losses and expenses;
- ability of borrowers to repay loans, which can be adversely affected by a number of factors, including changes in economic conditions, adverse trends or events affecting business industry groups, reductions in real estate values or markets, business closings or lay-offs, natural disasters, and international instability;
- changes in monetary and tax policies, including potential impacts from the Tax Cuts and Jobs Act;

- changes in political conditions or the legislative or regulatory environment;

- the adequacy of the level of our allowance for loan losses and the amount of loan loss provisions required to replenish the allowance in future periods;

- reduced earnings due to higher credit losses because our loans are concentrated by loan type, industry segment, borrower type, or location of the borrower or collateral;

- changes in the interest rate environment which could reduce anticipated or actual margins;

- increased funding costs due to market illiquidity, increased competition for funding, higher interest rates, and increased regulatory requirements with regard to funding;

- results of examinations by our regulatory authorities, including the possibility that the regulatory authorities may, among other things, require us to increase our allowance for loan losses through additional loan loss provisions or write-down of our assets;

- the rate of delinquencies and amount of loans charged-off;
- the impact of our efforts to raise capital on our financial position, liquidity, capital, and profitability;
- risks and uncertainties relating to not successfully closing and integrating the currently contemplated acquisitions within our currently expected timeframe and other terms;
- significant increases in competition in the banking and financial services industries;
- changes in the securities markets; and
- loss of consumer confidence and economic disruptions resulting from national disasters or terrorist activities;
- our ability to retain our existing customers, including our deposit relationships;
- changes occurring in business conditions and inflation;
- changes in technology;
- changes in deposit flows;
- changes in accounting principles, policies, or guidelines;
- our ability to maintain adequate internal controls over financial reporting;
- other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission (“SEC”).

The Company disclaims any obligation to update such factors or to publicly announce the results of any revisions to any of the forward-looking statements included herein to reflect future events or developments. Further information on The First Bancshares, Inc. is available in its filings with the Securities and Exchange Commission, available at the SEC’s website, <http://www.sec.gov>.

**CRITICAL ACCOUNTING POLICIES**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and incorporate various assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the allowance for loan and lease losses (referred to as the "allowance for loan losses" or the "ALLL"), as explained in detail in Note 10 - Loans to the Consolidated Financial Statements and in the "Allowance for Loan and Lease Losses" sections of this Item 2. – Management's Discussion and Analysis of Financial Condition and Results of Operations; the valuation of impaired loans and foreclosed assets, as discussed in Note 10 - Loans to the Consolidated Financial Statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this Item No. 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations; and goodwill and other intangible assets, which are evaluated annually for impairment and for which we have determined that no impairment exists, as discussed in the "Other Assets" section of this Item 2. – Management's Discussion and Analysis of Financial Condition and Results of Operations. Critical accounting policies are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate our most recent expectations with regard to those areas.

## **OVERVIEW OF THE RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

### **RESULTS OF OPERATIONS SUMMARY**

#### **Second quarter 2018 compared to second quarter 2017**

The Company reported net income available to common shareholders of \$5.2 million for the three months ended June 30, 2018, compared with net income available to common shareholders of \$2.4 million for the same period last year.

Net interest income increased to \$21.6 million, or 45.4% for the three months ended June 30, 2018, compared to \$14.8 million for the same period in 2017. Quarterly average earning assets at June 30, 2018, increased \$651.4 million, or 41.3% and quarterly average interest-bearing liabilities increased \$484.5 million or 38.2% when compared to June 30, 2017.

Noninterest income for the three months ended June 30, 2018, was \$5.6 million compared to \$3.8 million for the same period in 2017, reflecting an increase of \$1.9 million or 49.9%. This increase was composed of increases in service charges and interchange fee income of \$1.0 million. The Company also received a financial assistance award of \$0.9 million from the U.S. Treasury during the second quarter of 2018 as a result of our designation as a Community Development Financial Institution.

The provision for loan losses was \$857,000 for the three months ended June 30, 2018, compared with \$248,000 for the same period in 2017. The allowance for loan losses of \$9.5 million at June 30, 2018 or .56% of total loans is considered by management to be adequate to cover losses inherent in the loan portfolio. See “Allowance for Loan and Lease Losses” in this Item 2. – Management’s Discussion and Analysis of Financial Condition and Results of Operations for more information on this evaluation.

Noninterest expense was \$19.7 million for the three months ended June 30, 2018, an increase of \$4.6 million or 30.6%, when compared with the same period in 2017. Excluding acquisition charges of \$3.8 million and \$2.7 million for second quarter of 2018 and 2017, respectively, non-interest expense increased \$3.5 million in the second quarter of 2018 as compared to second quarter of 2017, of which \$1.8 million is attributable to the salaries and benefits related to the acquisitions of First Community Bank and Sunshine Community Bank.

**First half 2018 compared to first half 2017**

The Company had reported net income available to common shareholders of \$9.2 million for the six months ended June 30, 2018, compared to \$3.5 million for the same period last year. Operating net earnings increased \$6.1 million or 82.5% from \$7.4 million at June 30, 2017 to \$13.5 million at June 30, 2018. Operating net earnings excludes merger-related costs of \$4.3 million, net of tax for the year to date period ending June 30, 2018 and \$3.9 million, net of tax for the year to date period ending June 30, 2017.

Net interest income increased to \$37.9 million from \$29.0 million for the six months ended June 30, 2018, or an increase of 30.9% as compared to the same period in 2017. This increase was primarily due to interest earned on a high volume of loans as well as higher interest rates. Average earning assets at June 30, 2018, increased \$588.6 million, or 35.9% and average interest-bearing liabilities also increased \$464.8 million or 36.0% when compared to December 31, 2017.

Noninterest income for the six months ended June 30, 2018, was \$9.1 compared to \$7.1 million for the same period in 2017, reflecting an increase of \$1.9 million or 27.2%. This increase consists of the \$0.9 million financial assistance award, increased service charges of \$0.6 million and increased interchange fee income of \$0.7 million.

The provision for loan losses was \$1.1 million for the six months ended June 30, 2018, compared with \$294,000 for the same period in 2017. The allowance for loan losses of \$9.5 million at June 30, 2018 (approximately 0.56% of total loans) is considered by management to be adequate to cover losses inherent in the loan portfolio. Total valuation accounting adjustments total \$7.0 million on acquired loans. The level of this allowance is dependent upon a number of factors, including the total amount of past due loans, general economic conditions, and management's assessment of potential losses. This evaluation is inherently subjective as it requires estimates that are susceptible to significant change. Ultimately, losses may vary from current estimates and future additions to the allowance may be necessary.

Thus, there can be no assurance that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the loan loss allowance will not be required. Management evaluates the adequacy of the allowance for loan losses quarterly and makes provisions for loan losses based on this evaluation.

Noninterest expense was \$34.3 million for the six months ended June 30, 2018, an increase of \$3.1 million or 10.0%, when compared with the same period in 2017. \$2.0 million of the increase was attributable to the salaries and benefits related to the acquisitions of First Community Bank and Sunshine Bank. Increases in occupancy, FDIC premiums, amortization of core deposit intangibles and other non-interest expense were also attributable to the acquisitions.

#### FINANCIAL CONDITION

The First represents the primary asset of the Company. The First reported total assets of \$2.5 billion at June 30, 2018 compared to \$1.8 billion at December 31, 2017, an increase of \$0.7 billion. Loans increased \$485.0 million to \$1.710 billion or 39.6%, during the first six months of 2018. Deposits at June 30, 2018, totaled \$2.1 billion compared to \$1.5 billion at December 31, 2017. The First acquired loans of \$437.1 million, net of fair value marks and deposits of \$509.2 million, net of fair value marks as a result of the acquisitions of First Community Bank and Sunshine Bank during the first half of 2018. See Note 4 – Business Combinations to the Consolidated Financial Statements.

For the six month period ended June 30, 2018, The First reported net income of \$11.6 million compared to \$4.6 million for the six months ended June 30, 2017. Merger charges net of tax equaled \$4.3 million for the first six months of 2018 as compared to \$3.9 million for the first half of 2017.

## **EARNINGS PERFORMANCE**

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees as well as mortgage income but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expense is comprised of operating costs that facilitate offering a full range of banking services to our customers.



## Net interest income AND NET INTEREST MARGIN

Net interest income increased by \$6.7 million, or 45.4%, for the second quarter of 2018 relative to the second quarter of 2017. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

The following tables depict, for the periods indicated, certain information related to the average balance sheet and average yields on assets and average costs of liabilities. Such yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities. Average balances have been derived from daily averages.

## Average Balances, Tax Equivalent Interest and Yields/Rates

| (\$ In Thousands)                        | Three Months Ended<br>June 30, 2018 |                               |                | Three Months Ended<br>June 30, 2017 |                               |                |
|--|-------------------------------------|-------------------------------|----------------|-------------------------------------|-------------------------------|----------------|
|  | Avg.<br>Balance                     | Tax<br>Equivalent<br>interest | Yield/<br>Rate | Avg.<br>Balance                     | Tax<br>Equivalent<br>interest | Yield/<br>Rate |
| Earning Assets:                          |                                     |                               |                |                                     |                               |                |
| Taxable securities                       | \$ 328,898                          | \$ 2,423                      | 2.95 %         | \$ 282,235                          | \$ 1,605                      | 2.27 %         |
| Tax exempt securities                    | 117,875                             | 1,015                         | 3.44 %         | 95,272                              | 897                           | 3.77 %         |
| Total investment securities              | 446,773                             | 3,438                         | 3.08 %         | 377,507                             | 2,502                         | 2.65 %         |
| Fed funds sold                           | 17,242                              | 61                            | 1.42 %         | 39,048                              | 95                            | 0.97 %         |
| Interest bearing deposits in other banks | 68,079                              | 81                            | 0.48 %         | 5,214                               | 2                             | 0.15 %         |
| Loans                                    | 1,696,737                           | 21,714                        | 5.12 %         | 1,155,699                           | 14,170                        | 4.90 %         |
| Total earning assets                     | 2,228,831                           | 25,294                        | 4.54 %         | 1,577,468                           | 16,769                        | 4.25 %         |
| Other assets                             | 214,345                             |                               |                | 173,624                             |                               |                |
| Total assets                             | \$ 2,443,176                        |                               |                | \$ 1,751,092                        |                               |                |

## Interest-bearing liabilities:

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|  |             |           |        |             |           |        |
|--|-------------|-----------|--------|-------------|-----------|--------|
| Deposits                                   | \$1,676,110 | \$ 2,547  | 0.61 % | \$1,211,959 | \$ 1,303  | 0.43 % |
| Reverse Repurchase Agreement               | -           | -         | -      | 5,000       | 48        | 3.84 % |
| Fed funds purchased                        | 1,382       | 9         | 2.60 % | 1,906       | 8         | 1.68 % |
| FHLB and First Tennessee                   | 22,959      | 138       | 2.40 % | 40,765      | 203       | 1.99 % |
| Subordinated debentures                    | 54,036      | 774       | 5.73 % | 10,310      | 67        | 2.60 % |
| Total interest-bearing liabilities         | 1,754,487   | 3,468     | 0.79 % | 1,269,940   | 1,629     | 0.51 % |
| Other liabilities                          | 414,154     |           |        | 325,485     |           |        |
| Stockholders' equity                       | 274,535     |           |        | 155,667     |           |        |
| Total liabilities and stockholders' equity | \$2,443,176 |           |        | \$1,751,092 |           |        |
| Net interest income                        |             | \$ 21,569 |        |             | \$ 14,835 |        |
| Net interest margin                        |             |           | 3.87 % |             |           | 3.76 % |
| Net interest income (FTE)*                 |             | \$ 21,826 | 3.75 % |             | \$ 15,140 | 3.74 % |
| Net interest Margin (FTE)*                 |             |           | 3.92 % |             |           | 3.84 % |

\*See reconciliation of Non-GAAP financial measures.

## Average Balances, Tax Equivalent Interest and Yields/Rates

| (\$ In Thousands)                          | YTD June 30, 2018 |                         |             | YTD June 30, 2017 |                         |             |
|--|-------------------|-------------------------|-------------|-------------------|-------------------------|-------------|
|  | Avg. Balance      | Tax Equivalent interest | Yield/ Rate | Avg. Balance      | Tax Equivalent interest | Yield/ Rate |
| <b>Earning Assets:</b>                     |                   |                         |             |                   |                         |             |
| Taxable securities                         | \$ 307,135        | \$ 4,409                | 2.87 %      | \$ 258,514        | \$ 3,139                | 2.43 %      |
| Tax exempt securities                      | 112,050           | 1,919                   | 3.43 %      | 91,154            | 1,792                   | 3.93 %      |
| Total investment securities                | 419,185           | 6,328                   | 3.02 %      | 349,668           | 4,931                   | 2.82 %      |
| Fed funds sold                             | 14,750            | 96                      | 1.30 %      | 44,851            | 219                     | 0.98 %      |
| Interest Bearing deposits in other banks   | 64,495            | 158                     | 0.49 %      | 5,100             | 4                       | 0.16 %      |
| Loans                                      | 1,597,739         | 37,699                  | 4.72 %      | 1,138,097         | 27,670                  | 4.86 %      |
| Total earning assets                       | 2,096,169         | 44,281                  | 4.22 %      | 1,537,716         | 32,824                  | 4.27 %      |
| Other assets                               | 198,513           |                         |             | 198,822           |                         |             |
| Total assets                               | \$2,294,682       |                         |             | \$1,736,538       |                         |             |
| <b>Interest-bearing liabilities:</b>       |                   |                         |             |                   |                         |             |
| Deposits                                   | \$1,561,573       | \$ 4,387                | 0.56 %      | \$1,182,189       | \$ 2,461                | 0.42 %      |
| Reverse Repurchase Agreement               | -                 | -                       | 0.00 %      | 5,000             | 96                      | 3.84 %      |
| Fed funds purchased                        | 795               | 10                      | 2.52 %      | 1,398             | 10                      | 1.43 %      |
| FHLB and First Tennessee                   | 47,524            | 597                     | 2.51 %      | 59,883            | 517                     | 1.73 %      |
| Subordinated debentures                    | 32,294            | 852                     | 5.28 %      | 10,310            | 130                     | 2.52 %      |
| Total interest-bearing liabilities         | 1,642,186         | 5,846                   | 0.71 %      | 1,258,780         | 3,214                   | 0.51 %      |
| Other liabilities                          | 399,969           |                         |             | 321,031           |                         |             |
| Stockholders' equity                       | 252,527           |                         |             | 156,727           |                         |             |
| Total liabilities and stockholders' equity | \$2,294,682       |                         |             | \$1,736,538       |                         |             |
| Net interest income                        |                   | \$ 37,949               |             |                   | \$ 29,003               |             |
| Net interest margin                        |                   |                         | 3.62 %      |                   |                         | 3.77 %      |
| Net interest income (FTE)*                 |                   | \$ 38,435               | 3.51 %      |                   | \$ 29,610               | 3.76 %      |
| Net interest Margin (FTE)*                 |                   |                         | 3.67 %      |                   |                         | 3.85 %      |

\*See reconciliation of Non-GAAP financial measures.



**NON-INTEREST INCOME AND NON-INTEREST EXPENSE**

The following table provides details on the Company's non-interest income and non-interest expense for the three- and six-month periods ended June 30, 2018 and 2017:

| (\$ In Thousands)<br>EARNINGS STATEMENT  | Three Months Ended |            |          |            | Six Months Ended |            |          |            |
|--|--------------------|------------|----------|------------|------------------|------------|----------|------------|
|  | 6/30/18            | % of Total | 6/30/17  | % of Total | 6/30/18          | % of Total | 6/30/17  | % of Total |
| Non-interest income:                     |                    |            |          |            |                  |            |          |            |
| Service charges on deposit accounts      | \$1,341            | 23.8 %     | \$922    | 24.5 %     | \$2,368          | 26.1 %     | \$1,790  | 25.0 %     |
| Mortgage fee income                      | 1,213              | 21.6 %     | 1,208    | 32.2 %     | 2,013            | 22.1 %     | 2,124    | 29.8 %     |
| Interchange fee income                   | 1,500              | 26.6 %     | 959      | 25.5 %     | 2,540            | 27.9 %     | 1,862    | 26.0 %     |
| Gain (loss) on securities, net           | (5 )               | (0.1 )%    | (1 )     | -          | (5 )             | (0.1 )%    | (9 )     | (0.1 )%    |
| Financial Assistance Award               | 917                | 16.3 %     | -        | -          | 917              | 10.1 %     | -        | -          |
| Other charges and fees                   | 666                | 11.8 %     | 669      | 17.8 %     | 1,258            | 13.9 %     | 1,381    | 19.3 %     |
| Total non-interest income                | \$5,632            | 100 %      | \$3,757  | 100 %      | \$9,091          | 100 %      | \$7,148  | 100 %      |
| Non-interest expense:                    |                    |            |          |            |                  |            |          |            |
| Salaries and employee benefits           | 9,502              | 48.3 %     | 7,625    | 50.6 %     | 17,291           | 50.5 %     | 15,247   | 48.9 %     |
| Occupancy expense                        | 2,034              | 10.3 %     | 1,348    | 8.9 %      | 3,680            | 10.8 %     | 2,718    | 8.7 %      |
| FDIC premiums                            | 368                | 1.9 %      | 331      | 2.2 %      | 735              | 2.1 %      | 532      | 1.7 %      |
| Marketing                                | 70                 | 0.4 %      | 99       | 0.7 %      | 150              | 0.4 %      | 168      | 0.5 %      |
| Amortization of core deposit intangibles | 356                | 1.8 %      | 182      | 1.2 %      | 557              | 1.6 %      | 331      | 1.1 %      |
| Other professional services              | 438                | 2.2 %      | 567      | 3.8 %      | 627              | 1.8 %      | 910      | 2.9 %      |
| Other non-interest expense               | 3,074              | 15.6 %     | 2,236    | 14.8 %     | 5,641            | 16.5 %     | 4,979    | 16.0 %     |
| Acquisition and integration charges      | 3,838              | 19.5 %     | 2,682    | 17.8 %     | 5,596            | 16.3 %     | 6,280    | 20.2 %     |
| Total non-interest expense               | \$19,680           | 100 %      | \$15,070 | 100 %      | \$34,277         | 100 %      | \$31,165 | 100 %      |

Second quarter 2018 noninterest income increased \$1.9 million, or 49.9% as compared to second quarter 2017. The largest increases in noninterest income were the \$0.9 million financial assistance award coupled with increases in service charges and interchange fee income. Second quarter 2018 noninterest expense increased \$4.6 million, or 30.6% as compared to second quarter 2017. Excluding acquisition charges of \$3.8 million and \$2.7 million for the second quarter of 2018 and 2017, respectively, non-interest expense increased \$3.4 million as compared to second quarter of 2017, as a result of increases in salaries and benefits attributed to the acquisitions of First Community Bank and Sunshine Bank.

Non-interest income was \$9.1 million at June 30, 2018, an increase of \$1.9 million in year-over-year comparison, consisting of increases in service charges on deposit accounts, interchange fee income, other charges and fees as well as the financial assistance award. Non-interest expense was \$34.3 million at June 30, 2018, an increase of \$3.1 million

in year-over-year comparison primarily resulting from increases in salaries and benefits of \$2.0 million which relates to the acquisitions of First Community Bank and Sunshine Bank. Increases in occupancy, FDIC premiums, amortization of core deposit intangibles and other non-interest expense were attributable to the acquisitions.

## PROVISION FOR INCOME TAXES

The Company sets aside a provision for income taxes on a monthly basis. The amount of the provision is determined by first applying the Company's statutory income tax rates to estimated taxable income, which is pre-tax book income adjusted for permanent differences, and then subtracting available tax credits if applicable. Permanent differences include but are not limited to tax-exempt interest income, bank-owned life insurance cash surrender value income, and certain book expenses that are not allowed as tax deductions.

The Company's provision for income taxes was \$1.4 million or 21.3% of earnings before income taxes for the second quarter of 2018, compared to \$0.9 million or 27.7% of earnings before income taxes for the same period in 2017. The provision for the six months ended June 30, 2018 was \$2.4 million or 20.9% of earnings before income taxes compared to \$1.2 million or 25.7% of earnings before income taxes for the same period in 2017.

## BALANCE SHEET ANALYSIS

### EARNING ASSETS

The Company's interest-earning assets are comprised of investments and loans, and the composition, growth characteristics, and credit quality of both are significant determinants of the Company's financial condition. Investments are analyzed in the section immediately below, while the loan and lease portfolio and other factors affecting earning assets are discussed in the sections following investments.

### INVESTMENTS

The Company's investments can at any given time consist of debt securities and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank ("FRB") account, and overnight fed funds sold. Surplus FRB balances and fed funds sold to correspondent banks represent the temporary investment of excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are another interest-earning option for surplus funds when loan demand is light; and 5) they can

provide partially tax exempt income. Total securities, excluding other securities, totaled \$443.0 million, or 17.9% of total assets at June 30, 2018 compared to \$362.9 million, or 20.0% of total assets at December 31, 2017.

We had \$2.0 million in federal funds sold at June 30, 2018 and \$0.5 million of federal funds sold at December 31, 2017; and interest-bearing balances at other banks decreased to \$20.8 million at June 30, 2018 from \$48.5 million at December 31, 2017. The Company's investment portfolio increased \$80.3 million, or 21.6%, to a total fair market value of \$454.5 million at June 30, 2018 compared to December 31, 2017, \$81.9 million of which was due to the acquisitions of First Community Bank and Sunshine Financial during the first half of 2018. The Company carries investments principally at their fair market values. The Company holds a small amount of "held-to-maturity" investments with a fair market value of \$7.2 million at June 30, 2018 as compared to \$7.4 million at December 31, 2017. All other investment securities are classified as "available-for-sale" to allow maximum flexibility with regard to interest rate risk and liquidity management.



Refer to the table shown in Note 9 – Securities to the Consolidated Financial Statements for information on the Company's amortized cost and fair market value of its investment portfolio by investment type.

## LOAN AND LEASE PORTFOLIO

The Company's gross loans and leases, excluding the associated allowance for loan losses and including loans held for sale, totaled \$1.716 billion at June 30, 2018, an increase of \$486.1 million, or 39.5%, from December 31, 2017. The acquisitions of First Community Bank and Sunshine Financial accounted for approximately \$437.2 million of the increase.

A distribution of the Company's loans showing the balance and percentage of loans by type is presented for the noted periods in the table below. The balances shown are before deferred or unamortized loan origination, extension, or commitment fees, and deferred origination costs.

The following table shows the composition of the loan portfolio by category:

### Composition of Loan Portfolio

|  | June 30, 2018     |                  | December 31, 2017 |                  |   |
|--|-------------------|------------------|-------------------|------------------|---|
|  | Amount            | Percent of Total | Amount            | Percent of Total |   |
|  | (\$ In Thousands) |                  |                   |                  |   |
| Loans held for sale                    | \$5,914           | 0.3              | % \$4,790         | 0.3              | % |
| Commercial, financial and agricultural | 228,643           | 13.3             | 165,780           | 13.5             |   |
| Real Estate:                           |                   |                  |                   |                  |   |
| Mortgage-commercial                    | 658,096           | 38.3             | 467,484           | 38.0             |   |
| Mortgage-residential                   | 546,120           | 31.8             | 385,099           | 31.3             |   |
| Construction                           | 229,164           | 13.4             | 183,328           | 14.9             |   |
| Lease financing receivable             | 2,476             | 0.1              | 2,450             | 0.2              |   |
| Obligations of states and subdivisions | 10,627            | 0.6              | 3,109             | 0.3              |   |
| Consumer and other                     | 35,145            | 2.2              | 18,056            | 1.5              |   |
| Total loans                            | 1,716,185         | 100              | % 1,230,096       | 100              | % |
| Allowance for loan losses              | (9,512 )          |                  | (8,288 )          |                  |   |
| Net loans                              | \$1,706,673       |                  | \$1,221,808       |                  |   |

In the context of this discussion, a "real estate mortgage loan" is defined as any loan, other than a loan for construction purposes, secured by real estate, regardless of the purpose of the loan. The Company follows the common practice of financial institutions in the Company's market area of obtaining a security interest in real estate whenever possible, in addition to any other available collateral. This collateral is taken to reinforce the likelihood of the ultimate repayment of the loan and tends to increase the magnitude of the real estate loan portfolio component. Generally, the Company limits its loan-to-value ratio to 80%. Management attempts to maintain a conservative philosophy regarding its underwriting guidelines and believes that the risk elements of its loan portfolio have been reduced through strategies that diversify the lending mix.

Loans held for sale consist of mortgage loans originated by the Bank and sold into the secondary market. Associated servicing rights are not retained. Commitments from investors to purchase the loans are obtained upon origination.

## LOAN CONCENTRATIONS

Diversification within the loan portfolio is an important means of reducing inherent lending risks. At June 30, 2018, The First had no concentrations of ten percent or more of total loans in any single industry or any geographical area outside its immediate market areas, which include Mississippi, Louisiana, Alabama and Florida.

## NONPERFORMING ASSETS

At June 30, 2018, The First had loans past due as follows:

|   | (\$ In Thousands) |
|---|-------------------|
| Past due 30 through 89 days                 | \$ 6,490          |
| Past due 90 days or more and still accruing | 940               |

Nonperforming assets are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets including mobile homes and OREO. Loans are placed on nonaccrual status when they become ninety days past due (principal and/or interest), unless the loans are adequately secured and in the process of collection. Nonaccrual loans totaled \$8.4 million at June 30, 2018, which increased \$2.8 million from December 31, 2017. This increase is due to nonaccrual acquired loans.

Other real estate owned is carried at fair value, determined by an appraisal, less estimated costs to sell. Other real estate owned totaled \$7.9 million at June 30, 2018 as compared to \$7.2 million at December 31, 2017.

A loan is classified as a restructured loan when the following two conditions are present: First, the borrower is experiencing financial difficulty and second, the creditor grants a concession it would not otherwise consider but for the borrower's financial difficulties. At June 30, 2018, the Bank had \$9.1 million in loans that were modified as troubled debt restructurings ("TDRs"), of which \$6.3 million were performing as agreed with modified terms. At December 31, 2017, the Bank had \$6.9 million in loans that were classified as troubled debt restructurings of which

\$4.7 million were performing as agreed with modified terms. TDRs may be classified as either nonperforming or performing loans depending on their accrual status. As of June 30, 2018, \$2.8 million in loans categorized as TDRs are classified as nonperforming as compared to \$2.0 million at December 31, 2017.

The following table presents comparative data for the Company's nonperforming assets and performing TDRs as of the dates noted:

### Nonperforming Assets and Performing Troubled Debt Restructurings

(\$ In Thousands)

#### NON-ACCRUAL LOANS

|   |          |          |          |  |  |
|---|----------|----------|----------|--|--|
| Real Estate:  | 6/30/18  | 12/31/17 | 6/30/17  |  |  |
| 1-4 family residential construction   | \$-      | \$-      | \$-      |  |  |
| Other construction/land   | 326      | 92       | 191      |  |  |
| 1-4 family residential revolving/open-end   | 414      | 61       | -        |  |  |
| 1-4 family residential closed-end   | 4,552    | 2,631    | 2,299    |  |  |
| Nonfarm, nonresidential, owner-occupied   | 650      | 610      | 783      |  |  |
| Nonfarm, nonresidential, other nonfarm nonresidential                             | 1,065    | 1,114    | 554      |  |  |
| TOTAL REAL ESTATE   | 7,007    | 4,508    | 3,827    |  |  |
| Commercial and industrial   | 1,325    | 1,120    | 131      |  |  |
| Loans to individuals - other  | 108      | 46       | 21       |  |  |
| TOTAL NON-ACCRUAL LOANS   | 8,440    | 5,674    | 3,979    |  |  |
| Other real estate owned   | 7,890    | 7,158    | 8,072    |  |  |
| TOTAL NON-PERFORMING ASSETS   | \$16,330 | \$12,832 | \$12,051 |  |  |
| Performing TDRs   | \$6,309  | \$4,715  | \$4,936  |  |  |
| Total non-performing assets as a % of total loans & leases net of unearned income | 0.95 %   | 1.04 %   | 1.01 %   |  |  |
| Total non-accrual loans as a % of total loans & leases net of unearned income     | 0.49 %   | 0.46 %   | 0.33 %   |  |  |

Nonperforming assets totaled \$16.3 million at June 30, 2018, compared to \$12.8 million at December 31, 2017, an increase of \$3.5 million. The ALLL/total loans ratio was 0.56% at June 30, 2018, and 0.68% at December 31, 2017. Total valuation accounting adjustments total \$7.0 million on acquired loans. The ratio of annualized net charge-offs (recoveries) to total loans was 0.003% for the quarter ended June 30, 2018 compared to (0.003)% for the quarter ended June 30, 2017.

The following table represents the Company's impaired loans at June 30, 2018, and December 31, 2017.

**June  
30,**      **December 31,**

|   | <b>2018</b>              | <b>2017</b> |
|---|--------------------------|-------------|
|   | <b>(\$ In Thousands)</b> |             |
| Impaired Loans:   |                          |             |
| Impaired loans without a valuation allowance              | \$9,978                  | \$ 6,559    |
| Impaired loans with a valuation allowance                 | 4,770                    | 4,015       |
| Total impaired loans                                      | \$14,748                 | \$ 10,574   |
| Allowance for loan losses on impaired loans at period end | 780                      | 661         |
| <br>  |                          |             |
| Total nonaccrual loans                                    | 8,440                    | 5,674       |
| <br>  |                          |             |
| Past due 90 days or more and still accruing               | 940                      | 285         |
| Average investment in impaired loans                      | 11,855                   | 9,041       |

### **ALLOWANCE FOR LOAN AND LEASE LOSSES**

The Company has developed policies and procedures for evaluating the overall quality of its credit portfolio and the timely identification of potential problem loans. Management's judgment as to the adequacy of the allowance is based upon a number of assumptions which it believes to be reasonable, but which may not prove to be accurate, particularly given the Company's growth and the economy. Thus, there can be no assurance that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the loan loss allowance will not be required.

The Company's allowance consists of two parts. The first part is determined in accordance with authoritative guidance regarding contingencies. The Company's determination of this part of the allowance is based upon quantitative and qualitative factors. A loan loss history based upon the prior seven years is utilized in determining the appropriate allowance. Historical loss factors are determined by risk rated loans by loan type. These historical loss factors are applied to the loans by loan type to determine an indicated allowance. The loss factors of peer groups are considered in the determination of the allowance and are used to assist in the establishment of a long-term loss history for areas in which this data is unavailable and incorporated into the qualitative factors to be considered. The historical loss factors may also be modified based upon other qualitative factors including but not limited to local and national economic conditions, trends of delinquent loans, changes in lending policies and underwriting standards, concentrations, and management's knowledge of the loan portfolio. These factors require judgment upon the part of management and are based upon state and national economic reports received from various institutions and agencies including the Federal Reserve Bank, United States Bureau of Economic Analysis, Bureau of Labor Statistics, meetings with the Company's loan officers and loan committee, and data and guidance received or obtained from the Company's regulatory authorities.

The second part of the allowance is determined in accordance with authoritative guidance regarding loan impairment. Impaired loans are determined based upon a review by internal loan review and senior management.

The sum of the two parts constitutes management's best estimate of an appropriate allowance for loan losses. When the estimated allowance is determined, it is presented to the Company's audit committee for review and approval on a quarterly basis.

A loan is considered impaired when, based on current information and events, it is probable that the Company 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 all 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, and a specific allowance is assigned to each loan determined to be impaired. Impaired loans not deemed collateral dependent are analyzed according to the ultimate repayment source, whether that is cash flow from the borrower, guarantor or some other source of repayment. Impaired loans are deemed collateral dependent if, in the Company's opinion, the ultimate source of repayment will be generated from the liquidation of collateral.

The Company discontinues accrual of interest on loans when management believes, after considering economic and business conditions and collection efforts, that a borrower's financial condition is such that the collection of interest is

doubtful. Generally, the Company will place a delinquent loan in nonaccrual status when the loan becomes 90 days or more past due. At the time a loan is placed in nonaccrual status, all interest which has been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain.

The allowance for loan and lease losses is established through a provision for loan and lease losses. It is maintained at a level that management believes is adequate to absorb probable incurred losses inherent in the loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when sufficient cash payments are received subsequent to the charge off.



The table that follows summarizes the activity in the allowance for loan and lease losses for the noted periods:

Allowance for Loan and Lease Losses

(\$ In Thousands)

|   | <b>3 months<br/>ended<br/>6/30/18</b> | <b>3 months<br/>ended<br/>6/30/17</b> | <b>6 months<br/>ended<br/>6/30/18</b> | <b>6 months<br/>ended<br/>6/30/17</b> | <b>For the<br/>Year Ended<br/>12/31/17</b> |
|---|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|--|
| <b>Balances:</b>  |                                       |                                       |                                       |                                       |  |
| Average gross loans & leases outstanding during period: | \$1,696,737                           | \$1,155,699                           | \$1,597,739                           | \$1,138,097                           | \$1,168,882                                |
| Gross Loans & leases outstanding at end of period       | 1,716,185                             | 1,193,843                             | 1,716,185                             | 1,193,843                             | 1,230,096                                  |
| <b>Allowance for Loan and Lease Losses:</b>             |                                       |                                       |                                       |                                       |  |
| Balance at beginning of period                          | \$8,659                               | \$7,813                               | \$8,288                               | \$7,510                               | \$7,510                                    |
| Provision charged to expense                            | 857                                   | 248                                   | 1,134                                 | 294                                   | 506  |
| <b>Charge-offs:</b>                                     |                                       |                                       |                                       |                                       |  |
| <b>Real Estate-</b>                                     |                                       |                                       |                                       |                                       |  |
| 1-4 family residential construction                     | -                                     | -                                     | -                                     | 32                                    | 32   |
| Other construction/land                                 | 6                                     | 69                                    | 10                                    | 72                                    | 111  |
| 1-4 family revolving, open-ended                        | 7                                     | 42                                    | 7                                     | 67                                    | 71   |
| 1-4 family closed-end                                   | -                                     | 44                                    | -                                     | 49                                    | 48   |
| Nonfarm, nonresidential, owner-occupied                 | -                                     | -                                     | -                                     | -                                     | -  |
| Total Real Estate                                       | 13                                    | 155                                   | 17                                    | 220                                   | 262  |
| Commercial and industrial                               | 5                                     | -                                     | 5                                     | 1                                     | 62   |
| Credit cards  | -                                     | -                                     | -                                     | -                                     | -  |
| Automobile loans  | -                                     | 15                                    | -                                     | 18                                    | 45   |
| Loans to individuals - other                            | 13                                    | -                                     | 32                                    | -                                     | -  |
| All other loans   | -                                     | 19                                    | -                                     | 24                                    | 36   |
| Total   | 31                                    | 189                                   | 54                                    | 263                                   | 405  |
| <b>Recoveries:</b>                                      |                                       |                                       |                                       |                                       |  |
| <b>Real Estate-</b>                                     |                                       |                                       |                                       |                                       |  |
| 1-4 family residential construction                     | (-)                                   | (-)                                   | (-)                                   | (-)                                   | -  |
| Other construction/land                                 | (19)                                  | (35)                                  | (26)                                  | (250)                                 | 280  |
| 1-4 family revolving, open-ended                        | (8)                                   | (7)                                   | (8)                                   | (51)                                  | 52   |
| 1-4 family closed-end                                   | (13)                                  | (103)                                 | (27)                                  | (144)                                 | 176  |
| Nonfarm, nonresidential, owner-occupied                 | (1)                                   | (7)                                   | (2)                                   | (8)                                   | 14   |
| Total Real Estate                                       | (41)                                  | (152)                                 | (63)                                  | (453)                                 | 522  |

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|                                   |         |   |         |   |         |   |         |   |         |   |
|-----------------------------------|---------|---|---------|---|---------|---|---------|---|---------|---|
| Commercial and industrial         | (10     | ) | (15     | ) | (18     | ) | (32     | ) | 50      |   |
| Credit cards                      | 1       |   | (-)     |   | (-)     |   | (-)     |   | -       |   |
| Automobile loans                  | (7      | ) | (7      | ) | (13     | ) | (7      | ) | 22      |   |
| Loans to individuals - other      | 1       |   | (13     | ) | (10     | ) | (14     | ) | 36      |   |
| All other loans                   | 29      |   | (11     | ) | (40     | ) | (23     | ) | 47      |   |
| Total                             | (27     | ) | (198    | ) | (144    | ) | (529    | ) | 677     |   |
| Net loan charge offs (recoveries) | 4       |   | (9      | ) | (90     | ) | (266    | ) | (272    | ) |
| Balance at end of period          | \$9,512 |   | \$8,070 |   | \$9,512 |   | \$8,070 |   | \$8,288 |   |

RATIOS

|  |        |   |        |    |        |    |        |    |        |    |
|--|--------|---|--------|----|--------|----|--------|----|--------|----|
| Net Charge-offs (recoveries) to average Loans & Leases(annualized) | 0.0009 | % | (0.003 | )% | (0.011 | )% | (0.05  | )% | (0.02  | )% |
| Allowance for Loan Losses to gross Loans & Leases at end of period | 0.56   | % | 0.68   | %  | 0.56   | %  | 0.68   | %  | 0.67   | %  |
| Net Loan Charge-offs (recoveries) to provision for loan losses     | 0.47   | % | (3.63  | )% | (7.94  | )% | (90.48 | )% | (53.75 | )% |

## Allocation of the Allowance for Loan Losses

|                            | <b>June 30, 2018</b>     |   |   |
|----------------------------|--------------------------|---|---|
|                            | <b>(\$ In Thousands)</b> |   |   |
|                            | <b>Amount</b>            | <b>% of loans<br/>in each category<br/>to total loans</b> |   |
| Commercial Non Real Estate | \$ 2,011                 | 13.5  | % |
| Commercial Real Estate     | 5,136                    | 62.6  | % |
| Consumer Real Estate       | 1,598                    | 20.7  | % |
| Consumer                   | 184                      | 3.2   | % |
| Unallocated                | 583                      | -   |   |
| Total                      | \$ 9,512                 | 100   | % |

  

|                            | <b>December 31, 2017</b> |   |   |
|----------------------------|--------------------------|---|---|
|                            | <b>(\$ In Thousands)</b> |   |   |
|                            | <b>Amount</b>            | <b>% of loans<br/>in each category<br/>to total loans</b> |   |
| Commercial Non Real Estate | \$ 1,608                 | 14.0  | % |
| Commercial Real Estate     | 4,644                    | 64.8  |   |
| Consumer Real Estate       | 1,499                    | 18.9  |   |
| Consumer                   | 173                      | 2.3   |   |
| Unallocated                | 364                      | -   |   |
| Total                      | \$ 8,288                 | 100   | % |

OTHER ASSETS

The Company's balance of non-interest earning cash and due from banks was \$97.6 million at June 30, 2018 and \$43.0 million at December 31, 2017. The balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks), the level of cash maintained on hand at our branches, and our reserve requirement among other things, and is subject to significant fluctuation in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its short-term cash position through the utilization of overnight loans to and borrowings from correspondent banks, including the Federal Reserve Bank and the Federal Home Loan Bank. Should a large "short" overnight position persists for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a "long" position is prevalent, the Company will let brokered deposits or other wholesale borrowings roll off as they mature, or might invest excess liquidity in higher-yielding, longer-term bonds.

Total equity securities increased \$0.4 million due to an increase in FHLB stock and federal reserve stock. The Company's net premises and equipment at June 30, 2018 was \$62.3 million and \$46.4 million at December 31, 2017; an increase of \$15.9 million, or 34.2% for the first six months of 2018. Included in the acquisition of First Community Bank and Sunshine Financial was \$9.2 million in bank-owned life insurance, creating a balance of \$36.6 million at June 30, 2018. Bank-owned life insurance is also discussed above in the "Non-Interest Income and Non-Interest Expense" section. Goodwill increased to \$54.9 million at June 30, 2017, an increase of \$35.0 million as a result of the acquisitions of Southwest and Sunshine Financial. Other intangible assets, consisting primarily of the Company's core deposit intangible, increased by \$6.5 million due to the acquisitions. The Company's goodwill and other intangible assets are evaluated annually for potential impairment, and pursuant to that analysis management has determined that no impairment exists as of June 30, 2018.

Other real estate owned increased \$0.7 million, or 10.2% during the first six months of 2018.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

The Company maintains commitments to extend credit in the normal course of business, as long as there are no violations of conditions established in the outstanding contractual arrangements. Unused commitments to extend credit totaled \$241.2 million at June 30, 2018 and \$281.4 million at December 31, 2017, although it is not likely that all of those commitments will ultimately be drawn down. Unused commitments represented approximately 14.1% of gross loans outstanding at June 30, 2018 and 22.9% at December 31, 2017, with the increase due in part to higher commitments in commercial and industrial loans. The Company also had undrawn letters of credit issued to customers totaling \$9.1 million at June 30, 2018 and \$8.2 million at December 31, 2017. The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. However, the "Liquidity" section in this Form 10-Q outlines resources available to draw upon should we be required to fund a significant portion of unused commitments. For more information regarding the Company's off-balance sheet arrangements, see NOTE 8 to the consolidated financial statements.

In addition to unused commitments to provide credit, the Company is utilizing a \$73.0 million letter of credit issued by the Federal Home Loan Bank (“FHLB”) on the Company’s behalf as security as of June 30, 2018. That letter of credit is backed by loans which are pledged to the FHLB by the Company.

## **liquidity and CAPITAL RESOURCES**

### **LIQUIDITY**

Liquidity management refers to the Company’s ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. Detailed cash flow projections are reviewed by management on a monthly basis, with various scenarios applied to assess our ability to meet liquidity needs under adverse conditions. Liquidity ratios are also calculated and reviewed on a regular basis. While those ratios are merely indicators and are not measures of actual liquidity, they are closely monitored and we are focused on maintaining adequate liquidity resources to draw upon should unexpected needs arise.

The Company, on occasion, experiences cash needs as the result of loan growth, deposit outflows, asset purchases or liability repayments. To meet short-term needs, the Company can borrow overnight funds from other financial institutions, draw advances via FHLB lines of credit, or solicit brokered deposits if deposits are not immediately obtainable from local sources. The net availability on lines of credit from the FHLB totaled \$593.3 million at June 30, 2018. Furthermore, funds can be obtained by drawing down the Company’s correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of June 30, 2018, the market value of unpledged debt securities plus pledged securities in excess of current pledging requirements comprised \$108.1 million of the Company’s investment balances, compared to \$95.5 million at December 31, 2017. The increase in unpledged securities from June 2018 compared to December 2017 is primarily due to an increase in portfolio assets. Other forms of balance sheet liquidity include but are not necessarily limited to any outstanding fed funds sold and vault cash. The Company has a higher level of actual balance sheet liquidity than might otherwise be the case, since we utilize a letter of credit from the FHLB rather than investment securities for certain pledging requirements. That letter of credit, which is backed by loans that are pledged to the FHLB by the Company, totaled \$68.0 million at June 30, 2018. Management is of the opinion that available investments and other potentially liquid assets, along with the standby funding sources it has arranged, are more than sufficient to meet the Company’s current and anticipated short-term liquidity needs.

The Company’s liquidity ratio as of June 30, 2018 was 10.7%, as compared to internal liquidity policy guidelines of 10% minimum. Other liquidity ratios reviewed include the following along with policy guidelines:

|   | <b>June 30, 2018</b> |   | <b>Policy<br/>Maximum</b> | <b>Policy<br/>Compliance</b> |
|---|----------------------|---|---------------------------|------------------------------|
| Loans to Deposits (including FHLB advances) | 79.9                 | % | 90.0                      | % In Policy                  |
| Net Non-core Funding Dependency Ratio       | 3.0                  | % | 20.0                      | % In Policy                  |
| Fed Funds Purchased / Total Assets          | 0.0                  | % | 10.0                      | % In Policy                  |
| FHLB Advances / Total Assets                | 0.5                  | % | 20.0                      | % In Policy                  |
| FRB Advances / Total Assets                 | 0.0                  | % | 10.0                      | % In Policy                  |
| Pledged Securities to Total Securities      | 82.7                 | % | 90.0                      | % In Policy                  |

Continued growth in core deposits and relatively high levels of potentially liquid investments have had a positive impact on our liquidity position in recent periods, but no assurance can be provided that our liquidity will continue at current robust levels.

The Company's primary uses of funds are ordinary operating expenses and stockholder dividends, and its primary source of funds is dividends from the Bank since the Company does not conduct regular banking operations. Management anticipates that the Bank will have sufficient earnings to provide dividends to the Company to meet its funding requirements for the foreseeable future. Both the Company and the Bank are subject to legal and regulatory limitations on dividend payments, as outlined in Item 1. Business – Supervision and Regulation in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

## DEPOSITS

Deposits are another key balance sheet component impacting the Company's net interest margin and other profitability metrics. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly non-maturity deposits such as demand deposit accounts, NOW accounts, savings accounts, and money market demand accounts. Information concerning average balances and rates paid by deposit type for the three-month periods ended June 30, 2018 and 2017 is included in the Average Balances and Rates tables appearing above, in the section titled "Net Interest Income and Net Interest Margin." A distribution of the Company's deposits showing the balance and percentage of total deposits by type is presented for the noted periods in the following table.

### Deposit Distribution

| (\$ In Thousands)                    | June 30, 2018 | December 31, 2017 |
|--------------------------------------|---------------|-------------------|
| Non-interest bearing demand deposits | \$ 459,402    | \$ 301,989        |
| NOW accounts and Other               | 731,617       | 601,694           |
| Money Market accounts                | 286,815       | 149,715           |
| Savings accounts                     | 232,701       | 133,864           |
| Time Deposits of less than \$250,000 | 308,086       | 220,951           |
| Time Deposits of \$250,000 or more   | 78,614        | 62,352            |
| Total deposits                       | 2,097,235     | 1,470,565         |

### Percentage of Total Deposits

|                                      |      |   |      |   |
|--------------------------------------|------|---|------|---|
| Non-interest bearing demand deposits | 21.9 | % | 20.5 | % |
| NOW accounts and other               | 34.9 | % | 40.9 | % |
| Money Market accounts                | 13.7 | % | 10.2 | % |
| Savings accounts                     | 11.0 | % | 9.2  | % |
| Time Deposits of less than \$250,000 | 14.7 | % | 15.0 | % |

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|                                    |     |   |     |   |
|------------------------------------|-----|---|-----|---|
| Time Deposits of \$250,000 or more | 3.8 | % | 4.2 | % |
| Total                              | 100 | % | 100 | % |

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As of June 30, 2018, cash and cash equivalents were \$120.4 million. In addition, loans and investment securities repricing or maturing within one year or less were approximately \$503.4 million at June 30, 2018. Approximately \$241.2 million in loan commitments could fund within the next three months and other commitments, primarily standby letters of credit, totaled \$9.1 million at June 30, 2018.

## **OTHER INTEREST-BEARING LIABILITIES**

The Company's non-deposit borrowings may, at any given time, include fed funds purchased from correspondent banks, borrowings from the Federal Home Loan Bank, advances from the Federal Reserve Bank, securities sold under agreements to repurchase, and/or junior subordinated debentures. The Company uses short-term FHLB advances and fed funds purchased on uncommitted lines to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit depends on the level of pledged collateral.

Total non-deposit interest-bearing liabilities decreased by \$28.7 million, or 25.1%, in the first six months of 2018, due to a decrease in notes payable to the FHLB of \$93.6 which was net of acquired. The Company issued \$66 million in aggregate principal amount of subordinated on April 30, 2018. The Company had junior subordinated debentures totaling \$10.3 million at June 30, 2018 and December 31, 2017, in the form of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities.

## **OTHER NON-INTEREST BEARING LIABILITIES**

Other liabilities are principally comprised of accrued interest payable and other accrued but unpaid expenses. Other liabilities increased by \$6.9 million, or 118.8%, during the first six months of 2018, due to the increase in other accrued but unpaid expenses.

## **CAPITAL**

At June 30, 2018 the Company had total stockholders' equity of \$285.8 million, comprised of \$13.1 million in common stock, less than \$0.5 million in treasury stock, \$216.0 million in surplus, \$61.7 million in undivided profits, \$(4.5) million in accumulated comprehensive income (loss) for available-for-sale securities. Total stockholders' equity at the end of 2017 was \$222.5 million. The increase of \$63.4 million, or 28.5%, in stockholders' equity during the first six months of 2018 is comprised of capital added via net earnings of \$9.2 million, \$4.0 million decrease in

accumulated comprehensive income for available-for-sale securities, and \$36.0 million of common stock issued for the purchase of Southwest, offset by \$1.2 million in cash dividends paid and \$23.4 million of common stock issued for the purchase of Sunshine Financial.

The Company uses a variety of measures to evaluate its capital adequacy, including risk-based capital and leverage ratios that are calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to help ensure that they meet or surpass established internal and external guidelines. As permitted by the regulators for financial institutions that are not deemed to be “advanced approaches” institutions, the Company has elected to opt out of the Basel III requirement to include accumulated other comprehensive income in risk-based capital. The following table sets forth the Company’s and the Bank’s regulatory capital ratios as of the dates indicated.

## Regulatory Capital Ratios

## The First, ANBA

|                       | <b>June 30,</b> |   | <b>December 31,</b> |   | <b>Minimum</b>        |   |
|-----------------------|-----------------|---|---------------------|---|-----------------------|---|
|                       | <b>2018</b>     |   | <b>2017</b>         |   | <b>Required to be</b> |   |
|                       |                 |   |                     |   | <b>Well</b>           |   |
|                       |                 |   |                     |   | <b>Capitalized</b>    |   |
| Common Equity Tier 1  |                 |   |                     |   |                       |   |
| Capital Ratio         | 14.9            | % | 14.5                | % | 6.5                   | % |
| Tier 1 Capital Ratio  | 14.9            | % | 14.5                | % | 8.0                   | % |
| Total Capital Ratio   | 15.4            | % | 15.1                | % | 10.0                  | % |
| Tier 1 Leverage Ratio | 11.6            | % | 11.4                | % | 5.0                   | % |

## Regulatory Capital Ratios

## The First Bancshares, Inc.

|                        | <b>June 30,</b> |   | <b>December 31,</b> |   | <b>Minimum</b>        |   |
|------------------------|-----------------|---|---------------------|---|-----------------------|---|
|                        | <b>2018</b>     |   | <b>2017</b>         |   | <b>Required to be</b> |   |
|                        |                 |   |                     |   | <b>Well</b>           |   |
|                        |                 |   |                     |   | <b>Capitalized</b>    |   |
| Common Equity Tier 1   |                 |   |                     |   |                       |   |
| Capital Ratio*         | 12.2            | % | 14.2                | % | 6.5                   | % |
| Tier 1 Capital Ratio** | 12.8            | % | 14.9                | % | 8.0                   | % |
| Total Capital Ratio    | 13.3            | % | 15.5                | % | 10.0                  | % |
| Tier 1 Leverage Ratio  | 10.0            | % | 11.7                | % | 5.0                   | % |

\* The numerator does not include Preferred Stock and Trust Preferred.

\*\* The numerator includes Trust Preferred.

The Company's regulatory capital ratios decreased from December 31, 2017 to June 30, 2018. Capital for recent acquisitions was added during the fourth quarter of 2017, with new assets being added during 2018. Our capital ratios remain very strong relative to the median for peer financial institutions, and at June 30, 2018 were well above the threshold for the Company and the Bank to be classified as "well capitalized," the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act of 1991. We do not foresee any circumstances that would cause the Company or the Bank to be less than well capitalized, although no assurance can be given that this will not occur. As of June 30, 2018, management believes that each of the Bank and the Company meet all capital adequacy requirements to which they are subject. Basel III rules require a "capital conservation buffer" for both the Company and the Bank. When fully phased in on January 1, 2019, each of the Company and the Bank will be required to maintain a 2.5% capital conservation buffer, above and beyond the capital levels otherwise required under applicable regulation. The implementation of this capital conservation buffer began on January 1, 2016 at a level of 0.625% and will increase by 0.625% on each subsequent January 1 until it reaches 2.5% on January 1, 2019. Under this guidance banking institutions with a CET1, Tier 1

Capital Ratio and Total Risk Based Capital above the minimum regulatory adequate capital ratios but below the capital conservation buffer will face constraints on their ability to pay dividends, repurchase equity and pay discretionary bonuses to executive officers, based on the amount of the shortfall.

Total consolidated equity capital at June 30, 2018, was \$285.8 million, or approximately 11.5% of total assets. The Company currently has adequate capital positions to meet the minimum capital requirements for all regulatory agencies.

On June 30, 2006, The Company issued \$4,124,000 of floating rate junior subordinated deferrable interest debentures to The First Bancshares Statutory Trust 2 in which the Company owns all of the common equity. The debentures are the sole asset of the Trust. The Trust issued \$4,000,000 of Trust Preferred Securities (TPSs) to investors. The Company's obligations under the debentures and related documents, taken together, constitute a full and unconditional guarantee by the Company of the Trust's obligations under the preferred securities. The preferred securities are redeemable by the Company at its option. The preferred securities must be redeemed upon maturity of the debentures in 2036. Interest on the preferred securities is the three month London Interbank Offer Rate (LIBOR) plus 1.65% and is payable quarterly. The terms of the subordinated debentures are identical to those of the preferred securities. On July 27, 2007, The Company issued \$6,186,000 of floating rate junior subordinated deferrable interest debentures to The First Bancshares Statutory Trust 3 in which the Company owns all of the common equity. The debentures are the sole asset of Trust 3. The Trust issued \$6,000,000 of Trust Preferred Securities (TPSs) to investors. The Company's obligations under the debentures and related documents, taken together, constitute a full and unconditional guarantee by the Company of the Trust's obligations under the preferred securities. The preferred securities are redeemable by the Company at its option. The preferred securities must be redeemed upon maturity of the debentures in 2037. Interest on the preferred securities is the three month LIBOR plus 1.40% and is payable quarterly. The terms of the subordinated debentures are identical to those of the preferred securities. In accordance with the authoritative guidance, the trusts are not included in the consolidated financial statements.

### **Subordinated Notes**

On April 30, 2018, The Company entered into two Subordinated Note Purchase Agreements pursuant to which the Company sold and issued \$24 million in aggregate principal amount of 5.875% fixed-to-floating rate subordinated notes due 2028 and \$42 million in aggregate principal amount of 6.40% fixed-to-floating rate subordinated notes due 2033 (collectively, the "Notes").

The Notes are not convertible into or exchangeable for any other securities or assets of the Company or any of its subsidiaries. The Notes are not subject to redemption at the option of the holder. Principal and interest on the Notes are subject to acceleration only in limited circumstances. The Notes are unsecured, subordinated obligations of the Company and rank junior in right to payment to the Company's current and future senior indebtedness, and each Note is *pari passu* in right to payment with respect to the other Notes.

The Company intends to use the net proceeds from the sale of the Notes for general corporate purposes, which may include increasing bank level capital ratios to support future growth, repaying an existing line of credit and

establishing holding company reserves.

### **Reconciliation of Non-GAAP Financial Measures**

We report net interest income and net interest margin on a fully tax equivalent, or FTE, basis, which calculations are not in accordance with generally accepted accounting principles, or GAAP. The tax equivalent adjustment to net interest income recognizes the income tax savings when comparing taxable and tax-exempt assets and assumes a 34% tax rate for 2017 and 25.3% for 2018. Management believes that it is a standard practice in the banking industry to present net interest income and net interest margin on a fully tax equivalent basis, and believes it enhances the comparability of income and expenses arising from taxable and nontaxable sources. Net interest income and net interest margin on a fully tax equivalent basis should not be viewed as a substitute for net interest income or net interest margin provided in accordance with GAAP. See reconciliation of net interest income (FTE) to net interest income calculated in accordance with GAAP and net interest margin (FTE) to net interest margin calculated in accordance with GAAP below:

## Net Interest Income Fully Tax Equivalent

| (\$ In Thousands)                        | Three Months<br>Ended<br>June 30,<br>2018 | Three Months<br>Ended<br>June 30,<br>2017 | Six Months<br>Ended<br>June 30,<br>2018 | Six Months<br>Ended<br>June 30,<br>2017 |
|--|---|---|---|---|
| Net interest income                      | \$ 21,569                                 | \$ 14,835                                 | \$ 37,949                               | \$ 29,003                               |
| Tax exempt investment income             | (758 )                                    | (592 )                                    | (1,433 )                                | (1,185 )                                |
| Taxable investment income                | 1,015                                     | 897                                       | 1,919                                   | 1,792                                   |
| Net interest income fully tax equivalent | 21,826                                    | 15,140                                    | 38,435                                  | 29,610                                  |
| Average earning assets                   | 2,228,831                                 | 1,577,468                                 | 2,096,169                               | 1,537,716                               |
| Net interest margin fully tax equivalent | 3.92                                      | 3.84                                      | 3.67                                    | 3.85                                    |

## Operating Net Earnings

| (\$ In Thousands)  | Six Months<br>Ended<br>June 30, 2018 | Six Months<br>Ended<br>June 30, 2017 |
|--|--------------------------------------|--------------------------------------|
| Net income available to common shareholders              | \$ 9,202                             | \$ 3,488                             |
| Effect of acquisition charges                            | 5,596                                | 6,280                                |
| Tax  | (1,303 )                             | (2,372 )                             |
| Net earnings available to common shareholders, operating | \$ 13,495                            | \$ 7,396                             |
| Average earning assets                                   | 2,228,831                            | 1,577,468                            |
| Net interest margin fully tax equivalent                 | 3.92                                 | 3.84                                 |

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

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital under a variety of interest rate scenarios.

To identify areas of potential exposure to interest rate changes, we utilize commercially available modeling software to perform earnings simulations and calculate the Company's market value of portfolio equity under varying interest rate scenarios every month. The model imports relevant information for the Company's financial instruments and incorporates Management's assumptions on pricing, duration, and optionality for anticipated new volumes. Various rate scenarios consisting of key rate and yield curve projections are then applied in order to calculate the expected effect of a given interest rate change on interest income, interest expense, and the value of the Company's financial instruments. The rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).



The following table shows the estimated changes in net interest income at risk and market value of equity along with policy limits:

| Change in Interest Rates | Net Interest Income at Risk |              |   | Market Value of Equity |              |   |   |
|--------------------------|-----------------------------|--------------|---|------------------------|--------------|---|---|
|                          | % Change from Base          | Policy Limit | % | % Change from Base     | Policy Limit | % | % |
| Up 400 bps               | 8.0 %                       | -20.0        | % | 23.2 %                 | -40.0        | % | % |
| Up 300 bps               | 8.1 %                       | -15.0        | % | 21.7 %                 | -30.0        | % | % |
| Up 200 bps               | 6.6 %                       | -10.0        | % | 17.7 %                 | -20.0        | % | % |
| Up 100 bps               | 3.9 %                       | -5.0         | % | 10.7 %                 | -10.0        | % | % |
| Down 100 bps             | (6.9 )%                     | -5.0         | % | (16.2 )%               | -10.0        | % | % |
| Down 200 bps             | (11.4 )%                    | -10.0        | % | (18.2 )%               | -20.0        | % | % |

We use seven standard interest rate scenarios in conducting our 12-month net interest income simulations: “static,” upward shocks of 100, 200, 300 and 400 basis points, and downward shocks of 100, and 200 basis points. Pursuant to policy guidelines, we typically attempt to limit the projected decline in net interest income relative to the stable rate scenario to no more than 5% for a 100 basis point (bp) interest rate shock, 10% for a 200 bp shock, 15% for a 300 bp shock, and 20% for a 400 bp shock. As of June 30, 2018, the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures or credit quality deterioration:

| June 30, 2018<br>(\$ In Thousands) | Net Interest Income at Risk – Sensitivity Year 1 |          |        |         |         |          |          |
|------------------------------------|--|----------|--------|---------|---------|----------|----------|
|                                    | -200 bp  | -100 bp  | STATIC | +100 bp | +200 bp | +300 bp  | +400 bp  |
| Net Interest Income                | 76,642   | 80,570   | 85,981 | 87,457  | 86,899  | 84,279   | 79,373   |
| Dollar Change                      | (9,339 )   | (5,411 ) |        | 1,476   | 918     | (1,702 ) | (6,608 ) |
| NII @ Risk - Sensitivity Y1        | (10.9 )%   | (6.3 )%  |        | 1.7 %   | 1.1 %   | (2.0 )%  | (7.7 )%  |

If there were an immediate and sustained downward adjustment of 200 basis points in interest rates, all else being equal, net interest income over the next twelve months would likely be approximately \$9.3 million lower than in a stable interest rate scenario, for a negative variance of 10.9%. The unfavorable variance increases if rates were to drop below 200 basis points, due to the fact that certain deposit rates are already relatively low (on NOW accounts and savings accounts, for example), and will hit a natural floor of close to zero while non-floored variable-rate loan yields continue to drop. This effect would be exacerbated by accelerated prepayments on fixed-rate loans and mortgage-backed securities when rates decline, although rate floors on some of our variable-rate loans partially offset other negative pressures. While management believes that further interest rate reductions are highly unlikely, the potential percentage drop in net interest income exceeds our internal policy guidelines in declining interest rate

scenarios and we will continue to monitor our interest rate risk profile and take corrective action as deemed appropriate.

Net interest income would likely improve by \$1.0 million, or 1.1%, if interest rates were to increase by 200 basis points relative to a stable interest rate scenario, with the favorable variance expanding the higher interest rates rise. The initial increase in rising rate scenarios will be limited to some extent by the fact that some of our variable-rate loans are currently at rate floors, resulting in a re-pricing lag while base rates are increasing to floored levels, but the Company would expect to benefit from a material upward shift in the yield curve.

The Company's one year cumulative GAP ratio is approximately 242.6%, which means that there are more assets repricing than liabilities within the first year. The Company is "asset-sensitive." These results are based on cash flows from assumptions of assets and liabilities that reprice (maturities, likely calls, prepayments, etc.) Typically, the net interest income of asset-sensitive financial institutions should improve with rising rates and decrease with declining rates.

In addition to the net interest income simulations shown above, we run stress scenarios modeling the possibility of no balance sheet growth, the potential runoff of "surge" core deposits which flowed into the Company in the most recent economic cycle, and potential unfavorable movement in deposit rates relative to yields on earning assets. Even though net interest income will naturally be lower with no balance sheet growth, the rate-driven variances projected for net interest income in a static growth environment are similar to the changes noted above for our standard projections. When a greater level of non-maturity deposit runoff is assumed or unfavorable deposit rate changes are factored into the model, projected net interest income in declining rate and flat rate scenarios does not change materially relative to standard growth projections. However, the benefit we would otherwise experience in rising rate scenarios is minimized and net interest income remains relatively flat.

The economic value (or "fair value") of financial instruments on the Company's balance sheet will also vary under the interest rate scenarios previously discussed. The difference between the projected fair value of the Company's financial assets and the fair value of its financial liabilities is referred to as the economic value of equity ("EVE"), and changes in EVE under different interest rate scenarios are effectively a gauge of the Company's longer-term exposure to interest rate risk. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at projected replacement interest rates for each account type, while the fair value of non-financial accounts is assumed to equal their book value for all rate scenarios. An economic value simulation is a static measure utilizing balance sheet accounts at a given point in time, and the measurement can change substantially over time as the characteristics of the Company's balance sheet evolve and interest rate and yield curve assumptions are updated.

The change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including stated interest rates or spreads relative to current or projected market-level interest rates or spreads, the likelihood of principal prepayments, whether contractual interest rates are fixed or floating, and the average remaining time to maturity. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are

factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and Management's best estimates. The table below shows estimated changes in the Company's EVE as of June 30, 2018, under different interest rate scenarios relative to a base case of current interest rates:

| (\$ In Thousands)       | <b>Balance Sheet Shock</b> |          |  |  | STATIC<br>(Base) | +100 bp | +200 bp | +300 bp | +400 bp |
|-------------------------|----------------------------|----------|--|--|------------------|---------|---------|---------|---------|
|                         | -200 bp                    | -100 bp  |  |  |                  |         |         |         |         |
| Market Value of Equity  | 486,151                    | 497,528  |  |  | 594,009          | 657,374 | 698,851 | 723,035 | 732,077 |
| Change in EVE from base | (107,858)                  | (96,481) |  |  |                  | 63,365  | 104,842 | 129,026 | 138,068 |
| % Change                | (18.2 )%                   | (16.2 )% |  |  |                  | 10.7 %  | 17.7 %  | 21.7 %  | 23.2 %  |
| Policy Limits           | -20.0 %                    | -10.0 %  |  |  |                  | -10.0 % | -20.0 % | -30.0 % | -40.0 % |

The table shows that our EVE will generally deteriorate in declining rate scenarios, but should benefit from a parallel shift upward in the yield curve. As noted previously, however, Management believes that the potential for a significant rate decline is low. We also run stress scenarios for EVE to simulate the possibility of higher loan prepayment rates, unfavorable changes in deposit rates, and higher deposit decay rates. Model results are highly sensitive to changes in assumed decay rates for non-maturity deposits, in particular.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### Evaluation of Disclosure Controls and Procedures

As of June 30, 2018, (the “Evaluation Date”), we carried out an evaluation, under the supervision of and with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, as of the Evaluation Date, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms.

##### Changes in Internal Controls

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended June 30, 2018, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **PART II – OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The Company is involved in various legal proceedings in the normal course of business. Management does not believe, based on currently available information, that the outcome of any such proceedings will have a material adverse effect on our financial condition or results of operations.

**ITEM 1A. RISK FACTORS**

There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017.

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

Not applicable

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable

**Item 5. Other Information**

Not applicable

**ITEM 6. EXHIBITS**

(a) Exhibits

**Exhibit No. Description**

- |            |   |
|------------|---|
| <u>3.1</u> | <u>Amended and Restated Articles of Incorporation of The First Bancshares, Inc. (incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K filed on July 28, 2016.</u> |
| <u>3.2</u> | <u>Amendment to the Amended and Restated Articles of Incorporation of The First Bancshares, Inc.*</u>   |

- 3.3 Amended and Restated Bylaws of The First Bancshares, Inc. effective as of March 17, 2016 (incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K filed on March 18, 2016.
- 4.1 Form of Certificate of Common Stock (incorporated by reference to Exhibit 4.3 to the Company's Registration Statement No. 333-220491 on Form S-3 filed on September 15, 2017.
- 31.1 Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 31.2 Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 32.1 Certification of principal executive officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*\*
- 32.2 Certification of principal financial officer pursuant to 18 U. S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*\*
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
- 101.LAB XBRL Taxonomy Extension Label Linkbase
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase

\* Filed herewith.

\*\* Furnished herewith.



SIGNATURES

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

THE FIRST BANCSHARES, INC.  
(Registrant)

August 9, 2018 /s/ M. RAY (HOPPY)COLE, JR.  
(Date) M. Ray (Hoppy) Cole, Jr.  
Chief Executive Officer

August 9, 2018 /s/ DONNA T. (DEE DEE) LOWERY  
(Date) Donna T. (Dee Dee) Lowery, Executive  
Vice President and Chief Financial Officer