

SB FINANCIAL GROUP, INC.  
Form 10-Q  
November 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

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

Commission file number 1-36785

SB FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

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

401 Clinton Street, Defiance, Ohio 43512

(Address of principal executive offices)

(Zip Code)

(419) 783-8950

(Registrant's telephone number, including area code)

N/A

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

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

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

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

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Large accelerated filer  
Non-accelerated filer (Do not check if a smaller reporting company) Accelerated filer  
Smaller reporting company  
Emerging growth company

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

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Shares, No Par Value	The NASDAQ Stock Market, LLC
<b>6,503,250</b> Outstanding at November 8, 2018	(NASDAQ Capital Market)

**SB FINANCIAL GROUP, INC.**

**FORM 10-Q**

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

SB Financial Group, Inc.

**Consolidated Balance Sheets**

(\$ in thousands)	September 2018 <b>(unaudited)</b>	December 2017 <b>(audited)</b>
<b>ASSETS</b>		
Cash & due from banks	\$ 45,515	\$26,616
Securities available for sale, at fair value	84,114	82,790
Other securities - FRB and FHLB Stock	4,123	3,748
Loans held for sale	6,888	3,940
Loans, net of unearned income	771,698	696,615
Allowance for loan losses	(8,489 )	(7,930 )
Premises and equipment, net	21,900	21,277
Cash surrender value of life insurance	16,745	16,479
Goodwill & other intangibles	16,404	16,411
Foreclosed assets held for sale, net	105	26
Mortgage servicing rights	11,129	9,907
Accrued interest receivable	2,433	1,825
Other assets	6,615	4,923
<b>Total assets</b>	<b>\$ 979,180</b>	<b>\$876,627</b>
<b>LIABILITIES AND EQUITY</b>		
<b>Deposits</b>		
Non interest bearing demand	\$ 134,747	\$ 135,592
Interest bearing demand	130,897	131,079
Savings	114,213	103,267
Money market	170,190	141,844
Time deposits	239,379	217,818
<b>Total deposits</b>	<b>789,426</b>	<b>729,600</b>
Repurchase agreements	15,539	15,082
Advances from Federal Home Loan Bank	24,500	18,500

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Trust preferred securities	10,310	10,310
Accrued interest payable	891	592
Other liabilities	11,405	8,543
Total liabilities	852,071	782,627
Commitments & Contingent Liabilities	-	-
Stockholder's Equity		
Preferred stock, Series A	13,979	13,983
Common stock	40,485	12,569
Additional paid-in capital	15,160	15,405
Retained earnings	61,854	55,439
Accumulated other comprehensive loss	(1,654 )	(141 )
Treasury stock, at cost	(2,715 )	(3,255 )
Total stockholder's equity	127,109	94,000
Total liabilities and stockholder's equity	\$ 979,180	\$ 876,627

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

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

**Sb Financial Group, Inc.****Consolidated Statements of Income - (Unaudited)**

(\$ in thousands, except per share data)	Three Months Ended		Nine Months Ended	
	September 2018	September 2017	September 2018	September 2017
Interest income				
Loans				
Taxable	\$9,499	\$ 7,653	\$26,607	\$ 21,696
Tax exempt	42	21	99	62
Securities				
Taxable	610	532	1,795	1,562
Tax exempt	107	132	339	398
Total interest income	10,258	8,338	28,840	23,718
Interest expense				
Deposits	1,472	907	3,538	2,518
Repurchase agreements & other	11	4	27	10
Federal Home Loan Bank advances	140	86	329	235
Trust preferred securities	106	78	293	223
Total interest expense	1,729	1,075	4,187	2,986
Net interest income	8,529	7,263	24,653	20,732
Provision for loan losses	-	-	600	200
Net interest income after provision for loan losses	8,529	7,263	24,053	20,532
Noninterest income				
Wealth management fees	705	688	2,155	2,059
Customer service fees	672	674	1,991	1,981
Gain on sale of mortgage loans & OMSR's	2,066	2,211	5,224	5,524
Mortgage loan servicing fees, net	273	227	991	851
Gain on sale of non-mortgage loans	125	294	935	1,093
Data service fees	-	182	-	559
Net gain on sale of securities	70	119	70	119
Gain/(loss) on sale/disposal of assets	-	8	21	10
Other income	291	458	1,308	929
Total noninterest income	4,202	4,861	12,695	13,125
Noninterest expense				
Salaries and employee benefits	5,372	4,844	15,513	13,897
Net occupancy expense	588	566	1,797	1,678
Equipment expense	667	688	2,133	2,012
Data processing fees	489	429	1,345	1,195
Professional fees	393	502	1,316	1,282
Marketing expense	197	180	622	581

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Telephone and communications	124	120	374	349
Postage and delivery expense	83	103	221	336
State, local and other taxes	177	198	538	535
Employee expense	243	242	629	570
Other expenses	456	412	1,507	1,037
<b>Total noninterest expense</b>	<b>8,789</b>	<b>8,284</b>	<b>25,995</b>	<b>23,472</b>
Income before income tax expense	3,942	3,840	10,753	10,185
Income tax expense	824	1,117	2,074	3,152
Net income	\$3,118	\$ 2,723	\$8,679	\$ 7,033
Preferred Stock Dividends	244	244	732	731
Net income available to common shareholders	\$2,874	\$ 2,479	\$7,947	\$ 6,302
Common share data:				
Basic earnings per common share	\$0.45	\$ 0.52	\$1.30	\$ 1.31
Diluted earnings per common share	\$0.39	\$ 0.43	\$1.14	\$ 1.11
Average common shares outstanding (in thousands):				
Basic:	6,503	4,797	6,106	4,825
Diluted:	8,022	6,326	7,626	6,356

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



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

(\$ in thousands)	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Net income	\$3,118	\$2,723	\$8,679	\$7,033
Other comprehensive income:				
Available for sale investment securities:				
Unrealized holding gain (loss) arising in the period	(524 )	112	(1,914)	550
Related tax (expense) benefit	110	(38 )	401	(187 )
Less: Reclassification for gain realized in income	(70 )	(119 )	(70 )	(119 )
Related tax expense	15	40	15	40
Net effect on other comprehensive income	(469 )	(5 )	(1,568)	284
Total comprehensive income	\$2,649	\$2,718	\$7,111	\$7,317

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

## SB Financial Group, Inc.

## Condensed Consolidated Statements of Shareholders' Equity (unaudited)

(\$ in thousands, except per share data)	Preferred	Common	Additional	Retained	Accumulated	Treasury	Total
	Stock	Stock	Paid-in Capital	Earnings	Other Comprehensive Income	Stock	
Balance, January 1, 2018	\$ 13,983	\$ 12,569	\$ 15,405	\$ 55,439	\$ (141 )	\$ (3,255 )	\$ 94,000
Net income				8,679			8,679
Common stock issuance (1,666,666 shares)		27,912					27,912
Conversion of preferred to common	(4 )	4					-
Other comprehensive loss					(1,513 )		(1,513 )
Dividends on common, \$0.235 per share				(1,532 )			(1,532 )
Dividends on preferred, \$0.4875 per share				(732 )			(732 )
Restricted stock vesting			(257 )			257	-
Stock options exercised			(200 )			392	192
Repurchased stock						(109 )	(109 )
Stock based compensation expense			212				212
Balance, September 30, 2018	\$ 13,979	\$ 40,485	\$ 15,160	\$ 61,854	\$ (1,654 )	\$ (2,715 )	\$ 127,109
Balance, January 1, 2017	\$ 13,983	\$ 12,569	\$ 15,362	\$ 46,688	\$ 51	\$ (2,105 )	\$ 86,548
Net income				7,033			7,033
Other comprehensive income					284		284
Dividends on common, \$0.205 per share				(998 )			(998 )
Dividends on preferred, \$0.4875 per share				(732 )			(732 )
Restricted stock vesting			(163 )			163	-
Stock options exercised			(77 )			416	339
Stock buyback						(1,778 )	(1,778 )
Share based compensation expense			213				213
Balance, September 30, 2017	\$ 13,983	\$ 12,569	\$ 15,335	\$ 51,991	\$ 335	\$ (3,304 )	\$ 90,909

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

## Consolidated Statements of Cash Flows (Unaudited)

(\$ in thousands)	Nine Months Ended September 30,	
	2018	2017
Operating Activities		
Net Income	\$8,679	\$7,033
Items providing/(using) cash		
Depreciation and amortization	1,261	1,152
Provision for loan losses	600	200
Expense of share-based compensation plan	212	213
Amortization of premiums and discounts on securities	275	437
Amortization of intangible assets	7	8
Amortization of originated mortgage servicing rights	931	863
Impairment (recovery) of mortgage servicing rights	(8 )	40
Proceeds from sale of loans held for sale	200,306	203,999
Originations of loans held for sale	(200,364)	(202,652)
Gain from sale of loans	(6,159 )	(6,617 )
(Gain)/loss on sale of assets	(21 )	47
Changes in		
Interest receivable	(608 )	368
Other assets	(1,367 )	(2,726 )
Interest payable and other liabilities	3,161	1,551
Net cash provided by operating activities	6,905	3,916
Investing Activities		
Purchases of available-for-sale securities	(16,248 )	(25,785 )
Proceeds from maturities of available-for-sale securities	10,619	16,234
Proceeds from sales of available-for-sale securities	2,115	14,369
Purchase of FRB stock	(375 )	-
Proceeds from bank owned life insurance	-	386
Net change in loans	(75,034 )	(30,901 )
Purchase of premises and equipment and software	(1,383 )	(3,294 )
Proceeds from sale of equipment	134	-
Proceeds from sale of foreclosed assets	152	945
Net cash used in investing activities	(80,020 )	(28,046 )
Financing Activities		
Net increase in demand deposits, money market, interest checking and savings accounts	38,265	19,561
Net increase in certificates of deposit	21,561	24,173
Net increase in securities sold under agreements to repurchase	457	811

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Proceeds from Federal Home Loan Bank advances	13,000	5,000
Repayment of Federal Home Loan Bank advances	(7,000 )	(11,000 )
Share repurchase	(109 )	(1,778 )
Exercise of Stock Options	192	339
Issuance of Common Stock	27,912	-
Dividends on Common Stock	(1,532 )	(998 )
Dividends on Preferred Stock	(732 )	(732 )
Net cash provided by financing activities	92,014	35,376
Increase in Cash and Cash Equivalents	18,899	11,246
Cash and Cash Equivalents, Beginning of Year	26,616	17,012
Cash and Cash Equivalents, End of Period	\$45,515	\$28,258
Supplemental Cash Flows Information		
Interest paid	\$3,888	\$2,783
Income taxes paid	\$2,290	\$2,863
Transfer of loans to foreclosed assets	\$175	\$94

See notes to condensed consolidated financial statements (unaudited)

SB FINANCIAL GROUP, INC.

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

**NOTE 1 – BASIS OF PRESENTATION**

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

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements reflect all adjustments that are, in the opinion of management, necessary to fairly present the financial position, results of operations and cash flows of the Company. Those adjustments consist only of normal recurring adjustments. Results of operations for the nine months ended September 30, 2018, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2017 has been derived from the audited consolidated balance sheet of the Company as of that date.

For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

The following paragraphs summarize the impact of new accounting pronouncements:

**Accounting Standards Update (ASU) No. 2018-07: Compensation – Stock Compensation (Topic 718)**

This ASU expands scope of Topic 718, to include share-based payments issued to nonemployees for goods or services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. This ASU supersedes Subtopic 505-50, Equity-Based Payments to Non-Employees. The amendments in this ASU are effective for periods beginning after December 15, 2018. At this time, the Company does not recognize the existence of any nonemployee relationships involving share-based payments.

**ASU No. 2018-02: Income Statement – Reporting Comprehensive Income (Topic 220)**

This ASU provides for the reclassification of stranded tax effects in accumulated other comprehensive income (AOCI) an option rather than a requirement; however, disclosure is required if not elected. The reclassification from accumulated other comprehensive income to retained earnings results from the newly elected federal corporate income tax rate resulting from the Tax Cuts and Jobs Acts enacted in December 2017. The Company has adopted this ASU on December 31, 2017 and reclassified approximately \$23 thousand into retained earnings.

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

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

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

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

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

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

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

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

This ASU is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this ASU are effective for reporting periods beginning after December 15, 2018. The Company has little leasing activity and management has determined that the impact on the Company's consolidated financial statements will be immaterial.



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

This ASU has a number of provisions including the requirements that public business entities use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, a separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e. securities or loans receivables), and eliminating the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendment was effective for the Company in the first quarter of 2018 and did not have a significant impact on the consolidated financial statements or on fair value and other required disclosures.

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

This ASU implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of the amendment is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. ASU 2014-09 establishes a five-step model, which entities must follow to recognize revenue and removes inconsistencies and weaknesses in existing guidance. The majority of our revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as our loans, letters of credit, derivatives and investment securities, as well as revenue related to our mortgage servicing activities, as these activities are subject to other GAAP discussed elsewhere within our disclosures. ASU 2014-09 became effective on January 1, 2018 and had no material effect on how we recognize revenue or to our consolidated financial statements and disclosures.

**Interest Income** – The largest source of revenue for the Company is interest income, which is primarily recognized on an accrual basis according to nondiscretionary formulas in written contracts, such as loan and lease agreements or investment securities contracts.

**Noninterest Income** – The Company earns noninterest income through a variety of financial and transaction services provided to corporate and consumer clients such as Wealth Management, deposit account, debit card and mortgage banking. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed. In certain circumstances, noninterest income is reported net of associated expenses.



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Net earnings allocated to participating securities	11	9
Dividends on convertible preferred shares	732	731
Net Income allocated to common shares and participating securities	\$8,679	\$7,033
Weighted average shares outstanding for basic earnings per share	6,106	4,825
Dilutive effect of stock compensation	63	73
Dilutive effect of convertible shares	1,457	1,458
Weighted average shares outstanding for diluted earnings per share	7,626	6,356
Basic earnings per common share	\$1.30	\$1.31
Diluted earnings per common share	\$1.14	\$1.11

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**Note 3 – Securities**

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at September 30, 2018 and December 31, 2017 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>(\$ in thousands)</b>				
Available for Sale Securities:				
September 30, 2018				
U.S. Treasury and Government agencies	\$ 11,897	\$ 5	\$ (326 )	\$ 11,576
Mortgage-backed securities	63,312	34	(1,876 )	61,470
State and political subdivisions	10,998	127	(57 )	11,068
	\$ 86,207	\$ 166	\$ (2,259 )	\$ 84,114

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

The amortized cost and fair value of securities available for sale at September 30, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale Amortized Cost	Fair Value
<b>(\$ in thousands)</b>		
Within one year	\$2,118	\$2,135

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Due after one year through five years	7,516	7,444
Due after five years through ten years	9,692	9,486
Due after ten years	3,569	3,579
	22,895	22,644
Mortgage-backed securities	63,312	61,470
Totals	\$86,207	\$84,114



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

The total potential unrealized loss as of September 30, 2018 in the securities portfolio was \$2.3 million, compared to a \$0.78 million unrealized loss at December 31, 2017. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. Management has determined there is no other-than-temporary-impairment on these securities.

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

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoffs, are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Generally, all loan classes are placed on non-accrual status not later than 90 days past due, unless the loan is well-secured and in the process of collection. All interest accrued, but not collected, for loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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

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

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

A loan is considered impaired when, based on current information and events, it is probable that State Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration each of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay,



the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, agricultural, and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent.

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

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

Categories of loans at September 30, 2018 and December 31, 2017 include:

(\$ in thousands)	Total Loans		Non-Accrual Loans	
	September 2018	December 2017	September 2018	December 2017
Commercial & Industrial	\$119,242	\$101,554	360	121
Commercial RE & Construction	356,563	332,154	228	1,322
Agricultural & Farmland	52,814	51,947	-	-
Residential Real Estate	178,033	150,854	1,541	1,123
Consumer & Other	64,478	59,619	252	138
Total Loans	\$771,130	\$696,128	\$2,381	\$2,704
Net deferred costs	\$568	\$487		
Total Loans, net deferred costs	\$771,698	\$696,615		
Allowance for loan losses	\$(8,489 )	\$(7,930 )		

The following tables present the activity in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of September 30, 2018, December 31, 2017 and September 30, 2017.

(\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
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#### ALLOWANCE FOR LOAN AND LEASE LOSSES

For the Three Months Ended - September 30, 2018

Beginning balance	\$ 1,061	\$ 3,720	\$ 488	\$ 2,550	\$ 675	\$8,494
Charge Offs	-	-	-	-	(11 )	\$(11 )
Recoveries	-	-	-	-	6	6
Provision	13	5	(9 )	(39 )	30	-
Ending Balance	\$ 1,074	\$ 3,725	\$ 479	\$ 2,511	\$ 700	\$8,489

For the Nine Months Ended -September 30, 2018

Beginning balance	\$ 823	\$ 3,779	\$ 505	\$ 2,129	\$ 694	\$7,930
Charge Offs	-	(36 )	-	(26 )	(23 )	\$(85 )
Recoveries	-	29	-	2	13	44

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Provision	251	(47	)	(26	)	406	16	600
Ending Balance	\$ 1,074	\$ 3,725		\$ 479		\$ 2,511	\$ 700	\$8,489

(\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
Loans Receivable at September 30, 2018						
Allowance:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ -	\$ -	\$ 77	\$ 4	\$81
Ending balance:						
collectively evaluated for impairment	\$ 1,074	\$ 3,725	\$ 479	\$ 2,434	\$ 696	\$8,408
Loans:						
Ending balance:						
individually evaluated for impairment	\$ 329	\$ 287	\$ -	\$ 1,889	\$ 177	\$2,682
Ending balance:						
collectively evaluated for impairment	\$ 118,913	\$ 356,276	\$ 52,814	\$ 176,144	\$ 64,301	\$768,448

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

(\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Three Months Ended - September 30, 2017						
Beginning balance	\$ 995	\$ 3,452	\$ 512	\$ 1,988	\$ 878	\$ 7,825
Charge Offs	-	(26 )	-	(20 )	(29 )	\$(75 )
Recoveries	-	-	1	2	7	10
Provision	(138 )	195	(17 )	44	(84 )	-
Ending Balance	\$ 857	\$ 3,621	\$ 496	\$ 2,014	\$ 772	\$ 7,760

(\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Nine Months Ended - September 30, 2017						
Beginning balance	\$ 1,204	\$ 3,321	\$ 347	\$ 1,963	\$ 890	\$ 7,725
Charge Offs	(50 )	(26 )	-	(42 )	(77 )	\$(195 )
Recoveries	6	2	3	6	13	30
Provision	(303 )	324	146	87	(54 )	200
Ending Balance	\$ 857	\$ 3,621	\$ 496	\$ 2,014	\$ 772	\$ 7,760

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

#### Commercial and Agricultural

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

#### Commercial Real Estate including Construction

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

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

### Residential and Consumer

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

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of September 30, 2018 and December 31, 2017.

<b><u>September 30, 2018</u></b>	<b>Commercial</b>	<b>Commercial</b>	<b>Agricultural</b>	<b>Residential</b>	<b>Consumer</b>	
<b>(\$ in thousands)</b>	<b>&amp; Industrial</b>	<b>RE</b>	<b>&amp; Farmland</b>	<b>Real Estate</b>	<b>&amp; Other</b>	<b>Total</b>
		<b>&amp; Construction</b>				
1-2	\$ -	\$ -	\$ -	\$ -	\$ -	\$-
3	17,929	99,297	7,564	134,491	62,095	321,376
4	97,591	255,261	44,747	41,564	1,982	441,145
Total Pass (1 - 4)	115,520	354,558	52,311	176,055	64,077	762,521
Special Mention (5)	737	1,056	503	-	62	2,358
Substandard (6)	2,625	683	-	1,978	339	5,625
Doubtful (7)	360	266	-	-	-	626
Loss (8)	-	-	-	-	-	-

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Total Loans           \$ 119,242     \$ 356,563           \$ 52,814     \$ 178,033     \$ 64,478     \$771,130

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

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

### **Credit Risk Profile**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$100 thousand and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

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

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

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

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

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



The following tables present the Company's loan portfolio aging analysis as of September 30, 2018 and December 31, 2017.

### Loan Portfolio Aging Analysis

As of September 30, 2018 and December 31, 2017

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
<b><u>September 30, 2018</u></b>						
Commercial & Industrial	\$ -	\$ 125	\$ 329	\$ 454	\$ 118,788	\$ 119,242
Commercial RE & Construction	75	-	7	82	356,481	356,563
Agricultural & Farmland	-	-	-	-	52,814	52,814
Residential Real Estate	215	310	471	996	177,037	178,033
Consumer & Other	146	46	141	333	64,145	64,478
Total Loans	\$ 436	\$ 481	\$ 948	\$ 1,865	\$ 769,265	\$ 771,130

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

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

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

The following tables present impaired loan information as of and for the three and nine months ended September 30, 2018 and 2017, and for the twelve months ended December 31, 2017:

<b>Nine Months Ended September 30, 2018</b> (\$ in thousands)	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
With no related allowance recorded:					
Commercial & Industrial	\$ 329	\$ 329	\$ -	\$ 777	\$ 19
Commercial RE & Construction	287	287	-	336	17
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,021	1,064	-	1,745	57
Consumer & Other	97	97	-	106	5
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	-	-	-	-	-
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	868	894	77	428	15
Consumer & Other	80	80	4	92	4
Totals:					
Commercial & Industrial	329	329	-	777	19
Commercial RE & Construction	287	287	-	336	17
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,889	1,958	77	2,173	72
Consumer & Other	\$ 177	\$ 177	\$ 4	\$ 198	\$ 9

<b>Three Months Ended September 30, 2018</b> (\$ in thousands)	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
With no related allowance recorded:		
Commercial & Industrial	\$ 763	\$ (9 )
Commercial RE & Construction	336	5

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Agricultural & Farmland	-	-	
Residential Real Estate	1,733	16	
Consumer & Other	102	2	
With a specific allowance recorded:			
Commercial & Industrial	-	-	
Commercial RE & Construction	-	-	
Agricultural & Farmland	-	-	
Residential Real Estate	424	5	
Consumer & Other	90	1	
Totals:			
Commercial & Industrial	763	(9	)
Commercial RE & Construction	336	5	
Agricultural & Farmland	-	-	
Residential Real Estate	2,157	21	
Consumer & Other	\$ 192	\$ 3	

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

<b>September 30, 2017</b> (\$ in thousands)	<b>Nine Months Ended</b>		<b>Three Months Ended</b>	
	<b>Average Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
With no related allowance recorded:				
Commercial & Industrial	\$-	\$ -	\$-	\$ -
Commercial RE & Construction	757	29	754	7
Agricultural & Farmland	-	-	-	-
Residential Real Estate	539	20	535	5
Consumer & Other	130	7	126	2
With a specific allowance recorded:				
Commercial & Industrial	-	-	-	-
Commercial RE & Construction	721	(2 )	689	-
Agricultural & Farmland	-	-	-	-
Residential Real Estate	631	20	625	7
Consumer & Other	95	4	92	1
Totals:				
Commercial & Industrial	\$-	\$ -	\$-	\$ -
Commercial RE & Construction	\$1,478	\$ 27	\$1,443	\$ 7
Agricultural & Farmland	\$-	\$ -	\$-	\$ -
Residential Real Estate	\$1,170	\$ 40	\$1,160	\$ 12
Consumer & Other	\$225	\$ 11	\$218	\$ 3

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

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

**Troubled Debt Restructured (TDR) Loans**

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

### TDR Concession Types

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

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

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

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

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

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

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

During the three and nine months ended September 30, 2018 and 2017, the Company had no new TDR activity.

The Company had one TDR, a consumer loan with a recorded balance of \$8,000 that during the last 12-month period defaulted on its new contractual agreement.

**NOTE 5 – MORTGAGE SERVICING RIGHTS**

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balance of mortgage loans serviced for others approximated \$1.07 billion at September 30, 2018 and \$0.99 billion at December 31, 2017. Contractually specified servicing fees of approximately, \$1.9 million and \$1.8 million were included in mortgage loan servicing fees in the income statement for the periods ending September 30, 2018 and 2017, respectively.

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

(\$ in thousands)	2018	2017
Carrying amount, January 1	\$9,907	\$8,422
Mortgage servicing rights capitalized during the year	2,288	2,042
Mortgage servicing rights amortization during the year	(931 )	(864 )
Net change in valuation allowance	8	(40 )
Carrying amount, September 30	\$11,272	\$9,560
Valuation allowance:		
January 1	\$151	\$228
Increase/(reduction)	(8 )	40
September 30	\$143	\$268

## NOTE 6 – DERIVATIVE FINANCIAL INSTRUMENTS AND REPURCHASE AGREEMENTS

### *Risk Management Objective of Using Derivatives*

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

### *Non-designated Hedges*

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest



rate swaps are simultaneously offset by interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2018 and December 31, 2017, the notional amount of customer-facing swaps was approximately \$50.7 million and \$39.3 million, respectively. The same amounts were offset with third party counterparties, as described above.

The Company has minimum collateral posting thresholds with its derivative counterparties. As of September 30, 2018 and December 31, 2017, the Company had no posted cash as collateral with correspondents. At September 30, 2018, the Company held cash from counterparties as collateral in the amount of \$1.3 million.

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the balance sheet, as of September 30, 2018 and December 31, 2017.

(\$ in thousands)	Asset Derivatives September 30, 2018		Liability Derivatives September 30, 2018	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 1,455	Other Liabilities	\$ 1,455

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

The Company's derivative financial instruments had no net effect on the income statements for the three and nine months ended September 30, 2018 and 2017.

#### *Securities Sold Under Repurchase Agreements*

State Bank has retail repurchase agreements to facilitate cash management transactions with commercial customers. These obligations are secured by agency and mortgage-backed securities and such collateral is held by the Federal Home Loan Bank. The agreements mature within one month. These repurchase agreements are secured by agency and mortgage-backed securities with a fair value of \$18.7 million. These securities have various maturity dates beyond 2018.

#### **NOTE 7 – FAIR VALUE OF ASSETS AND LIABILITIES**

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

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

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

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

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

Available-for-Sale Securities

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

Interest Rate Contracts

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

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

**Fair Value Measurements Using:**

(\$ in thousands)	September 30,	(Level	(Level	(Level
Available for Sale Securities:	2018	1)	2)	3)
U.S. Treasury and Government Agencies	\$ 11,576	\$ -	\$11,576	\$ -
Mortgage-backed securities	61,470	-	61,470	-
State and political subdivisions	11,068	-	11,068	-
Interest rate contracts - assets	1,455	-	1,455	-
Interest rate contracts - liabilities	(1,455	)	(1,455	)

**Fair Value Measurements Using:**

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

Level 1 – Quoted Prices in Active Markets for Identical Assets

Level 2 – Significant Other Observable Inputs

Level 3 – Significant Unobservable Inputs

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

Collateral-dependent Impaired Loans, NET of ALLL

Loans for which it is probable the Company will not collect all principal and interest due according to contractual terms are measured for impairment. The estimated fair value of collateral-dependent impaired loans is based on the appraised value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy. This method requires obtaining an independent appraisal of the collateral, which is reviewed for accuracy and consistency by Credit Administration. These appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by applying a discount factor to the value based on the Company's loan review policy. All impaired loans held by the Company were collateral dependent at September 30, 2018 and December 31, 2017.

Mortgage Servicing Rights

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

(\$ in thousands) Description	Fair Values at September 30, 2018	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 428	\$ -	\$ -	\$428
Mortgage Servicing Rights	2,707	-	-	2,707

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

Level 1 - Quoted Prices in Active Markets for Identical Assets

Level 2 - Significant Other Observable Inputs

Level 3 - Significant Unobservable Inputs

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**Unobservable (Level 3) Inputs**

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

(\$ in thousands)	Fair Values at September 30, 2018	Valuation Technique	Unobservable Inputs	Weighted Ave Range	
Collateral-dependent impaired loans	\$ 428	Market comparable properties	Comparability adjustments (%)	20	%
Mortgage servicing rights	2,707	Discounted cash flow	Discount Rate	10.42	%
			Constant prepayment rate	6.59	%
			P&I earnings credit	2.23	%
			T&I earnings credit	2.94	%
			Inflation for cost of servicing	1.50	%
(\$ in thousands)	Fair Value at December 31, 2017	Valuation Technique	Unobservable Inputs	Range	
Collateral-dependent impaired loans	\$ 982	Market comparable properties	Comparability adjustments (%)	Not available	
Mortgage servicing rights	1,490	Discounted cash flow	Discount Rate	9.65	%
			Constant prepayment rate	7.51	%
			P&I earnings credit	1.56	%
			T&I earnings credit	2.13	%
			Inflation for cost of servicing	1.50	%

There were no changes in the inputs or methodologies used to determine fair value at September 30, 2018 as compared to December 31, 2017.

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



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

The carrying amount approximates the fair value.

Loans Held for Sale

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

Loans

The estimated fair value for loans receivable is based on estimates of the rate State Bank would charge for similar loans at September 30, 2018 and December 31, 2017, applied for the time period until the loans are assumed to re-price or be paid.

Mortgage Servicing Rights

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

Deposits, FHLB advances & Repurchase agreements

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates the fair value. The estimated fair value for fixed-maturity time deposits, as well as borrowings,

is based on estimates of the rate State Bank could pay on similar instruments with similar terms and maturities at September 30, 2018 and December 31, 2017.

### Loan Commitments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The estimated fair values for other financial instruments and off-balance-sheet loan commitments approximate cost at September 30, 2018 and December 31, 2017 and are not considered significant to this presentation.

Trust Preferred Securities

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

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

	September 30,			
	2018	Fair Value Measurements Using		
(\$ in thousands)	Carrying Amount	(Level 1)	(Level 2)	(Level 3)
<b>Financial assets</b>				
Cash and cash equivalents	\$ 45,515	\$45,515	\$-	\$-
Loans held for sale	6,888	-	6,952	-
Loans, net of allowance for loan losses	763,209	-	-	750,037
Federal Reserve and FHLB Bank stock	4,123	-	4,123	-
Accrued interest receivable	2,433	-	2,433	-
<b>Financial liabilities</b>				
Deposits	\$ 789,426	\$550,127	\$237,191	\$-
Repurchase agreements	15,539	-	15,539	-
FHLB advances	24,500	-	24,220	-
Trust preferred securities	10,310	-	10,511	-
Accrued interest payable	891	-	891	-
		December 31,		
		2017		
		Fair Value Measurements Using		
(\$ in thousands)	Carrying Amount	(Level 1)	(Level 2)	(Level 3)
<b>Financial assets</b>				
Cash and due from banks	\$ 26,616	\$26,616	\$-	\$-
Loans held for sale	3,940	-	4,041	-
Loans, net of allowance for loan losses	688,685	-	-	686,940

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Federal Reserve and FHLB Bank stock, at cost	3,748	-	3,748	-
Accrued interest receivable	1,825	-	1,825	-
Financial liabilities				
Deposits	\$ 729,600	\$511,782	\$220,823	\$-
Repurchase agreements	15,082	-	15,082	-
FHLB advances	18,500	-	18,385	-
Trust preferred securities	10,310	-	9,673	-
Accrued interest payable	592	-	592	-

**NOTE 8 – SHARE BASED COMPENSATION**

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

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

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

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

A summary of incentive option activity under the Company's plans as of September 30, 2018 and changes during the period then ended, is presented below:

(\$ in thousands - except per share data)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term	Aggregate Intrinsic Value
Outstanding, December 31, 2017	92,500	\$ 6.97		
Granted	-	-		
Exercised	(28,500)	6.92		
Forfeited	-	-		
Expired	-	-		
Outstanding, September 30, 2018	64,000	\$ 6.99	1.36	\$ 855
Exercisable, September 30, 2018	64,000	\$ 6.99	1.36	\$ 855

During 2018, the 28,500 option shares exercised had a total intrinsic value of \$0.35 million and the cash received from these exercised options was \$0.2 million. The tax benefit from these transactions was immaterial. As of September 30, 2018, there was no unrecognized compensation cost related to incentive option share-based compensation arrangements granted under the 2008 Plan.

On February 5, 2013, the Company adopted a Long Term Incentive (LTI) Plan. The Plan awards restricted stock in the Company to certain key executives under the 2008 Plan. These restricted stock awards vest over a four-year period and are intended to assist the Company in retention of key executives. During 2017, the Company met certain performance targets and restricted stock awards were approved and issued in February of 2018. The compensation cost charged against income for the Long Term Incentive (LTI) Plan was \$0.2 million, with a total income tax benefit recognized in the income statement of \$0.04 million.

As of September 30, 2018, there was \$0.59 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements related to the restricted stock awards under the 2008 Plan which were granted in accordance with the Long Term Incentive (LTI) plan. That cost is expected to be recognized over a

weighted-average period of 2.7 years.

A summary of restricted stock activity under the Company's plans as of September 30, 2018 and changes during the period then ended, is presented below:

	Shares	Weighted-Average Value per Share
Nonvested, December 31, 2017	52,258	\$ 14.91
Granted	16,268	17.66
Vested	(21,632)	13.95
Forfeited	-	-
Nonvested, September 30, 2018	46,894	\$ 16.31

In April 2017, the Company's shareholders approved a new equity-based incentive compensation plan, the 2017 Stock Incentive Plan (the "2017"). The 2017 Plan permits the company to grant stock options, restricted stock and other equity-based awards and cash-based awards to employees and directors of the Company and its subsidiaries. A total of 500,000 common shares of the Company are available for grants of awards under the 2017 Plan. As of September 30, 2018, 16,268 shares had been granted under the 2017 Plan.

#### **NOTE 9 – EQUITY CAPITAL**

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

#### **NOTE 10 – GENERAL LITIGATION**

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





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

**Cautionary Statement Regarding Forward-Looking Information**

This Quarterly Report on Form 10-Q, including Management’s Discussion and Analysis of Financial Condition and Results of Operations, contains certain forward-looking statements that are provided to assist in the understanding of anticipated future financial performance. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payment or non-payment of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our management or Board of Directors, including those relating to products or services; (c) statements of future economic performance; (d) statements regarding future customer attraction or retention; and (e) statements of assumptions underlying such statements. Words such as “anticipates”, “believes”, “plans”, “intends”, “expects”, “projects”, “estimates”, “should”, “may”, “will allow”, “will likely result”, “will continue”, “will remain”, or other similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying those statements. Forward-looking statements are based on management’s expectations and are subject to a number of risks and uncertainties. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements. Risks and uncertainties that could cause actual results to differ materially include, without limitation, risks and uncertainties inherent in the national and regional banking industry, changes in economic conditions in the market areas in which the Company and its subsidiaries operate, changes in policies and supervisory and enforcement activities by regulatory agencies, changes in accounting standards and policies, changes in tax laws, fluctuations in interest rates, demand for loans in the market areas in which the Company and its subsidiaries operate, increases in FDIC insurance premiums, changes in the competitive environment, losses of significant customers, geopolitical events and the loss of key personnel. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in Management’s Discussion and Analysis of Financial Condition and Results of Operations is available in the Company’s filings with the Securities and Exchange Commission, including the risks identified under the heading “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017. Undue reliance should not be placed on the forward-looking statements, which speak only as of the date hereof. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect unanticipated events or circumstances after the date on which the statement is made.

**Overview of SB Financial**

SB Financial Group, Inc. (“SB Financial” or the “Company”) is a bank holding company registered with the Federal Reserve Board. SB Financial’s wholly-owned subsidiary, The State Bank and Trust Company (“State Bank”), is an Ohio-chartered bank engaged in commercial banking.

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

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

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

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

### **Critical Accounting Policies**

Note 1 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017 describes the significant accounting policies used in the development and presentation of the Company's financial statements. The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The Company's financial position and results of operations can be affected by these estimates and assumptions and are integral to the understanding of reported results. Critical accounting policies are those policies that management believes are the most important to the portrayal of the Company's financial condition and results, and they require management to make estimates that are difficult, subjective, and/or complex.

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

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

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

environment. To the extent that actual results differ from management's estimates, additional loan loss provisions may be required that could adversely impact earnings for future periods.

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

**Three Months Ended September 30, 2018 compared to Three Months Ended September 30, 2017**

**Net Income:** Net income for the third quarter of 2018 was \$3.1 million compared to net income of \$2.7 million for the third quarter of 2017, an increase of 14.5 percent. Earnings per diluted share (EPS) of \$0.39 were down 9.3 percent from the \$0.43 for the third quarter of 2017. The lower EPS figure was the result of 1.7 million additional shares in February of 2018.

**Provision for Loan Losses:** There was no provision during the quarter ended September 30, 2018, which was the same as the prior year quarter. Net charge offs for the quarter were \$0.01 million compared to net charge offs of \$0.065 million for the year-ago quarter. Total delinquent loans ended the quarter at \$1.9 million, which is down \$0.53 million from the prior year or 0.24 percent of outstanding loans.

<b>Asset Quality Review – For the Period Ended</b>	<b>Sep. 30, 2018</b>	<b>Sep. 30, 2017</b>
<i>(\$'s in Thousands)</i>		
Net charge-offs	\$6	\$65
Nonaccruing loans	2,381	2,381
Accruing Trouble Debt Restructures	940	1,258
Nonaccruing and restructured loans	3,321	3,639
OREO / OAO	105	94
Nonperforming assets	3,426	3,733
Nonperforming assets/Total assets	0.35 %	0.43 %
Allowance for loan losses/Total loans	1.10 %	1.15 %
Allowance for loan losses/Nonperforming loans	255.6 %	213.3 %

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$12.7 million for the third quarter of 2018, an increase of \$0.6 million, or 5.0 percent, from the \$12.1 million generated during the 2017 third quarter.

Net interest income was \$8.5 million, which is up \$1.2 million from the prior year third quarter's \$7.3 million. The Company's earning assets increased \$92.8 million, coupled with a 43 basis point increase in the yield on earning assets. The net interest margin for the third quarter of 2018 was 3.95 percent compared to 3.76 percent for the third quarter of 2017. Funding costs for interest bearing liabilities for the third quarter of 2018 were 1.00 percent compared to 0.68 percent for the prior year third quarter.

Noninterest income was \$4.2 million for the 2018 third quarter, which is down \$0.7 million from the prior year third quarter's \$4.9 million. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.1 million, down \$0.2 million from the same period in 2017. Noninterest income as a percentage of average assets for the third quarter of 2018 was 1.75 percent compared to 2.27 percent for the prior year third quarter.

State Bank originated \$95.3 million of mortgage loans during the third quarter of 2018, of which \$80.6 million of loans were sold with the remainder of loans held for investment. This compares to \$89.2 million of loans originated during for the third quarter of 2017, of which \$76.9 million of loans were sold with the remainder in loans held for investment. These third quarter 2018 originations and subsequent sales resulted in \$2.1 million of gains, down 6.5 percent from \$2.2 million of gains for the third quarter of 2017. Net mortgage banking revenue was \$2.3 million for the third quarter of 2018 compared to \$2.4 million for the third quarter of 2017 due to higher OMSR impairment and lower sale gains. The 2018 third quarter included a \$0.06 million valuation impairment on our mortgage servicing rights, due to increased prepayment speeds in the portfolio.

**Consolidated Noninterest Expense:** Noninterest expense for the third quarter of 2018 was \$8.8 million, which is up \$0.5 million compared to \$8.3 million in the prior-year third quarter. The increase was all due to staffing growth in mortgage, SBA and support areas.

**Income Taxes:** Income taxes for the third quarter of 2018 were \$0.8 million (effective rate 20.9 percent) compared to \$1.1 million (effective rate 29.1 percent) for the third quarter of 2017. This decrease in the effective tax rate was the result of the Tax and Jobs Act enacted in December 2017.

**Nine Months Ended September 30, 2018 compared to Nine Months Ended September 30, 2017**

**Net Income:** Net income for the first nine months of 2018 was \$8.7 million compared to net income of \$7.0 million for the first nine months of 2017, an increase of 23.4 percent. Earnings per diluted share (EPS) for the period of \$1.14 were up 2.7 percent from the \$1.11 for the prior year nine-month period. EPS growth was impacted due to the issuance of 1.7 million shares in February 2018.

**Provision for Loan Losses:** The provision for loan losses for the first nine-months of 2018 was \$0.6 million compared to \$0.2 million for the prior year first nine months. Net charge-offs for the period were \$0.04 million compared to net charge-offs of \$0.17 million for the prior year nine-month period.

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$37.3 million for the first nine months of 2018, an increase of \$3.5 million, or 10.3 percent, from the \$33.9 million generated during the 2017 first nine months.

Net interest income was \$24.7 million, which is up \$4.0 million from net interest income of \$20.7 million for the prior year first nine months. The Company's earning assets increased \$81.1 million, and had a 41 basis point increase in the yield on earning assets for the first nine months of 2018. The net interest margin for the first nine months of 2018 was 3.94 percent compared to 3.67 percent for the first nine months of 2017. Funding cost for interest bearing liabilities for the first nine months of 2018 were 0.84 percent compared to 0.64 percent for the prior year first nine months.

Noninterest income was \$12.7 million for the 2018 first nine months, which is down \$0.4 million from noninterest income of \$13.1 million for the prior year first nine months. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.9 million, compared to \$1.1 million for the same period in 2017.

State Bank originated \$263.2 million of mortgage loans during the first nine months of 2018, of which \$200.3 million of loans were sold with the remainder of loans held for investment. These levels were up 8.0 percent but down 3.4 percent respectively as compared to the prior year first nine months. The 2018 first nine months had a slight negative valuation impairment (\$0.01 million) on our mortgage servicing rights compared to a \$0.04 million negative valuation impairment in the prior year nine-month period.

**Consolidated Noninterest Expense:** Noninterest expense for the first nine months of 2018 was \$26.0 million, which is up \$1.5 million compared to \$23.5 million in the prior-year first nine months. The increase in noninterest expenses compared to the prior year was solely due to increased staffing, primarily in our mortgage, SBA, wealth management and support divisions.

**Income Taxes:** Income taxes for the first nine months of 2018 were \$2.1 million (effective rate 19.3 percent) compared to \$3.2 million (effective rate 30.9 percent) for the first nine months of 2017. This decrease in the effective tax rate was the result of the Tax and Jobs Act enacted in December 2017.



### **Changes in Financial Condition**

Total assets at September 30, 2018 were \$979.2 million, an increase of \$102.6 million or 11.7 percent since 2017 year end. Total loans, net of unearned income, were \$771.7 million as of September 30, 2018, up \$75.1 million from year end, an increase of 10.8 percent.

Total deposits at September 30, 2018 were \$789.4 million, an increase of \$59.8 million or 8.2 percent since 2017 year end. Borrowed funds (consisting of FHLB advances, and REPOs) totaled \$40.0 million at September 30, 2018. This is up from year-end when borrowed funds totaled \$33.6 million due to an increase in FHLB advances of \$6.0 million. Total equity for the Company of \$127.1 million now stands at 13.0 percent of total assets, which is up from the December 31, 2017 level of \$94.0 million. Equity balances were higher due to the common capital raise completed by the Company in the first quarter of 2018 as detailed in Note 9.

The allowance for loan loss of \$8.5 million is up from the 2017 year end by \$0.6 million. This increase combined with the loan growth results in an allowance to loans of 1.10 percent. The 1.10 percent level is considered appropriate by management given the risk profile of the portfolio. The allowance to loan loss level at September 30, 2017 was 1.15 percent. The decline from the prior year was the result of higher loan growth and lower provision expenses due to improved asset quality.

### **Capital Resources**

As of September 30, 2018, based on the computations in its call report the State Bank is classified as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the State Bank must maintain capital ratios as set forth in the table below. There are no conditions or events since September 30, 2018 that management believes have changed the State Bank's capital classification.

State Bank's actual capital levels and ratios as of September 30, 2018 and December 31, 2017 are presented in the following table. Capital levels are presented for State Bank only as the Company is now exempt from quarterly reporting on capital levels at the holding company level (\$'s in thousands):

**To Be Well  
Capitalized**

	Actual		For Capital Adequacy Purposes		Under Prompt Corrective Action Procedures	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(\$ in thousands)						
As of September 30, 2018						
Tier I Capital to average assets	\$ 106,575	11.26 %	\$ 37,865	4.0 %	\$ 47,332	5.0 %
Tier I Common equity capital to risk-weighted assets	106,575	12.16 %	39,435	4.5 %	56,962	6.5 %
Tier I Capital to risk-weighted assets	106,575	12.16 %	52,580	6.0 %	70,107	8.0 %
Total Risk-based capital to risk-weighted assets	115,064	13.13 %	70,107	8.0 %	87,633	10.0 %
As of December 31, 2017						
Tier I Capital to average assets	\$ 83,807	9.72 %	\$ 34,477	4.0 %	\$ 43,097	5.0 %
Tier I Common equity capital to risk-weighted assets	83,807	10.54 %	35,786	4.5 %	51,691	6.5 %
Tier I Capital to risk-weighted assets	83,807	10.54 %	47,715	6.0 %	63,620	8.0 %
Total Risk-based capital to risk-weighted assets	91,737	11.54 %	63,620	8.0 %	79,524	10.0 %

Effective January 1, 2015, new regulatory capital requirements commonly referred to as “Basel III” were implemented and are reflected in the September 30, 2018 capital table above. Management opted out of the accumulated other comprehensive income treatment under the new requirements and as such, unrealized gains and losses from available for sale securities will continue to be excluded from State Banks regulatory capital. losses from available-for-sale securities will continue to be excluded from State Bank regulatory capital.

## LIQUIDITY

Liquidity relates primarily to the Company’s ability to fund loan demand, meet deposit customers’ withdrawal requirements and provide for operating expenses. Assets used to satisfy these needs consist of cash and due from banks, federal funds sold, interest-earning deposits in other financial institutions, securities available-for-sale and loans held for sale. These assets are commonly referred to as liquid assets. Liquid assets were \$136.5 million at September 30, 2018, compared to \$113.3 million at December 31, 2017.

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

and Asset Liability Manager.

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The Company's commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolio of \$587.4 million at September 30, 2018 and \$535.0 million at December 31, 2017, which can and has been used to collateralize borrowings, is an additional source of liquidity. Management believes the Company's current liquidity level, without these borrowings, is sufficient to meet its liquidity needs. At September 30, 2018, all eligible commercial real estate, first mortgage residential and multi-family mortgage loans were pledged under an FHLB blanket lien.

The cash flow statements for the periods presented provide an indication of the Company's sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statements for the nine months ended September 30, 2018 and 2017 follows.

The Company experienced positive cash flows from operating activities for the nine months ended September 30, 2018 and September 30, 2017. Net cash provided by operating activities was \$6.9 million for the nine months ended September 30, 2018 and \$3.9 million was provided for the nine months ended September 30, 2017. Highlights for the current year include \$200.3 million in proceeds from the sale of loans, which is down \$3.7 million from the prior year. Originations of loans held for sale was a use of cash of \$200.3 million, which is also down from the prior year, by \$2.4 million. For the nine months ended September 30, 2018, there was a gain on sale of loans of \$6.2 million, and depreciation and amortization of \$1.3 million.

The Company experienced negative cash flows from investing activities for the nine months ended September 30, 2018 and September 30, 2017. Net cash flows used in investing activities was \$80.0 million for the nine months ended September 30, 2018 and \$28.0 million for the nine months ended September 30, 2017. Highlights for the nine months ended September 30, 2018 include \$16.2 million in purchases of available-for-sale securities. These cash payments were mostly offset by \$12.7 million in proceeds from maturities and sales of securities, which is down \$17.9 million from the prior year nine-month period. The Company experienced a \$75.0 million increase in loans, which is up \$44.1 million from the prior year nine-month period.

The Company experienced positive cash flows from financing activities for the nine months ended September 30, 2018 and September 30, 2017. Net cash flow provided by financing activities was \$92.0 million for the nine months ended September 30, 2018 and \$35.4 million for the nine months ended September 30, 2017. Highlights for the current period include a \$38.3 million increase in transaction deposits for the nine months ended September 30, 2018, which is up from the \$19.6 million increase for the prior year nine-month period. Certificates of deposit increased by \$21.6 million in the current year compared to an increase of \$24.2 million for the prior year.

ALCO uses an economic value of equity ("EVE") analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis calculates the net present value of the Company's assets and liabilities in rate shock environments that range from -400 basis points to +400

basis points. The likelihood of a significant decrease in rates as of September 30, 2018 and December 31, 2017 was considered unlikely given the current interest rate environment and therefore, only the minus 200 basis point rate change (September 2018) and minus 100 basis point rate change (December 2017) was included in this analysis. The results of this analysis are reflected in the following tables for September 30, 2018 and December 31, 2017.

**September 30, 2018**

**Economic Value of Equity**

**(\$'s in thousands)**

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	\$212,310	\$19,797	10.28 %
+300 basis points	208,525	16,012	8.32
+200 basis points	204,517	12,004	6.24
+100 basis points	199,116	6,603	3.43
Base Case	192,513	-	-
-100 basis points	183,530	(8,983 )	(4.67 )
-200 basis points	169,673	(22,840)	(11.86 )

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

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

**Off-Balance-Sheet Borrowing Arrangements:**

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

The Company's commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolios in the aggregate amount of \$587.4 million have been pledged to meet FHLB collateralization requirements as of September 30, 2018. Based on the current collateralization requirements of the FHLB, the Company had approximately \$87.2 million of additional borrowing capacity at September 30, 2018. The Company also had \$21.0 million in unpledged securities that may be used to pledge for additional borrowings.

The Company's contractual obligations as of September 30, 2018 were comprised of long-term debt obligations, other debt obligations, operating lease obligations and other long-term liabilities. Long-term debt obligations are comprised of FHLB Advances of \$24.5 million, and Trust Preferred Securities of \$10.3 million. Total time deposits at September 30, 2018 were \$239.3 million, of which \$106.3 million matures beyond one year.

Also, as of September 30, 2018, the Company had commitments to sell mortgage loans totaling \$24.5 million. The Company believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If the Company requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

## **ASSET LIABILITY MANAGEMENT**

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

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

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

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

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

**There are several ways** an institution can manage interest rate risk including: 1) matching repricing periods for new assets and liabilities, for example, by shortening or lengthening terms of new loans, investments, or liabilities; 2) selling existing assets or repaying certain liabilities; and 3) hedging existing assets, liabilities, or anticipated transactions. An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest rate risk. Interest rate swaps, futures contracts, options on futures contracts, and other such derivative financial instruments can be used for this purpose. Because these instruments are sensitive to interest rate changes,



they require management's expertise to be effective. The Company does not currently utilize any derivative financial instruments to manage interest rate risk. As market conditions warrant, the Company may implement various interest rate risk management strategies, including the use of derivative financial instruments.

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

Management believes there has been no material change in the Company's market risk from the information contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC") for the year ended December 31, 2017.

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

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

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

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

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

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

##### **Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II – OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In the ordinary course of our business, the Company and its subsidiaries are parties to various legal actions which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability, if any, with respect to these legal actions cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

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

There are certain risks and uncertainties in our business that could cause our actual results to differ materially from those anticipated. A detailed discussion of our risk factors is included in "Item 1A. Risk Factors" of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. There have been no material changes to the risk factors as presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

(a) Not Applicable

(b) Not Applicable

(c) Repurchases of Common Shares

None

### **Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

Exhibits

31.1 Rule 13a-14(a)/15d-14(a) Certification (Principal Executive Officer)

31.2 Rule 13a-14(a)/15d-14(a) Certification (Principal Financial Officer)

32.1 Section 1350 Certification (Principal Executive Officer)

32.2 Section 1350 Certification (Principal Financial Officer)

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**SIGNATURES**

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

SB FINANCIAL GROUP, INC.

Date: November 8, 2018 By: /s/ Mark A. Klein  
Mark A. Klein  
Chairman, President & CEO

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