

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
May 01, 2019  
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 March 31, 2019

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 001-38084

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

OHIO 34-1469491  
(State or other jurisdiction of (IRS Employer  
incorporation or organization) Identification No.)

307 North Defiance Street, Archbold, Ohio 43502  
(Address of principal executive offices) (Zip Code)

(419) 446-2501

Registrant's telephone number, including area code

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(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 Section 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 every Interactive Data File required to be submitted 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 such files). Yes      No

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

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

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

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

Yes      No

Indicate the number of shares of each of the issuers’ classes of common stock, as of the latest practicable date:

|                            |                                  |
|----------------------------|----------------------------------|
| Common Stock, No Par Value | 11,106,183                       |
| Class                      | Outstanding as of April 26, 2019 |

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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(1) Pursuant to Rule 406T of Regulation S-T, the interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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## ITEM 1 FINANCIAL STATEMENTS

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

|   | (in thousands of dollars) |                      |
|---|---------------------------|----------------------|
|   | March 31,<br>2019         | December 31,<br>2018 |
|   | (Unaudited)               |                      |
| <b>Assets</b>   |                           |                      |
| Cash and due from banks   | \$48,740                  | \$ 37,492            |
| Federal funds sold  | 33,109                    | 873                  |
| Total cash and cash equivalents   | 81,849                    | 38,365               |
| Interest-bearing time deposits  | 4,509                     | 4,019                |
| Securities - available-for-sale   | 174,682                   | 168,447              |
| Other securities, at cost   | 5,789                     | 3,679                |
| Loans held for sale   | 859                       | 495                  |
| Loans, net  | 1,091,829                 | 839,599              |
| Premises and equipment  | 25,205                    | 22,615               |
| Goodwill  | 47,340                    | 4,074                |
| Mortgage servicing rights   | 2,397                     | 2,385                |
| Other real estate owned   | 510                       | 600                  |
| Bank owned life insurance   | 14,963                    | 14,884               |
| Other assets  | 15,729                    | 17,001               |
| <b>Total Assets</b>   | <b>\$1,465,661</b>        | <b>\$ 1,116,163</b>  |
| <b>Liabilities and Stockholders' Equity</b>   |                           |                      |
| <b>Liabilities</b>  |                           |                      |
| <b>Deposits</b>   |                           |                      |
| Noninterest-bearing   | \$236,847                 | \$ 215,422           |
| <b>Interest-bearing</b>   |                           |                      |
| NOW accounts  | 418,773                   | 298,254              |
| Savings   | 272,875                   | 227,701              |
| Time  | 258,929                   | 187,413              |
| <b>Total deposits</b>   | <b>1,187,424</b>          | <b>928,790</b>       |
| Federal funds purchased and securities sold under agreements to<br>repurchase   | 25,521                    | 32,181               |
| Federal Home Loan Bank (FHLB) advances  | 24,682                    | -                    |
| Dividend payable  | 1,654                     | 1,379                |
| Accrued expenses and other liabilities  | 9,446                     | 10,526               |
| <b>Total liabilities</b>  | <b>1,248,727</b>          | <b>972,876</b>       |
| <b>Commitments and Contingencies</b>  |                           |                      |
| <b>Stockholders' Equity</b>   |                           |                      |
| <b>Common stock - No par value 20,000,000 shares authorized; issued and<br/>outstanding 12,230,000 shares 3/31/19, 10,400,000 shares 12/31/18</b> |                           |                      |
|   | 81,760                    | 10,823               |
| Treasury stock - 1,122,937 shares 3/31/19, 1,114,739 shares 12/31/18  | (12,680 )                 | (12,409 )            |
| Retained earnings   | 149,466                   | 147,887              |

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|  |             |              |
|--|-------------|--------------|
| Accumulated other comprehensive loss       | (1,612 )    | (3,014 )     |
| Total stockholders' equity                 | 216,934     | 143,287      |
| Total Liabilities and Stockholders' Equity | \$1,465,661 | \$ 1,116,163 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2018, Condensed Consolidated Balance Sheet has been derived from the audited Consolidated Balance Sheet as of that date.

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

|   | (in thousands of<br>dollars, except per<br>share data) |                   |
|---|--|-------------------|
|   | Three Months<br>Ended                                  |                   |
|   | March 31,<br>2019                                      | March 31,<br>2018 |
| <b>Interest Income</b>  |  |                   |
| Loans, including fees   | \$ 14,680  | \$ 10,102         |
| Debt securities:  |  |                   |
| U.S. Treasury and government agencies   | 713  | 623               |
| Municipalities  | 211  | 281               |
| Dividends   | 88   | 55                |
| Federal funds sold and other  | 170  | 75                |
| Total interest income   | 15,862   | 11,136            |
| <b>Interest Expense</b>   |  |                   |
| Deposits  | 2,613  | 1,319             |
| Federal funds purchased and securities sold under agreements<br>to repurchase | 185  | 124               |
| Borrowed funds  | 287  | 20                |
| Total interest expense  | 3,085  | 1,463             |
| Net Interest Income - Before Provision for Loan Losses                        | 12,777   | 9,673             |
| Provision for Loan Losses   | 30   | 40                |
| Net Interest Income After Provision For Loan Losses                           | 12,747   | 9,633             |
| <b>Noninterest Income</b>   |  |                   |
| Customer service fees   | 1,578  | 1,466             |
| Other service charges and fees  | 1,041  | 1,012             |
| Net gain on sale of loans   | 102  | 132               |
| Net loss on sale of available-for-sale securities                             | (26 )  | -                 |
| Total noninterest income  | 2,695  | 2,610             |
| <b>Noninterest Expense</b>  |  |                   |
| Salaries and wages  | 4,312  | 3,310             |
| Employee benefits   | 1,594  | 1,136             |
| Net occupancy expense   | 667  | 387               |
| Furniture and equipment   | 696  | 507               |
| Data processing   | 1,299  | 331               |
| Franchise taxes   | 258  | 239               |
| ATM expense   | 447  | 312               |
| Advertising   | 260  | 186               |
| Net loss on sale of other assets owned  | 15   | 17                |
| FDIC assessment   | 96   | 87                |
| Mortgage servicing rights amortization  | 75   | 85                |
| Consulting fees   | 113  | 110               |
| Other general and administrative  | 1,679  | 933               |

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|                                      |         |          |
|--------------------------------------|---------|----------|
| Total noninterest expense            | 11,511  | 7,640    |
| Income Before Income Taxes           | 3,931   | 4,603    |
| Income Taxes                         | 707     | 836      |
| Net Income                           | \$3,224 | \$ 3,767 |
| Basic and Diluted Earnings Per Share | \$0.29  | \$ 0.41  |
| Dividends Declared                   | \$0.15  | \$ 0.13  |

See Notes to Condensed Consolidated Unaudited Financial Statements

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

|  | (in thousands of<br>dollars) |                   |
|--|------------------------------|-------------------|
|  | Three Months<br>Ended        |                   |
|  | March 31,<br>2019            | March 31,<br>2018 |
| Net Income                                       | \$3,224                      | \$ 3,767          |
| Other Comprehensive Income (Loss) (Net of Tax):  |                              |                   |
| Net unrealized gain (loss) on available-for-sale |                              |                   |
| securities                                       | 1,749                        | (2,471 )          |
| Reclassification adjustment for loss on sale of  |                              |                   |
| available-for-sale securities                    | 26                           | -                 |
| Net unrealized gain (loss) on available-for-sale |                              |                   |
| securities                                       | 1,775                        | (2,471 )          |
| Tax expense (benefit)                            | 373                          | (519 )            |
| Other comprehensive income (loss)                | 1,402                        | (1,952 )          |
| Comprehensive Income                             | \$4,626                      | \$ 1,815          |

See Notes to Condensed Consolidated Unaudited Financial Statements

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## Farmers &amp; Merchants Bancorp, Inc. and Subsidiaries

## CONDENSED Consolidated StatementS of Changes TO Stockholders' Equity

For the Three Months Ended March 31, 2018 and 2019

(000's Omitted, Except Per Share Data)

|   | Shares of<br>Common<br>Stock | Common<br>Stock | Treasury<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Stockholders'<br>Equity |
|---|------------------------------|-----------------|-------------------|----------------------|---|----------------------------------|
| Balance - January 1, 2018                                   | 9,265,880                    | \$ 11,546       | \$(12,160)        | \$ 136,547           | \$ (1,826 )   | \$ 134,107                       |
| Net income  |                              |                 |                   | 3,767                |   | 3,767                            |
| Other comprehensive loss                                    |                              |                 |                   |                      | (1,952 )  | (1,952 )                         |
| Adoption of ASU 2018-02                                     |                              |                 |                   | 360                  | (360 )  | -                                |
| Issuance of 100 shares of restricted stock                  | 100                          | (16 )           | 2                 | 2                    |   | (12 )                            |
| Stock-based compensation expense                            |                              | 160             |                   |                      |   | 160                              |
| Cash dividends declared - \$0.13 per share                  |                              |                 |                   | (1,193 )             |   | (1,193 )                         |
| Balance - March 31, 2018                                    | 9,265,980                    | \$ 11,690       | \$(12,158)        | \$ 139,483           | \$ (4,138 )   | \$ 134,877                       |
| Balance - January 1, 2019                                   | 9,285,261                    | \$ 10,823       | \$(12,409)        | \$ 147,887           | \$ (3,014 )   | \$ 143,287                       |
| Net income  |                              |                 |                   | 3,224                |   | 3,224                            |
| Other comprehensive income                                  |                              |                 |                   |                      | 1,402   | 1,402                            |
| Issuance of 1,830,000 shares of common stock in acquisition | 1,830,000                    | 70,437          |                   |                      |   | 70,437                           |
| Purchase of Treasury stock                                  | (6,558 )                     |                 | (213 )            |                      |   | (213 )                           |
| Issuance of 400 shares of restricted stock                  |                              |                 |                   |                      |   |                                  |
| (Net of Forfeitures - 2,040)                                | (1,640 )                     | 66              | (58 )             | 9                    |   | 17                               |
| Stock-based compensation expense                            |                              | 434             |                   |                      |   | 434                              |
| Cash dividends declared - \$0.15 per share                  |                              |                 |                   | (1,654 )             |   | (1,654 )                         |
| Balance - March 31, 2019                                    | 11,107,063                   | \$ 81,760       | \$(12,680)        | \$ 149,466           | \$ (1,612 )   | \$ 216,934                       |

See Notes to Condensed Consolidated Unaudited Financial Statements

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

|  | (in thousands of<br>dollars) |                   |
|--|------------------------------|-------------------|
|  | Three Months Ended           |                   |
|  | March 31,<br>2019            | March 31,<br>2018 |
| <b>Cash Flows from Operating Activities</b>                                |                              |                   |
| Net income   | \$3,224                      | \$ 3,767          |
| Adjustments to reconcile net income to net cash from operating activities: |                              |                   |
| Depreciation   | 654                          | 448               |
| Amortization of available-for-sale securities, net                         | 170                          | 252               |
| Amortization of servicing rights   | 75                           | 85                |
| Amortization of core deposit intangible                                    | 182                          | 42                |
| Amortization of fair value adjustments                                     | 155                          | 2                 |
| Stock-based compensation expense   | 434                          | 160               |
| Provision for loan loss  | 30                           | 40                |
| Gain on sale of loans held for sale  | (102 )                       | (132 )            |
| Originations of loans held for sale  | (8,340 )                     | (11,626 )         |
| Proceeds from sale of loans held for sale                                  | 7,764                        | 9,971             |
| Loss on sale of other assets owned   | 15                           | 17                |
| Loss on sales of securities available-for-sale                             | 26                           | -                 |
| Change in other assets and other liabilities, net                          | 3,516                        | (4,015 )          |
| Net cash provided by (used in) operating activities                        | 7,803                        | (989 )            |
| <b>Cash Flows from Investing Activities</b>                                |                              |                   |
| Activity in available-for-sale securities:                                 |                              |                   |
| Maturities, prepayments and calls  | 1,703                        | 2,094             |
| Sales  | 11,100                       | -                 |
| Purchases  | 35                           | (1,308 )          |
| Sales  | 237                          | -                 |
| Change in interest-bearing time deposits                                   | (490 )                       | 1                 |
| Proceeds from sale of other assets owned                                   | 75                           | 5                 |
| Additions to premises and equipment  | (704 )                       | (813 )            |
| Loan originations and principal collections, net                           | 5,301                        | (10,166 )         |
| Acquisition of Limberlost, net of cash received                            | (2,089 )                     | -                 |
| Net cash provided by (used in) investing activities                        | 15,168                       | (10,187 )         |
| <b>Cash Flows from Financing Activities</b>                                |                              |                   |
| Net change in deposits   | 52,416                       | 33,998            |
| Net change in federal funds purchased and securities sold under agreements |                              |                   |
| to repurchase  | (6,660 )                     | (16,188 )         |
| Repayment of FHLB advances   | (23,651)                     | -                 |
| Purchase of treasury stock   | (213 )                       | -                 |
| Cash dividends paid on common stock  | (1,379 )                     | (1,193 )          |
| Net cash provided by financing activities                                  | 20,513                       | 16,617            |

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|   |          |          |
|---|----------|----------|
| Net Increase in Cash and Cash Equivalents     | 43,484   | 5,441    |
| Cash and Cash Equivalents - Beginning of year | 38,365   | 34,467   |
| Cash and Cash Equivalents - End of period     | \$81,849 | \$39,908 |

(continued)

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## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited) (Continued)

|   | (in thousands of<br>dollars) |                   |
|---|------------------------------|-------------------|
|   | Three Months Ended           |                   |
|   | March 31,<br>2019            | March 31,<br>2018 |
| <b>Supplemental Information</b>   |                              |                   |
| Cash paid during the year for:  |                              |                   |
| Interest  | \$2,655                      | \$ 1,479          |
| Income taxes  | -                            | -                 |
| Noncash investing activities:   |                              |                   |
| Transfer of loans to other real estate owned  | -                            | -                 |
| The Company purchased all of the capital stock of Limberlost for \$78,902 on January 1, 2019. In conjunction with the acquisition, liabilities were assumed as follows: |                              |                   |
| Fair value of assets acquired   | 336,380                      | -                 |
| Less: common stock issued   | 70,437                       | -                 |
| Cash paid for the capital stock   | 8,465                        | -                 |
| Liabilities assumed   | 257,478                      | -                 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 1 BASIS OF PRESENTATION AND OTHER

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 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2019 are not necessarily indicative of the results that are expected for the year ended December 31, 2019. The condensed consolidated balance sheet of the Company as of December 31, 2018, has been derived from the audited consolidated balance sheet of the Company as of that date. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The Company's principal source of revenue is interest income from loans and investment securities. The Company also earns noninterest income from various banking and financial services offered primarily through Farmers & Merchants State Bank. Interest income is primarily recognized on an accrual basis according to nondiscretionary formulas written in contracts, such as loan agreements or investment security contracts. The Company also earns noninterest income from various banking and financial services provided to business and consumer clients such as deposit account, debit card, and mortgage banking services. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed.

Reclassification

Certain amounts in the 2018 condensed consolidated financial statements have been reclassified to conform with the 2019 presentation. These reclassifications had no effect on income.

NOTE 2 BUSINESS COMBINATION AND ASSET PURCHASE

On January 1, 2019, the Company acquired Limberlost Bancshares, Inc. ("Limberlost"), the bank holding company for Bank of Geneva, a community bank based in Geneva, Indiana. Bank of Geneva operated six full-service offices in the northeast Indiana communities of Geneva, Berne, Decatur, Monroe, Portland and Monroeville. Shareholders of Limberlost received 1,830 shares of FMAO common stock and \$8,465.00 in cash for each share. Limberlost had 1,000 shares outstanding on January 1, 2019. The share price of Farmers & Merchants Bancorp, Inc. (FMAO) stock on January 1, 2019 was \$38.49. Total consideration for the acquisition was approximately \$78.9 million consisting of \$8.5 million in cash and \$70.4 million in stock. As a result of the acquisition, the Company will have an opportunity to increase its deposit base and reduce transaction costs. The Company also expects to reduce costs through economies of scale.

In 2018, the Company incurred \$742.1 thousand of third-party acquisition-related costs. The largest portion of the expenses recognized in 2018 related to consulting fees of \$340 thousand, other general and administration expenses of \$331.5 thousand and data processing expenses of \$58.6 thousand. These three categories of expense accounted for



98.4% of the total acquisition expenses impacting the 2018 financial statements of the Company.

In 2019, the Company has incurred additional third-party acquisition-related costs of \$1.3 million. These expenses are comprised of data processing of \$891.7 thousand, employee benefits of \$107.6 thousand, ATM expense of \$31.4 thousand, consulting fees of \$18.3 thousand and other general and administrative expense of \$238.3 thousand in the Company's consolidated statement of income for the quarter ended March 31, 2019.

Under the acquisition method of accounting, the total purchase is allocated to net tangible and intangible assets based on their current estimated fair values on the date of acquisition. Of the total purchase price of \$78.9 million, \$3.9 million has been allocated to core deposit intangible included in other assets and will be amortized over seven years on a straight line basis. Goodwill of \$43.3 million resulting from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of the Company and Bank of Geneva. Of that total amount, none of the purchase price is deductible for tax purposes. The following table summarizes the consideration paid for Bank of Geneva and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 2 BUSINESS COMBINATION AND ASSET PURCHASE (Continued)

| Fair Value of Consideration Transferred | (In<br>Thousands) |
|---|-------------------|
| Cash                                    | \$ 8,465          |
| Common Shares (1,830,000 shares)        | 70,437            |
| <b>Total</b>                            | <b>\$ 78,902</b>  |

## Recognized amounts of identifiable assets acquired and liabilities assumed

|  |                   |
|--|-------------------|
| <b>Assets</b>                          |                   |
| Cash and cash equivalents              | \$ 6,376          |
| Securities - available-for-sale        | 17,494            |
| Other securities, at cost              | 2,347             |
| Loans, net                             | 257,183           |
| Premises and equipment                 | 2,538             |
| Goodwill                               | 43,266            |
| Other assets                           | 7,176             |
| <b>Total Assets Purchased</b>          | <b>\$ 336,380</b> |
| <b>Liabilities</b>                     |                   |
| <b>Deposits</b>                        |                   |
| Noninterest bearing                    | \$ 37,822         |
| Interest bearing                       | 168,312           |
| <b>Total deposits</b>                  | <b>206,134</b>    |
| Federal Home Loan Bank (FHLB) advances | 48,196            |
| Accrued expenses and other liabilities | 3,148             |
| <b>Total Liabilities Assumed</b>       | <b>\$ 257,478</b> |

The fair value of the assets acquired includes loans with a fair value of \$257.2 million. The gross principal and contractual interest due under the contracts is \$359.2 million, of which \$4.7 million is expected to be uncollectible. The loans have a weighted average life of 70 months.

The fair value of building and land included in premises and equipment was written down by \$1.2 million and will be amortized based on the remaining life of each building. The combined average remaining life is 16.75 years.

The fair value for certificates of deposit incorporates a valuation amount of \$0.5 million which will be amortized over 1.5 years. The fair value of Federal Home Loan Bank (FHLB) advances includes a valuation amount of \$1.3 million which will be amortized over 2.3 years.

The Company acquired loans in the acquisition that had evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected.

Loans purchased with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit impaired. Evidence of credit quality

deterioration as of the purchase date may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. Purchased credit-impaired loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality (ASC 310-30) and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for credit losses related to these loans is not carried over and recorded at the acquisition date. Management estimated the cash flows expected to be collected at acquisition using our internal risk models, which incorporate the estimate of current key assumptions, such as default rates, severity and prepayment speeds.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 2 BUSINESS COMBINATION AND ASSET PURCHASE (Continued)

The carrying amount of those loans is included in loans, net on the balance sheet at March 31. The amounts of loans at March 31, 2019 are as follows:

|  | 2019<br>(In<br>Thousands) |
|--|---------------------------|
| Balance - January 1, 2019                    |                           |
| Commercial                                   | \$ 4,094                  |
| Consumer RE                                  | 231                       |
| Consumer                                     | 71                        |
| Carrying amount, net of allowance of \$2,118 | \$ 2,278                  |
| Balance - March 31, 2019                     |                           |
| Commercial                                   | \$ 4,091                  |
| Consumer RE                                  | 231                       |
| Consumer                                     | 33                        |
| Carrying amount, net of allowance of \$2,081 | \$ 2,274                  |

Loans acquired during 2019 for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

|   | (In<br>Thousands) |
|---|-------------------|
| Contractually required payments receivable at acquisition |                   |
| Commercial  | \$ 4,215          |
| Consumer RE   | 261               |
| Consumer  | 94                |
| Total required payments receivable                        | \$ 4,570          |
| Cash flows expected to be collected at acquisition        | \$ 2,788          |
| Basis in acquired loans at acquisition                    | \$ 4,396          |

No allowances for loan losses were reversed in 2019. The balance of the allowance for loan losses for loans acquired and accounted for under this guidance (ASC 310-30) was \$2.081 million at March 31, 2019 and \$2.118 million on January 1, 2019, respectively.

Changes in accretable yield, or income expected to be collected, are as follows:

|                           | 2019<br>(In<br>Thousands) |
|---------------------------|---------------------------|
| Balance - January 1, 2019 | \$ 2,544                  |
| Additions                 | 1                         |
| Accretion                 | (109 )                    |

|  |          |
|--|----------|
| Reclassification from nonaccretable difference | -        |
| Disposals                                      | -        |
| Balance - March 31, 2019                       | \$ 2,436 |

The results of operations of Bank of Geneva have been included in the Company's consolidated financial statements since the acquisition date of January 1, 2019. The following schedule includes pro-forma results for the three months ended March 31, 2019 and 2018 as if the Bank of Geneva acquisitions had occurred as of the beginning of the comparable prior reporting period.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 2 BUSINESS COMBINATION AND ASSET PURCHASE (Continued)

|  | (in thousands of<br>dollars, except per<br>share data) |                   |
|--|--|-------------------|
|  | Three Months<br>Ended                                  |                   |
|  | March 31,<br>2019                                      | March 31,<br>2018 |
| Summary of Operations                                  |  |                   |
| Net Interest Income - Before Provision for Loan Losses | \$ 12,777  | \$ 12,639         |
| Provision for Loan Losses                              | 30   | 145               |
| Net Interest Income After Provision For Loan Losses    | 12,747   | 12,494            |
| Noninterest Income                                     | 2,695  | 2,762             |
| Noninterest Expense                                    | 10,224   | 9,346             |
| Income Before Income Taxes                             | 5,218  | 5,910             |
| Income Taxes   | 965  | 1,108             |
| Net Income   | \$ 4,253   | \$ 4,802          |
| Basic and Diluted Earnings Per Share                   | \$ 0.38  | \$ 0.43           |

The pro-forma information includes adjustments for interest income on loans, amortization of intangibles arising from the transaction, interest expense on deposits acquired, premises expense for the branches acquired and the related income tax effects. The pro-forma information for the quarter ended March 31, 2019 includes approximately \$2.1 million, net of tax, of operating revenue from Bank of Geneva since acquisition.

The pro-forma financial information is presented for informational purposes only and is not indicative of the results of operations that actually would have been achieved had the acquisition been consummated as of that time, nor is it intended to be a projection of future results.

The Company purchased an office on December 13, 2013 in Custar, Ohio. Core deposit intangible assets of \$1.17 million were recognized and are being amortized over its remaining economic useful life of the deposits of 7 years on a straight line basis.

As mentioned previously, the acquisition of Bank of Geneva resulted in the recognition of \$3.9 million in core deposit intangible assets which are being amortized over its remaining life of 7 years on a straight line basis.

The amortization expense for the three months ended March 31, 2018 was \$42 thousand. Of the \$727 thousand to be expensed in 2019, \$182 thousand has been expensed for the three months ended March 31, 2019.

|      | (In Thousands)<br>Custar | (In Thousands)<br>Geneva | (In Thousands)<br>Total |
|------|--------------------------|--------------------------|-------------------------|
| 2019 | \$ 167                   | \$ 560                   | \$ 727                  |
| 2020 | 161                      | 560                      | 721                     |
| 2021 | -                        | 560                      | 560                     |
| 2022 | -                        | 560                      | 560                     |
| 2023 | -                        | 560                      | 560                     |
| 2024 | -                        | 560                      | 560                     |
| 2025 | -                        | 560                      | 560                     |
|      | \$ 328                   | \$ 3,920                 | \$ 4,248                |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES

Mortgage-backed securities, as shown in the following tables, are all government sponsored enterprises. The amortized cost and fair value of securities, with gross unrealized gains and losses at March 31, 2019 and December 31, 2018, follows:

|                                     | (In Thousands) |                        |                         |            |
|-------------------------------------|----------------|------------------------|-------------------------|------------|
|                                     | March 31, 2019 |                        |                         |            |
|                                     | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| <b>Available-for-Sale:</b>          |                |                        |                         |            |
| U.S. Treasury                       | \$23,059       | \$ 6                   | \$ (182 )               | \$22,883   |
| U.S. Government agencies            | 75,289         | 131                    | (1,205 )                | 74,215     |
| Mortgage-backed securities          | 38,619         | 97                     | (822 )                  | 37,894     |
| State and local governments         | 39,756         | 296                    | (362 )                  | 39,690     |
| Total available-for-sale securities | \$176,723      | \$ 530                 | \$ (2,571 )             | \$174,682  |

|                                     | (In Thousands)    |                        |                         |            |
|-------------------------------------|-------------------|------------------------|-------------------------|------------|
|                                     | December 31, 2018 |                        |                         |            |
|                                     | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| <b>Available-for-Sale:</b>          |                   |                        |                         |            |
| U.S. Treasury                       | \$23,078          | \$ 6                   | \$ (254 )               | \$22,830   |
| U.S. Government agencies            | 71,235            | 2                      | (1,910 )                | 69,327     |
| Mortgage-backed securities          | 37,342            | 62                     | (1,142 )                | 36,262     |
| State and local governments         | 40,608            | 225                    | (805 )                  | 40,028     |
| Total available-for-sale securities | \$172,263         | \$ 295                 | \$ (4,111 )             | \$168,447  |

Investment securities will at times depreciate to an unrealized loss position. The Company utilizes the following criteria to assess whether impairment is other than temporary. No one item by itself will necessarily signal that a security should be recognized as an other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB – by Standard and Poors.)
3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.



4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.

5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The amount of the write down shall be included in current earnings as a realized loss. The recovery in fair value, if any, shall be recognized in earnings when the security is sold. The table below is presented by category of security and length of time in a continuous loss position. The Company currently does not hold any securities with other than temporary impairment.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

Information pertaining to securities with gross unrealized losses at March 31, 2019 and December 31, 2018, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

|                                     | (In Thousands) |        |                 |           |
|-------------------------------------|----------------|--------|-----------------|-----------|
|                                     | March 31, 2019 |        |                 |           |
|                                     | Less           |        |                 |           |
|                                     | Than Twelve    | Twelve | Twelve Months & |           |
|                                     | Months         | Months | Gross           | Over      |
|                                     | Gross          | Gross  | Gross           | Gross     |
|                                     | Unrealized     | Fair   | Unrealized      | Fair      |
|                                     | Losses         | Value  | Losses          | Value     |
| U.S. Treasury                       | \$-            | \$-    | \$(182 )        | \$20,908  |
| U.S. Government agencies            | -              | -      | (1,205)         | 65,412    |
| Mortgage-backed securities          | (1)            | 720    | (821 )          | 29,528    |
| State and local governments         | -              | -      | (362 )          | 27,792    |
| Total available-for-sale securities | \$(1)          | \$720  | \$(2,570)       | \$143,640 |

|                                     | (In Thousands)    |         |                 |           |
|-------------------------------------|-------------------|---------|-----------------|-----------|
|                                     | December 31, 2018 |         |                 |           |
|                                     | Less              |         |                 |           |
|                                     | Than Twelve       | Twelve  | Twelve Months & |           |
|                                     | Months            | Months  | Gross           | Over      |
|                                     | Gross             | Gross   | Gross           | Gross     |
|                                     | Unrealized        | Fair    | Unrealized      | Fair      |
|                                     | Losses            | Value   | Losses          | Value     |
| U.S. Treasury                       | \$-               | \$-     | \$(254 )        | \$20,861  |
| U.S. Government agencies            | -                 | -       | (1,910)         | 64,727    |
| Mortgage-backed securities          | (4 )              | 697     | (1,138)         | 30,347    |
| State and local governments         | (22)              | 3,254   | (783 )          | 29,413    |
| Total available-for-sale securities | \$(26)            | \$3,951 | \$(4,085)       | \$145,348 |

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality, values have only been impacted by rate changes, and the Company has the intent and ability to hold the securities for the foreseeable future. Additionally, the decline in value is primarily due to changes in interest rates since the securities were purchased. The fair value is expected to recover as the bonds approach the maturity date.

Below are the gross realized gains and losses for the three months ended March 31, 2019 and March 31, 2018.

|  | Three Months<br>(In Thousands) |      |
|--|--------------------------------|------|
|  | 2019                           | 2018 |
| Gross realized gains                       | \$ 16                          | \$ - |
| Gross realized losses                      | (42 )                          | -    |
| Net realized losses                        | \$ (26 )                       | \$ - |
| Tax expense related to net realized losses | \$ (5 )                        | \$ - |

The net realized losses on sales and related tax expense is a reclassification out of accumulated other comprehensive income (loss). The net realized loss is included in net loss on sale of available-for-sale securities and the related tax expense is included in income taxes in the condensed consolidated statements of income and comprehensive income.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

The amortized cost and fair value of debt securities at March 31, 2019, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                    | (In Thousands) |            |
|------------------------------------|----------------|------------|
|                                    | Amortized      |            |
|                                    | Cost           | Fair Value |
| One year or less                   | \$30,977       | \$30,820   |
| After one year through five years  | 60,395         | 59,594     |
| After five years through ten years | 45,454         | 45,152     |
| After ten years                    | 1,278          | 1,222      |
| Total                              | \$138,104      | \$136,788  |
| Mortgage-backed securities         | 38,619         | 37,894     |
| Total                              | \$176,723      | \$174,682  |

Investments with a carrying value of \$83.1 million and \$81.8 million at March 31, 2019 and December 31, 2018, respectively, were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Indianapolis stock as of March 31, 2019. As of December 31, 2018, other securities only includes Federal Home Loan Bank of Cincinnati stock.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS

Loan balances as of March 31, 2019 and December 31, 2018:

| Loans:                                 | (In Thousands)    |                      |
|--|-------------------|----------------------|
|  | March 31,<br>2019 | December 31,<br>2018 |
| Consumer Real Estate                   | \$ 161,180        | \$ 80,766            |
| Agricultural Real Estate               | 192,903           | 68,609               |
| Agricultural                           | 114,920           | 108,495              |
| Commercial Real Estate                 | 441,200           | 419,784              |
| Commercial and Industrial              | 137,936           | 121,793              |
| Consumer                               | 47,573            | 41,953               |
| Industrial Development Bonds           | 7,384             | 5,889                |
|  | 1,103,096         | 847,289              |
| Less: Net deferred loan fees and costs | (1,133 )          | (915 )               |
|  | 1,101,963         | 846,374              |
| Less: Allowance for loan losses        | (6,636 )          | (6,775 )             |
| Less: Purchase Accounting Adjustments  | (3,498 )          | -                    |
| Loans - Net                            | \$ 1,091,829      | \$ 839,599           |

The following is a contractual maturity schedule by major category of loans as of March 31, 2019:

|                              | (In Thousands)        |   |                        |
|------------------------------|-----------------------|---|------------------------|
|                              | Within<br>One<br>Year | After<br>One<br>Year<br>Within<br>Five<br>Years | After<br>Five<br>Years |
| Consumer Real Estate         | \$6,370               | \$ 17,260                                       | \$ 137,550             |
| Agricultural Real Estate     | 680                   | 6,082   | 186,141                |
| Agricultural                 | 71,544                | 31,632  | 11,744                 |
| Commercial Real Estate       | 18,402                | 169,066   | 253,732                |
| Commercial and Industrial    | 74,195                | 53,787  | 9,954                  |
| Consumer                     | 6,025                 | 30,870  | 10,678                 |
| Industrial Development Bonds | 424                   | 291   | 6,669                  |

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of March 31, 2019:

|                              | (In Thousands) |          |
|------------------------------|----------------|----------|
|                              | Fixed          | Variable |
|                              | Rate           | Rate     |
| Consumer Real Estate         | \$66,857       | \$94,323 |
| Agricultural Real Estate     | 86,756         | 106,147  |
| Agricultural                 | 41,061         | 73,859   |
| Commercial Real Estate       | 272,827        | 168,373  |
| Commercial and Industrial    | 54,861         | 83,075   |
| Consumer                     | 42,487         | 5,086    |
| Industrial Development Bonds | 7,282          | 102      |

As of March 31, 2019 and December 31, 2018 one to four family residential mortgage loans amounting to \$85.5 and \$14.9 million, respectively, have been pledged as security for future loans and existing loans the Bank has received from the Federal Home Loan Bank.

Unless listed separately, Industrial Development Bonds are included in the Commercial and Industrial category for the remainder of the tables in this Note 4.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment (in thousands) in past due loans by portfolio classification of loans as of March 31, 2019 and December 31, 2018, net of deferred loan fees and costs:

|                           | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>Than<br>90<br>Days | Total<br>Past<br>Due | Current      | Total<br>Financing<br>Receivables | Recorded<br>Investment ><br>90 Days and<br>Accruing |
|---------------------------|------------------------------|------------------------------|-------------------------------|----------------------|--------------|-----------------------------------|---|
| March 31, 2019            |                              |                              |                               |                      |              |                                   |   |
| Consumer Real Estate      | \$ 844                       | \$ 142                       | \$ 700                        | \$ 1,686             | \$ 158,803   | \$ 160,489                        | \$ -  |
| Agricultural Real Estate  | -                            | -                            | -                             | -                    | 192,887      | 192,887                           | -   |
| Agricultural              | 74                           | -                            | -                             | 74                   | 114,969      | 115,043                           | -   |
| Commercial Real Estate    | -                            | -                            | -                             | -                    | 440,488      | 440,488                           | -   |
| Commercial and Industrial | -                            | -                            | -                             | -                    | 145,360      | 145,360                           | -   |
| Consumer                  | 77                           | 4                            | 35                            | 116                  | 47,580       | 47,696                            | -   |
| Total                     | \$ 995                       | \$ 146                       | \$ 735                        | \$ 1,876             | \$ 1,100,087 | \$ 1,101,963                      | \$ -  |
|                           |                              |                              |                               |                      |              |                                   |   |
|                           | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | Greater<br>Than<br>90<br>Days | Total<br>Past<br>Due | Current      | Total<br>Financing<br>Receivables | Recorded<br>Investment ><br>90 Days and<br>Accruing |
| December 31, 2018         |                              |                              |                               |                      |              |                                   |   |
| Consumer Real Estate      | \$ 342                       | \$ 24                        | \$ 254                        | \$ 620               | \$ 79,612    | \$ 80,232                         | \$ -  |
| Agricultural Real Estate  | -                            | -                            | -                             | -                    | 68,588       | 68,588                            | -   |
| Agricultural              | -                            | -                            | -                             | -                    | 108,616      | 108,616                           | -   |
| Commercial Real Estate    | -                            | -                            | -                             | -                    | 419,131      | 419,131                           | -   |
| Commercial and Industrial | -                            | -                            | -                             | -                    | 127,752      | 127,752                           | -   |
| Consumer                  | 85                           | 24                           | 8                             | 117                  | 41,938       | 42,055                            | -   |
| Total                     | \$ 427                       | \$ 48                        | \$ 262                        | \$ 737               | \$ 845,637   | \$ 846,374                        | \$ -  |



## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of March 31, 2019 and December 31, 2018:

|                          | (In Thousands)          |               |
|--------------------------|-------------------------|---------------|
|                          | March 31 / December 31, |               |
|                          | 2019                    | 2018          |
| Consumer Real Estate     | \$1,071                 | \$ 462        |
| Agricultural Real Estate | -                       | -             |
| Agricultural             | -                       | -             |
| Commercial Real Estate   | -                       | -             |
| Commercial & Industrial  | 70                      | 72            |
| Consumer                 | 47                      | 8             |
| <b>Total</b>             | <b>\$1,188</b>          | <b>\$ 542</b> |

Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:

**Consumer Real Estate:** Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

**Agricultural Real Estate:** Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.

**Agricultural:** Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmer's ability to hedge their position by the use of future contracts. The risk related to weather is often mitigated by requiring crop insurance.

**Commercial Real Estate:** Construction, purchase, and refinance of business purpose real estate. Risks include potential construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower's ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

**Commercial and Industrial:** Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of projections, financial leverage, economic trends, management ability and estimated capital expenditures during the fiscal year. The Bank does employ stress testing on higher balance loans to mitigate risk by

ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

Industrial Development Bonds (IDB): Funds for public improvements in the Bank's service area. Repayment ability is based on the continuance of the taxation revenue as the source of repayment.

Consumer: Funding for individual and family purposes. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

The Bank uses a nine tier risk rating system to grade its loans. The grade of a loan may change during the life of the loan.

The risk ratings are described as follows.

- 1.Zero (0) Unclassified. Any loan which has not been assigned a classification.
- 2.One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank's loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.

4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk – having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

Loans may be graded 3 when there is no recent information on which to base a current risk evaluation and the following conditions apply:

At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk:

a. At inception, the loan was secured with collateral possessing a loan-to-value adequate to protect the Bank from loss;

b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;

c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of these credit weaknesses are observed, a lower risk grade is warranted.

5. Four (4) Satisfactory / Monitored. A “4” (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines so long as the loan is given management supervision.

6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserve close attention but do not yet warrant substandard classification. Such loans pose unwarranted financial risk that if not corrected could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered “potential” versus “defined” impairments to the primary source of loan repayment and collateral.

7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:

a. Loans which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source and are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.

b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.

c. The primary source of repayment is weakened and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.

d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.

e. Unusual courses of action are needed to maintain a high probability of repayment.

f. The borrower is not generating enough cash flow to repay loan principal but continues to make interest payments.

g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.

- h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.
- i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.
- j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:

- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, these weaknesses make collection or liquidation in full based on existing conditions improbable.
- b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
- c. The possibility of loss is high, but because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements 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.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of March 31, 2019 and December 31, 2018:

| (In Thousands)           |                                |                   |                           |                              |                                    |
|--------------------------|--------------------------------|-------------------|---------------------------|------------------------------|------------------------------------|
|                          | Agricultural<br>Real<br>Estate | Agricultural      | Commercial<br>Real Estate | Commercial<br>and Industrial | Industrial<br>Development<br>Bonds |
| <b>March 31, 2019</b>    |                                |                   |                           |                              |                                    |
| 1-2                      | \$42,560                       | \$ 7,515          | \$ 9,985                  | \$ 4,641                     | \$ -                               |
| 3                        | 60,378                         | 44,179            | 82,470                    | 27,547                       | 2,505                              |
| 4                        | 74,077                         | 60,588            | 340,200                   | 93,937                       | 4,879                              |
| 5                        | 15,740                         | 2,761             | 5,262                     | 6,217                        | -                                  |
| 6                        | 132                            | -                 | 2,571                     | 4,753                        | -                                  |
| 7                        | -                              | -                 | -                         | 881                          | -                                  |
| 8                        | -                              | -                 | -                         | -                            | -                                  |
| <b>Total</b>             | <b>\$192,887</b>               | <b>\$ 115,043</b> | <b>\$ 440,488</b>         | <b>\$ 137,976</b>            | <b>\$ 7,384</b>                    |
| <br>                     |                                |                   |                           |                              |                                    |
|                          | Agricultural<br>Real Estate    | Agricultural      | Commercial<br>Real Estate | Commercial<br>and Industrial | Industrial<br>Development<br>Bonds |
| <b>December 31, 2018</b> |                                |                   |                           |                              |                                    |
| 1-2                      | \$ 4,442                       | \$ 5,753          | \$ 4,698                  | \$ 3,199                     | \$ -                               |
| 3                        | 14,118                         | 38,852            | 64,341                    | 16,284                       | 3,135                              |
| 4                        | 49,596                         | 63,380            | 346,072                   | 100,644                      | 2,754                              |
| 5                        | 422                            | 631               | 2,171                     | 308                          | -                                  |
| 6                        | 10                             | -                 | 1,849                     | 542                          | -                                  |
| 7                        | -                              | -                 | -                         | 886                          | -                                  |
| 8                        | -                              | -                 | -                         | -                            | -                                  |
| <b>Total</b>             | <b>\$ 68,588</b>               | <b>\$ 108,616</b> | <b>\$ 419,131</b>         | <b>\$ 121,863</b>            | <b>\$ 5,889</b>                    |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, as was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of March 31, 2019 and December 31, 2018.

|                     | (In Thousands)       |                      |
|---------------------|----------------------|----------------------|
|                     | Consumer Real Estate | Consumer Real Estate |
|                     | March 31,            | December 31,         |
|                     | 2019                 | 2018                 |
| Grade               |                      |                      |
| Pass                | \$158,309            | \$ 79,121            |
| Special Mention (5) | 135                  | 232                  |
| Substandard (6)     | 2,045                | 879                  |
| Doubtful (7)        | -                    | -                    |
| Total               | \$160,489            | \$ 80,232            |

|               | (In Thousands)    |              |                  |              |
|---------------|-------------------|--------------|------------------|--------------|
|               | Consumer - Credit |              | Consumer - Other |              |
|               | March 31,         | December 31, | March 31,        | December 31, |
|               | 2019              | 2018         | 2019             | 2018         |
| Performing    | \$3,861           | \$ 3,909     | \$43,366         | \$ 38,073    |
| Nonperforming | 14                | 19           | 455              | 54           |
| Total         | \$3,875           | \$ 3,928     | \$43,821         | \$ 38,127    |

Information about impaired loans as of March 31, 2019, December 31, 2018 and March 31, 2018 are as follows:

|   | (In Thousands) |                   |                |
|---|----------------|-------------------|----------------|
|   | March 31, 2019 | December 31, 2018 | March 31, 2018 |
| Impaired loans without a valuation allowance  | \$ 1,915       | \$ 1,808          | \$ 999         |
| Impaired loans with a valuation allowance     | 254            | 246               | 607            |
| Total impaired loans                          | \$ 2,169       | \$ 2,054          | \$ 1,606       |
| Valuation allowance related to impaired loans | \$ 59          | \$ 31             | \$ 104         |
| Total non-accrual loans                       | \$ 1,188       | \$ 542            | \$ 900         |



Total loans past-due ninety days or more and

|  |          |          |          |
|--|----------|----------|----------|
| still accruing                               | \$ -     | \$ -     | \$ -     |
| Quarter ended average investment in impaired |          |          |          |
| loans  | \$ 2,135 | \$ 2,533 | \$ 1,688 |
| Year to date average investment in impaired  |          |          |          |
| loans  | \$ 2,135 | \$ 1,958 | \$ 1,688 |

Additional funds of \$1 thousand are available to be advanced in connection with impaired loans.

The Bank had approximately \$102 thousand of its impaired loans classified as troubled debt restructured (TDR) as of March 31, 2019, \$178 thousand as of December 31, 2018 and \$527 thousand as of March 31, 2018. During the year to date 2019 and 2018, there were no new loans considered TDR.

For the three month period ended March 31, 2019 and 2018, there were no TDRs that subsequently defaulted after modification.

For the three month period ended March 31, 2019, there were no impaired loans classified as TDR paid off.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

For the majority of the Bank's impaired loans, the Bank will apply the fair value of collateral or use a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine fair value of collateral, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off, whether a partial or full loan balance. A charge-off in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-off may be realized as further unsecured positions are recognized.

The following tables present loans individually evaluated for impairment by class of loans for three months ended March 31, 2019 and March 31, 2018.

| Three Months Ended March 31, 2019          | (In Thousands)                   |                      |                      | QTD                               | QTD                              | QTD  |
|--|----------------------------------|----------------------|----------------------|-----------------------------------|----------------------------------|--|
|  | Unpaid<br>Recorded<br>Investment | Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>Cash Basis |
| <b>With no related allowance recorded:</b> |                                  |                      |                      |                                   |                                  |  |
| Consumer Real Estate                       | \$648                            | \$ 648               | \$ -                 | \$ 603                            | \$ 7                             | \$ 1   |
| Agricultural Real Estate                   | -                                | -                    | -                    | -                                 | -                                | -  |
| Agricultural                               | -                                | -                    | -                    | -                                 | -                                | -  |
| Commercial Real Estate                     | 192                              | 192                  | -                    | 193                               | 3                                | -  |
| Commercial and Industrial                  | 1,075                            | 1,075                | -                    | 1,085                             | 15                               | -  |
| Consumer                                   | -                                | -                    | -                    | -                                 | -                                | -  |
| <b>With a specific allowance recorded:</b> |                                  |                      |                      |                                   |                                  |  |
| Consumer Real Estate                       | 254                              | 254                  | 59                   | 254                               | -                                | -  |
| Agricultural Real Estate                   | -                                | -                    | -                    | -                                 | -                                | -  |
| Agricultural                               | -                                | -                    | -                    | -                                 | -                                | -  |
| Commercial Real Estate                     | -                                | -                    | -                    | -                                 | -                                | -  |
| Commercial and Industrial                  | -                                | -                    | -                    | -                                 | -                                | -  |
| Consumer                                   | -                                | -                    | -                    | -                                 | -                                | -  |
| <b>Totals:</b>                             |                                  |                      |                      |                                   |                                  |  |
| Consumer Real Estate                       | \$902                            | \$ 902               | \$ 59                | \$ 857                            | \$ 7                             | \$ 1   |
| Agricultural Real Estate                   | \$-                              | \$ -                 | \$ -                 | \$ -                              | \$ -                             | \$ -   |

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|                           |         |          |      |          |       |      |
|---------------------------|---------|----------|------|----------|-------|------|
| Agricultural              | \$-     | \$ -     | \$ - | \$ -     | \$ -  | \$ - |
| Commercial Real Estate    | \$192   | \$ 192   | \$ - | \$ 193   | \$ 3  | \$ - |
| Commercial and Industrial | \$1,075 | \$ 1,075 | \$ - | \$ 1,085 | \$ 15 | \$ - |
| Consumer                  | \$-     | \$ -     | \$ - | \$ -     | \$ -  | \$ - |

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

| Three Months Ended March 31, 2018          | (In Thousands)      |                          |                   | QTD                         | QTD                        | QTD                                   |
|--|---------------------|--------------------------|-------------------|-----------------------------|----------------------------|---------------------------------------|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized | Interest Income Recognized Cash Basis |
| <b>With no related allowance recorded:</b> |                     |                          |                   |                             |                            |                                       |
| Consumer Real Estate                       | \$489               | \$ 489                   | \$ -              | \$ 492                      | \$ 8                       | \$ 6                                  |
| Agricultural Real Estate                   | -                   | -                        | -                 | 67                          | -                          | -                                     |
| Agricultural                               | -                   | -                        | -                 | -                           | -                          | -                                     |
| Commercial Real Estate                     | 200                 | 200                      | -                 | 201                         | 3                          | -                                     |
| Commercial and Industrial                  | 310                 | 310                      | -                 | 209                         | 4                          | -                                     |
| Consumer                                   | -                   | -                        | -                 | -                           | -                          | -                                     |
| <b>With a specific allowance recorded:</b> |                     |                          |                   |                             |                            |                                       |
| Consumer Real Estate                       | 80                  | 80                       | 20                | 80                          | -                          | -                                     |
| Agricultural Real Estate                   | -                   | -                        | -                 | -                           | -                          | -                                     |
| Agricultural                               | -                   | -                        | -                 | -                           | -                          | -                                     |
| Commercial Real Estate                     | 418                 | 418                      | 42                | 420                         | 4                          | -                                     |
| Commercial and Industrial                  | 109                 | 109                      | 42                | 219                         | -                          | -                                     |
| Consumer                                   | -                   | -                        | -                 | -                           | -                          | -                                     |
| <b>Totals:</b>                             |                     |                          |                   |                             |                            |                                       |
| Consumer Real Estate                       | \$569               | \$ 569                   | \$ 20             | \$ 572                      | \$ 8                       | \$ 6                                  |
| Agricultural Real Estate                   | \$-                 | \$ -                     | \$ -              | \$ 67                       | \$ -                       | \$ -                                  |
| Agricultural                               | \$-                 | \$ -                     | \$ -              | \$ -                        | \$ -                       | \$ -                                  |
| Commercial Real Estate                     | \$618               | \$ 618                   | \$ 42             | \$ 621                      | \$ 7                       | \$ -                                  |
| Commercial and Industrial                  | \$419               | \$ 419                   | \$ 42             | \$ 428                      | \$ 4                       | \$ -                                  |
| Consumer                                   | \$-                 | \$ -                     | \$ -              | \$ -                        | \$ -                       | \$ -                                  |

As of March 31, 2019, the Company had no foreclosed residential real estate property obtained by physical possession and \$639 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions. As of March 31, 2018, the Company had \$3 thousand of foreclosed residential real estate property obtained by physical possession and \$49 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings were in process according to local jurisdictions.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The Allowance for Loan and Lease Losses (ALLL) has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense. The following tables summarize the activities in the allowance for credit losses.

|  | (In Thousands)                                |  |
|--|---|--|
|  | Three<br>Months<br>Ended<br>March 31,<br>2019 | Twelve Months<br>Ended<br>December 31,<br>2018 |
| <b>Allowance for Loan &amp; Lease Losses</b>         |   |  |
| Balance at beginning of year                         | \$6,775                                       | \$ 6,868                                       |
| Provision for loan loss                              | 30  | 324  |
| Loans charged off                                    | (207 )  | (580 )   |
| Recoveries   | 38  | 163  |
| Allowance for Loan & Lease Losses                    | \$6,636                                       | \$ 6,775                                       |
| <b>Allowance for Unfunded Loan Commitments &amp;</b> |   |  |
| Letters of Credit                                    | \$346   | \$ 274   |
| <b>Total Allowance for Credit Losses</b>             | <b>\$6,982</b>                                | <b>\$ 7,049</b>                                |

The Company segregates its ALLL into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).

The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table breaks down the activity within ACL for each loan portfolio classification and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

Additional analysis, presented in thousands, related to the allowance for credit losses for three months ended March 31, 2019 and March 31, 2018 in addition to the ending balances as of December 31, 2018 is as follows:

|   | Consumer    | Agricultural | Commercial   | Commercial                 | Commercial | Consumer | Credit | Unallocated | Total   |
|---|-------------|--------------|--------------|----------------------------|------------|----------|--------|-------------|---------|
|   | Real Estate | Real Estate  | Agricultural | Real Estate and Industrial | Commercial | Consumer | Credit | Unallocated | Total   |
|   |             |              |              |                            |            |          |        |             |         |
| Three Months Ended March 31, 2019                     |             |              |              |                            |            |          |        |             |         |
| ALLOWANCE FOR CREDIT LOSSES:                          |             |              |              |                            |            |          |        |             |         |
| Beginning balance                                     | \$247       | \$250        | \$768        | \$3,217                    | \$1,305    | \$484    | \$274  | \$504       | \$7,049 |
| Charge Offs   | -           | -            | -            | -                          | -          | (207 )   | -      | -           | (207 )  |
| Recoveries  | -           | -            | 1            | 2                          | 3          | 32       | -      | -           | 38      |
| Provision (Credit)                                    | 21          | 20           | (63 )        | (16 )                      | 182        | 187      | -      | (301 )      | 30      |
| Other Non-interest expense related to unfunded        | -           | -            | -            | -                          | -          | -        | 72     | -           | 72      |
| Ending Balance  | \$268       | \$270        | \$706        | \$3,203                    | \$1,490    | \$496    | \$346  | \$203       | \$6,982 |
| Ending balance: individually evaluated for impairment | \$59        | \$-          | \$-          | \$-                        | \$-        | \$-      | \$-    | \$-         | \$59    |
|   | \$209       | \$270        | \$706        | \$3,203                    | \$1,490    | \$496    | \$346  | \$203       | \$6,923 |



Ending balance:  
collectively  
evaluated

for impairment

Ending balance:  
loans acquired  
with

deteriorated  
credit quality

|     |     |     |     |     |     |     |     |     |     |
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| \$- | \$- | \$- | \$- | \$- | \$- | \$- | \$- | \$- | \$- |
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|

FINANCING

RECEIVABLES:

|                |            |            |            |            |            |           |      |      |              |
|----------------|------------|------------|------------|------------|------------|-----------|------|------|--------------|
| Ending balance | \$ 160,489 | \$ 192,887 | \$ 115,043 | \$ 440,488 | \$ 145,360 | \$ 47,696 | \$ - | \$ - | \$ 1,101,963 |
|----------------|------------|------------|------------|------------|------------|-----------|------|------|--------------|

Ending balance:  
individually  
evaluated

for impairment

|        |      |      |        |          |      |      |      |      |          |
|--------|------|------|--------|----------|------|------|------|------|----------|
| \$ 902 | \$ - | \$ - | \$ 192 | \$ 1,075 | \$ - | \$ - | \$ - | \$ - | \$ 2,169 |
|--------|------|------|--------|----------|------|------|------|------|----------|

Ending balance:  
collectively  
evaluated

for impairment

|            |            |            |            |            |           |      |      |              |
|------------|------------|------------|------------|------------|-----------|------|------|--------------|
| \$ 159,241 | \$ 192,887 | \$ 115,043 | \$ 440,296 | \$ 142,242 | \$ 47,696 | \$ - | \$ - | \$ 1,097,405 |
|------------|------------|------------|------------|------------|-----------|------|------|--------------|

Ending balance:  
loans acquired  
with

deteriorated  
credit quality

|        |      |      |      |          |      |      |      |          |
|--------|------|------|------|----------|------|------|------|----------|
| \$ 346 | \$ - | \$ - | \$ - | \$ 2,043 | \$ - | \$ - | \$ - | \$ 2,389 |
|--------|------|------|------|----------|------|------|------|----------|

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

(In Thousands)

|  | Consumer<br>Real Estate | Agricultural<br>Real Estate | Agricultural | Commercial<br>Real Estate | Commercial<br>and Industrial | Consumer | Unfunded<br>Loan<br>Commitment<br>&<br>Letters<br>of<br>Credit | Unallocated | Total     |
|--|-------------------------|-----------------------------|--------------|---------------------------|------------------------------|----------|--|-------------|-----------|
| December 31, 2018                                      |                         |                             |              |                           |                              |          |  |             |           |
| <b>ALLOWANCE<br/>FOR CREDIT<br/>LOSSES:</b>            |                         |                             |              |                           |                              |          |  |             |           |
| Ending Balance   | \$247                   | \$250                       | \$768        | \$3,217                   | \$1,305                      | \$484    | \$274  | \$504       | \$7,049   |
| Ending balance:<br>individually<br>evaluated for       |                         |                             |              |                           |                              |          |  |             |           |
| impairment   | \$26                    | \$-                         | \$-          | \$-                       | \$5                          | \$-      | \$-  | \$-         | \$31      |
| Ending balance:<br>collectively<br>evaluated for       |                         |                             |              |                           |                              |          |  |             |           |
| impairment   | \$221                   | \$250                       | \$768        | \$3,217                   | \$1,300                      | \$484    | \$274  | \$504       | \$7,018   |
| Ending balance:<br>loans acquired with<br>deteriorated |                         |                             |              |                           |                              |          |  |             |           |
| credit quality   | \$-                     | \$-                         | \$-          | \$-                       | \$-                          | \$-      | \$-  | \$-         | \$-       |
| <b>FINANCING<br/>RECEIVABLES:</b>                      |                         |                             |              |                           |                              |          |  |             |           |
| Ending balance   | \$80,232                | \$68,588                    | \$108,616    | \$419,131                 | \$127,752                    | \$42,055 | \$-  | \$-         | \$846,374 |
| Ending balance:<br>individually<br>evaluated for       |                         |                             |              |                           |                              |          |  |             |           |
| impairment   | \$757                   | \$-                         | \$-          | \$194                     | \$1,103                      | \$-      | \$-  | \$-         | \$2,054   |
| Ending balance:<br>collectively<br>evaluated for       |                         |                             |              |                           |                              |          |  |             |           |
| impairment   | \$79,359                | \$68,588                    | \$108,616    | \$418,937                 | \$126,649                    | \$42,055 | \$-  | \$-         | \$844,204 |
|  | \$116                   | \$-                         | \$-          | \$-                       | \$-                          | \$-      | \$-  | \$-         | \$116     |

Ending balance:  
loans acquired with

deteriorated  
credit quality

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

|   | Consumer    | Agricultural | Commercial   | Commercial                 | Commercial | Consumer        | Unallocated | Total  |            |
|---|-------------|--------------|--------------|----------------------------|------------|-----------------|-------------|--------|------------|
|   | Real Estate | Real Estate  | Agricultural | Real Estate and Industrial | Commercial | Consumer Credit | Letters of  |        |            |
|   |             |              |              |                            |            |                 | Commitment  |        |            |
|   |             |              |              |                            |            |                 | &           |        |            |
|   |             |              |              |                            |            |                 | Letters     |        |            |
|   |             |              |              |                            |            |                 | of          |        |            |
|   |             |              |              |                            |            |                 | Unallocated |        |            |
|   |             |              |              |                            |            |                 |             |        |            |
| Three Months Ended March 31, 2018                               |             |              |              |                            |            |                 |             |        |            |
| ALLOWANCE FOR CREDIT LOSSES:                                    |             |              |              |                            |            |                 |             |        |            |
| Beginning balance   | \$ 343      | \$ 244       | \$ 667       | \$ 3,149                   | \$ 1,546   | \$ 441          | \$ 227      | \$ 478 | \$ 7,095   |
| Charge Offs   | (34 )       | -            | -            | (14 )                      | -          | (97 )           | -           | -      | (145 )     |
| Recoveries  | -           | -            | 3            | 2                          | 2          | 30              | -           | -      | 37         |
| Provision (Credit)  | (55 )       | 19           | 36           | 537                        | (105 )     | 57              | -           | (449 ) | 40         |
| Other Non-interest expense related to                           |             |              |              |                            |            |                 |             |        |            |
| unfunded  | -           | -            | -            | -                          | -          | -               | 38          | -      | 38         |
| Ending Balance  | \$ 254      | \$ 263       | \$ 706       | \$ 3,674                   | \$ 1,443   | \$ 431          | \$ 265      | \$ 29  | \$ 7,065   |
| Ending balance: individually evaluated                          |             |              |              |                            |            |                 |             |        |            |
| for impairment  | \$ 20       | \$ -         | \$ -         | \$ 42                      | \$ 42      | \$ -            | \$ -        | \$ -   | \$ 104     |
| Ending balance: collectively evaluated                          |             |              |              |                            |            |                 |             |        |            |
| for impairment  | \$ 234      | \$ 263       | \$ 706       | \$ 3,632                   | \$ 1,401   | \$ 431          | \$ 265      | \$ 29  | \$ 6,961   |
| Ending balance: loans acquired with deteriorated credit quality | \$ -        | \$ -         | \$ -         | \$ -                       | \$ -       | \$ -            | \$ -        | \$ -   | \$ -       |
| FINANCING RECEIVABLES:  |             |              |              |                            |            |                 |             |        |            |
| Ending balance  | \$ 84,052   | \$ 67,569    | \$ 99,954    | \$ 414,666                 | \$ 129,865 | \$ 38,631       | \$ -        | \$ -   | \$ 834,737 |
|   | \$ 569      | \$ -         | \$ -         | \$ 618                     | \$ 419     | \$ -            | \$ -        | \$ -   | \$ 1,606   |

Ending balance:  
individually  
evaluated

for impairment  
Ending balance:  
collectively  
evaluated

|                |           |           |           |            |            |           |      |      |            |
|----------------|-----------|-----------|-----------|------------|------------|-----------|------|------|------------|
| for impairment | \$ 83,362 | \$ 67,569 | \$ 99,954 | \$ 414,048 | \$ 129,446 | \$ 38,631 | \$ - | \$ - | \$ 833,010 |
|----------------|-----------|-----------|-----------|------------|------------|-----------|------|------|------------|

Ending balance:  
loans acquired with

|                                |        |      |      |      |      |      |      |      |        |
|--------------------------------|--------|------|------|------|------|------|------|------|--------|
| deteriorated<br>credit quality | \$ 121 | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ 121 |
|--------------------------------|--------|------|------|------|------|------|------|------|--------|

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 EARNINGS PER SHARE

Basic earnings per share are calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e. unvested restricted stock), not subject to performance based measures. Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Application of the two-class method for participating securities results a more dilutive basic earnings per share as the participating securities are allocated the same amount of income as if they are outstanding for purposes of basic earnings per share. There is no additional potential dilution in calculating diluted earnings per share, therefore basic and diluted earnings per share are the same amounts. Other than the restricted stock plan, the Company has no other stock based compensation plans.

|   | (in thousands of dollars) |                   |
|---|---------------------------|-------------------|
|   | Three Months Ended        |                   |
|   | March 31,<br>2019         | March 31,<br>2018 |
| Earnings per share  |                           |                   |
| Net income  | \$3,224                   | \$3,767           |
| Less: distributed earnings allocated to participating securities              | (12 )                     | (12 )             |
| Less: undistributed earnings allocated to participating securities            | (12 )                     | (26 )             |
| Net earnings available to common shareholders                                 | \$3,200                   | \$3,729           |
| Weighted average common shares outstanding including participating securities | 11,089,839                | 9,265,959         |
| Less: average unvested restricted shares                                      | (83,417 )                 | (92,429 )         |
| Weighted average common shares outstanding                                    | 11,006,422                | 9,173,530         |
| Basic earnings and diluted per share  | \$0.29                    | \$0.41            |

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair values of financial instruments are management's estimate of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including deferred tax assets, premises, equipment and intangibles. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the estimates.

The following assumptions and methods were used in estimating the fair value for financial instruments:

Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash, cash equivalents and federal funds sold approximate their fair values. Also included in this line item are the carrying amounts of interest-bearing deposits maturing within ninety days which approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Interest Bearing Time Deposits

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Securities – Available-for-sale

Fair values for securities, excluding Federal Home Loan Bank are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Other Securities

The carrying value of Federal Home Loan Bank stock of Cincinnati and Indianapolis, approximates fair value based on the redemption provisions of the respective Federal Home Loan Bank.

Loans Held for Sale

The carrying amount approximates fair value due to insignificant amount of time between origination and date of sale.

Loans, net

The fair values of the loans are estimated using a credit mark adjustment along with discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The credit mark adjustment was estimated using merger and acquisition analysis of nationwide bank and thrift deals and/or



the Bank's most recent acquisition experience.

#### Deposits

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

#### Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

The carrying value of federal funds purchased and securities sold under agreements to repurchase approximates fair values.

#### FHLB Advances

Fair values of FHLB advances are estimated using discounted cash flow analysis based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

## Off Balance Sheet Financial Instruments

Fair values for off-balance sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter-parties' credit standing.

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of March 31, 2019 and December 31, 2018 are reflected below.

|   | (In Thousands) |           |          |         |           |
|---|----------------|-----------|----------|---------|-----------|
|   | March 31, 2019 |           |          |         |           |
|   | Carrying       | Fair      | Level 1  | Level 2 | Level 3   |
|   | Amount         | Value     |          |         |           |
| <b>Financial Assets:</b>                          |                |           |          |         |           |
| Cash and cash equivalents                         | \$81,849       | \$81,849  | \$81,849 | \$-     | \$-       |
| Interest-bearing time deposits                    | 4,509          | 4,509     | -        | 4,509   | -         |
| Securities - available-for-sale                   | 174,682        | 174,682   | 22,883   | 150,356 | 1,443     |
| Other securities                                  | 5,789          | 5,789     |          |         | 5,789     |
| Loans held for sale                               | 859            | 859       |          |         | 859       |
| Loans, net  | 1,091,829      | 1,070,726 |          |         | 1,070,726 |
| Interest receivable                               | 7,238          | 7,238     |          |         | 7,238     |
| <b>Financial Liabilities:</b>                     |                |           |          |         |           |
| Interest bearing deposits                         | \$691,648      | \$691,702 | \$-      | \$-     | \$691,702 |
| Non-interest bearing deposits                     | 236,847        | 236,847   | -        | 236,847 | -         |
| Time deposits                                     | 258,929        | 259,395   | -        | -       | 259,395   |
| Total Deposits                                    | 1,187,424      | 1,187,944 | -        | 236,847 | 951,097   |
| Federal funds purchased and securities sold under |                |           |          |         |           |
| agreement to repurchase                           | 25,521         | 25,521    | -        | -       | 25,521    |
| Federal Home Loan Bank advances                   | 24,682         | 24,604    | -        | -       | 24,604    |
| Interest payable                                  | 3,728          | 3,728     | -        | -       | 3,728     |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

|   | (In Thousands)     |               |          |         |           |
|---|--------------------|---------------|----------|---------|-----------|
|   | December 31, 2018  |               |          |         |           |
|   | Carrying<br>Amount | Fair<br>Value | Level 1  | Level 2 | Level 3   |
| <b>Financial Assets:</b>                          |                    |               |          |         |           |
| Cash and cash equivalents                         | \$38,365           | \$38,365      | \$38,365 | \$-     | \$-       |
| Interest-bearing time deposits                    | 4,019              | 3,954         | -        | 3,954   | -         |
| Securities - available-for-sale                   | 168,447            | 168,447       | 36,935   | 130,085 | 1,427     |
| Other securities                                  | 3,679              | 3,679         | -        | -       | 3,679     |
| Loans held for sale                               | 495                | 495           | -        | -       | 495       |
| Loans, net  | 839,599            | 823,914       | -        | -       | 823,914   |
| Interest receivable                               | 4,542              | 4,542         | -        | -       | 4,542     |
| <b>Financial Liabilities:</b>                     |                    |               |          |         |           |
| Interest bearing deposits                         | \$525,955          | \$525,955     | \$-      | \$-     | \$525,955 |
| Non-interest bearing deposits                     | 215,422            | 215,422       | -        | 215,422 | -         |
| Time deposits                                     | 187,413            | 187,545       | -        | -       | 187,545   |
| Total Deposits                                    | 928,790            | 928,922       | -        | 215,422 | 713,500   |
| Federal funds purchased and securities sold under |                    |               |          |         |           |
| agreement to repurchase                           | 32,181             | 3,181         | -        | -       | 32,181    |
| Federal Home Loan Bank advances                   | -                  | -             | -        | -       | -         |
| Interest payable                                  | 418                | 418           | -        | -       | 418       |

## Fair Value Measurements

In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities in active markets that the Company has the ability to access.

Available-for-sale securities, when quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Available-for-sale securities classified as Level 2 are valued using the prices obtained from an independent pricing service. The prices are not adjusted. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the

marketplace.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. The Bank holds some local municipals that the Bank evaluates based on the credit strength of the underlying project. The fair value is determined by valuing similar credit payment streams at similar rates.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset.

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of March 31, 2019 and December 31, 2018, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

| Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands) |                  |             |             |
|---|------------------|-------------|-------------|
|   | Quoted Prices in | Significant | Significant |
|   | Active Markets   | Observable  | Observable  |
|   | for Identical    | Inputs      | Inputs      |
|   |                  | (Level 2)   | (Level 3)   |
| March 31, 2019  | Assets (Level 1) | (Level 2)   | (Level 3)   |
| Assets - (Securities Available-for-Sale)  |                  |             |             |
| U.S. Treasury   | \$ 22,883        | \$ -        | \$ -        |
| U.S. Government agencies  | -                | 74,215      | -           |
| Mortgage-backed securities  | -                | 37,894      | -           |
| State and local governments   | -                | 38,247      | 1,443       |
| Total Securities Available-for-Sale   | \$ 22,883        | \$ 150,356  | \$ 1,443    |
|   | Quoted Prices in | Significant | Significant |
|   | Active Markets   | Observable  | Observable  |
|   | for Identical    | Inputs      | Inputs      |
|   |                  | (Level 2)   | (Level 3)   |
| December 31, 2018   | Assets (Level 1) | (Level 2)   | (Level 3)   |
| Assets - (Securities Available-for-Sale)  |                  |             |             |
| U.S. Treasury   | \$ 22,830        | \$ -        | \$ -        |
| U.S. Government agencies  | 14,105           | 55,222      | -           |
| Mortgage-backed securities  | -                | 36,262      | -           |
| State and local governments   | -                | 38,601      | 1,427       |
| Total Securities Available-for-Sale   | \$ 36,935        | \$ 130,085  | \$ 1,427    |

The following table represents the changes in the Level 3 fair-value category of which unobservable inputs are relied upon as of March 31, 2019 and March 31, 2018.

(In Thousands)  
Fair Value Measurements Using  
Significant

|                            | Unobservable Inputs (Level 3) |                 | Total       |
|----------------------------|-------------------------------|-----------------|-------------|
|                            | State and Local               | State and Local |             |
|                            | Governments                   |                 | Governments |
|                            | Tax-Exempt                    |                 |             |
| Balance at January 1, 2019 | \$-                           | \$ 1,427        | \$ 1,427    |
| Change in Market Value     | -                             | 16              | 16          |
| Payments & Maturities      | -                             | -               | -           |
| Balance at March 31, 2019  | \$-                           | \$ 1,443        | \$ 1,443    |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

|                            | (In Thousands)                |                 |                 |
|----------------------------|-------------------------------|-----------------|-----------------|
|                            | Fair Value Measurements Using |                 |                 |
|                            | Significant                   |                 |                 |
|                            | Unobservable Inputs (Level 3) |                 |                 |
|                            | State and Local               | State and Local | State and Local |
|                            | Governments                   | Governments     | Governments     |
|                            | Tax-Exempt                    | Tax-Exempt      | Total           |
| Balance at January 1, 2018 | \$-                           | \$ 1,428        | \$ 1,428        |
| Change in Market Value     | -                             | (5 )            | (5 )            |
| Payments & Maturities      | -                             | -               | -               |
| Balance at March 31, 2018  | \$-                           | \$ 1,423        | \$ 1,423        |

Most of the Company's available-for-sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At March 31, 2019 and December 31, 2018, such assets consist primarily of collateral dependent impaired loans. Collateral dependent impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

At March 31, 2019 and December 31, 2018, fair value of collateral dependent impaired loans categorized as Level 3 was \$195 and \$215 thousand, respectively. The specific allocation for impaired loans was \$59 and \$31 thousand as of March 31, 2019 and December 31, 2018, respectively, which are accounted for in the allowance for loan losses (see Note 4).

Other real estate is reported at either the lower of the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from third parties. If the fair value of the real estate, minus the estimated costs to sell the asset, is less than the asset's cost, the deficiency is recognized as a valuation allowance against the asset through a charge to expense. The valuation allowance is therefore increased or decreased, through charges or credits to expense, for changes in the asset's fair value or estimated selling costs.

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

|                            | (In<br>Thousands)<br>Fair Value<br>at<br>March 31,<br>2019 | Valuation Technique  | Unobservable Inputs                      | Range<br><br>(Weighted<br>Average) |
|----------------------------|--|----------------------|--|------------------------------------|
|                            |  |                      | Credit strength of underlying project or | 0-5%                               |
| State and local government | \$ 1,443   | Discounted Cash Flow | entity / Discount rate                   | (3.27%)                            |
| Collateral dependent       |  | Collateral based     | Discount to reflect current market       | 0-50%                              |
| impaired loans             | 195  | measurements         | conditions and ultimate collectability   | (23.33%)                           |
| Other real estate owned -  |  |                      | Discount to reflect current              | 0-20%                              |
| residential                | -  | Appraisals           | market                                   | (0% )                              |
| Other real estate owned -  |  |                      | Discount to reflect current              | 0-20%                              |
| commercial                 | 29   | Appraisals           | market                                   | (48.67% )                          |

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

|  | (In<br>Thousands)<br>Fair Value at<br>December 31,<br>2018 | Valuation Technique              | Unobservable Inputs<br>Credit strength of underlying project or<br>entity / Discount rate | Range<br>(Weighted<br>Average) |
|--|--|----------------------------------|---|--------------------------------|
| State and local government               | \$ 1,427   | Discounted Cash Flow             |   | 0-5%<br>(3.51%)                |
| Collateral dependent<br>impaired loans   | 215  | Collateral based<br>measurements | Discount to reflect current market<br>conditions and ultimate collectability              | 0-50%<br>(12.38%)              |
| Other real estate owned -<br>residential | -  | Appraisals                       | Discount to reflect current<br>market   | — %<br>( — )                   |
| Other real estate owned -<br>commercial  | -  | Appraisals                       | Discount to reflect current<br>market   | — %<br>( — )                   |

The following table presents impaired loans and other real estate owned as recorded at fair value on March 31, 2019 and December 31, 2018:

Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2019  
(In Thousands)

|  | Balance at<br>March 31,<br>2019 | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level 1) |   |        |
|--|---------------------------------|--|---|--------|
|  |                                 | Significant<br>Observable Inputs<br>(Level 2)                              | Significant<br>Unobservable Inputs<br>(Level 3) |        |
| Collateral dependent<br>impaired loans | \$ 195                          | \$ -   | \$ -  | \$ 195 |
| Other real estate                      | -                               | -  | -   | -      |

|                     |    |   |   |    |
|---------------------|----|---|---|----|
| owned - residential |    |   |   |    |
| Other real estate   |    |   |   |    |
| owned - commercial  | 29 | - | - | 29 |

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2018  
(In Thousands)

|                      | Balance at<br>December 31,<br>2018 | Quoted Prices<br>in Active                   |   |   |
|----------------------|------------------------------------|--|---|---|
|                      |                                    | Markets for<br>Identical<br>Assets (Level 1) | Significant<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
| Collateral dependent |                                    |  |   |   |
| impaired loans       | \$ 215                             | \$ -   | \$ -  | \$ 215  |
| Other real estate    |                                    |  |   |   |
| owned - residential  | -                                  | -  | -   | -   |
| Other real estate    |                                    |  |   |   |
| owned - commercial   | -                                  | -  | -   | -   |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 7 FEDERAL FUNDS PURCHASED AND SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

The Company had no Federal Funds purchased as of March 31, 2019 and \$6.5 million as of December 31, 2018, respectively. During the same time periods, the company also had \$25.5 million and \$25.7 million in securities sold under agreement to repurchase.

|                                 | March 31, 2019  |               |            |                      |          |  |
|---------------------------------|---|---------------|------------|----------------------|----------|--|
|                                 | Remaining Contractual Maturity of the Agreements (In Thousands) |               |            |                      |          |  |
|                                 | Overnight & Continuous  | Up to 30 days | 30-90 days | Greater Than 90 days | Total    |  |
| Federal funds purchased         | \$-   | \$ -          | \$ -       | \$ -                 | \$-      |  |
| Repurchase agreements           |   |               |            |                      |          |  |
| US Treasury & agency securities | 681   | -             | -          | 24,840               | 25,521   |  |
|                                 | \$681   | \$ -          | \$ -       | \$ 24,840            | \$25,521 |  |

|                                 | December 31, 2018   |               |            |                      |          |  |
|---------------------------------|---|---------------|------------|----------------------|----------|--|
|                                 | Remaining Contractual Maturity of the Agreements (In Thousands) |               |            |                      |          |  |
|                                 | Overnight & Continuous  | Up to 30 days | 30-90 days | Greater Than 90 days | Total    |  |
| Federal funds purchased         | \$6,486   | \$ -          | \$ -       | \$ -                 | \$6,486  |  |
| Repurchase agreements           |   |               |            |                      |          |  |
| US Treasury & agency securities | 806   | -             | -          | 24,889               | 25,695   |  |
|                                 | \$7,292   | \$ -          | \$ -       | \$ 24,889            | \$32,181 |  |

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued ASU No. 2016-02 “Leases (Topic 842).” ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company has adopted ASU 2016-02 on January 1, 2019 and recorded a right of use asset and a corresponding liability in the amount of \$491.7 thousand. This did not have a significant impact on the company’s financial statements.

In June 2016, FASB issued ASU No. 2016-13 “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company has contracted with an external advisor and has formed a committee to determine the methodology to be used. Most importantly, the Company is gathering as much data as possible to enable review scenarios and determine which calculations will produce the most reliable results. The Company is in the early stages of CECL conversion analysis with use of a third party service provider and is working to run parallel for a minimum of the last two quarters of 2019.

In January 2017, the FASB issued ASU No. 2017-04 “Intangibles – Goodwill and other (Topic 350) – Simplifying the Test for Goodwill Impairment.” These amendments eliminate Step 2 from the goodwill impairment test. The amendments 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. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative

impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment test performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company does not expect ASU 2017-04 to have a material impact on its financial statements, as goodwill testing has been completed annually without any impairment concerns.

In August 2018, the FASB issued ASU No. 2018-13 “Fair Value Measurement (Topic 820) - Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement.” ASU 2018-13 modifies the disclosure requirements on fair value measurements in Topic 820. The amendments in this update remove disclosures that no longer are considered cost beneficial, modify/clarify the specific requirements of certain disclosures, and add disclosure requirements identified as relevant. ASU 2018-13 will be effective until years beginning after December 15, 2019, with early adoption permitted. The Company is in the process of evaluating and does not expect ASU 2018-13 to have a material impact on its accounting disclosures.

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

### OVERVIEW

The Company completed the merger with Limberlost on January 1, 2019 and three weeks later integrated the Bank of Geneva into The Farmers & Merchants State Bank's core operating system. The first quarter of 2019 has been impacted by a very labor-intensive process as we welcomed new employees, customers and shareholders into the F&M family. Training and reconciliation of items has been priority one and has involved many extra hours from all parties involved. Training will continue to be a focus throughout the next two quarters. Great benefits will follow as the Company continues its strategy for long-term sustainable growth from the six offices that have been added. Financially, the merger is expected to be accretive to earnings during 2019, as a larger legal lending limit will enable the expansion of existing customer's borrowings, a wider range of products and services becomes available to all customers, and a larger organization provides additional revenue-generating opportunities for our employees. F&M will continue to operate on the foundation of a strong community bank platform in the communities we serve.

The positive effect of the merger is in having the balances added on day one of 2019 so we have a whole year of earnings to offset the expense. The negative effect is that most of the acquisition costs have been paid in the first quarter with only three months of earnings available to offset these costs. In first quarter 2019, approximately \$1.3 million of direct acquisition costs have been expensed which doesn't include the many indirect or soft costs such as overtime or the purchase accounting expenses surrounding the goodwill and fair value calculations.

Overall, the local economies continue to remain strong. The manufacturing sector has shown some expansion though tempered somewhat by possible recession concerns for 2020. Unemployment in our market areas remains low and has impacted expansion strategies. Finding quality employees is a challenge for all including the Company.

The agricultural sector faces similar challenges as last year with low grain prices (imports still impacting prices along with farm bill) and a very wet first quarter. However, there is time for both situations to improve before it will affect the agricultural community. Land values for good soil types are holding while sales on marginal soil types continue to show a slight deterioration in prices.

Federal rate increases have resulted in a widening of the net interest margin though Fed appears to be on hold for future increases in 2019. Pressure continues to build on cost of funds as depositors seek out higher rates. The Bank has offered new products in 2019 to attract new depositors and for current depositors to increase their holdings with us. Competitive pressure has forced us to increase rates and thereby put pressure on the margin. The Bank of Geneva had a larger net interest margin than F&M which will help widen the margin in 2019.

The dividend declared for the first quarter represented a 15.4% increase over the declaration of the same period last year. Core earnings were strong for the first quarter and exceeded the prior quarter and first quarter last year after

acquisition related expenses are factored out. The focus remains on growth for 2019 along with the widening of our footprint from additional offices. Welcoming and developing our newest offices is also important and a priority. The Company is positioned for positive results in 2019 and remains well capitalized.

#### NATURE OF ACTIVITIES

Farmers & Merchants Bancorp, Inc. (the “Company”) is a financial holding company incorporated under the laws of Ohio in 1985. Our subsidiaries are, The Farmers & Merchants State Bank (the “Bank”), a community bank operating in Northwest Ohio since 1897 and Farmers & Merchants Risk Management, Inc., a captive insurance company formed in December 2014 and is located in Nevada. We report our financial condition and net income on a consolidated basis and we have only one segment.

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419) 446-2501. The Bank operates thirty full service banking offices throughout Northwest Ohio and Northeast Indiana.

The Bank opened an additional office during February of 2018 in Findlay, Ohio and the office is located in Hancock County. The Bank purchased the building in 2017 and was subsequently remodeled. On January 1, 2019, six Bank of Geneva offices located in the Indiana counties of Adams, Allen and Jay, were merged with and into The Farmers & Merchants State Bank. The Bank has continued its expansion strategy and the new offices are expected to provide new growth opportunities.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The Farmers & Merchants State Bank engages in general commercial banking and savings business including commercial, agricultural and residential mortgage, consumer and credit card lending activities. The largest segment of the lending business relates to commercial, both real estate and non-real estate. The type of commercial business ranges from small business to multi-million dollar companies. The loans are a reflection of business located within the Banks' market area. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such items as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for the purchase of autos, trucks, recreational vehicles, motorcycles, and other consumer goods.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, Automated Teller Machines (ATMs) or Interactive Teller Machines (ITMs) are provided at most branch locations along with other independent locations in the market area. ITMs operate as an ATM with the addition of remote teller access to assist the user. The Bank has custodial services for Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. Over the past couple of years, the Bank has updated its consumer offerings with "Secure" and "Pure" checking in 2014 and with KASASA Cash Back in 2015. During the second quarter 2017, new business checking products were announced and existing business accounts were converted to one of three new products, Business Essential, Edge or Elite. The new products provided customers with new options to bundle services and for the Bank to utilize the full relationship to determine pricing. This was the next step of implementation for the Bank's "earn to free" strategic initiative. Upgrades to our digital products and services continue to occur in both retail and business lines.

The Bank has established underwriting policies and procedures which facilitate operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank's practice has been to not promote innovative, unproven credit products which may not be in the best interest of the Bank or its customers. The Bank does offer a hybrid mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank's adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank also normally retains the servicing rights on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by those agencies. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers.

All loan requests are reviewed as to credit worthiness and are subject to the Bank's underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank's Loan Policy. In addition, credit scores of those seeking consumer credit are reviewed and if they do not meet the Bank's Loan Policy guidelines an additional officer approval is required.



Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.

Loans above 100% are generally the result of additional charges for extended warranties and/or insurance coverage for wage or death.

Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.

1st or 2nd mortgages on 1-4 family homes range from 75%-90% with "in-house" first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

Commercial/Agriculture/Real Estate:

Maximum LTVs range from 70%-80% depending on type.

Accounts Receivable: Up to 80% LTV less retainages and greater than 90 days.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Inventory:

•Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.

•Commercial:

Maximum LTV of 50% on raw and finished goods.

•Floor plan:

oNew/used vehicles to 100% of wholesale.

oNew/Used recreational vehicles and manufactured homes to 80% of wholesale.

Equipment:

•New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.

•Restaurant equipment up to 35% of market value.

•Heavy trucks, titled trailers up to NTE 75% LTV and aircraft up to 75% of appraised value.

F&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services, Inc.

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended (the "Act"), in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations. The Company also formed a captive insurance company (the "captive") in December 2014 which is located in Nevada and regulated by the State of Nevada Division of Insurance.

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Hancock, Henry, Lucas, Williams, Wood and in the Indiana counties of Adams, Allen, DeKalb, Jay and Steuben. In our banking activities, we compete directly with other commercial banks, credit unions, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided.

At March 31, 2019, we had 313 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be good.

## REGULATORY DEVELOPMENTS

The Bank remains attentive to the current regulatory environment in light of the regulatory agencies' risk-based approach to examinations. Regulatory changes and the complexity of new and amended rules have resulted in lack of clarity and uncertainties which could pose an increased risk of noncompliance. Various significant mortgage rules require monitoring by means of testing, validation of results, additional training, and further research or consultation to assist with ongoing compliance.

The Economic Growth Regulatory Relief and Consumer Protection Act (EGRRCPA) was signed into law in May 2018. EGRRCPA was intended to pave the way for banks to lend to creditworthy borrowers and better serve their communities. Regulatory relief was not immediate, as guidance and new rulemaking remains to be completed to implement many of the changes. The Bank along with many community banks welcome the rollback of some burdensome requirements resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act. Sections in the EGRRCPA address access to mortgage credit; consumer access to credit; protections for veterans, consumers, and homeowners; rules for certain bank holding companies, capital access; and protections for student borrowers. Implementation of the rules and guidance for the various provisions of the EGRRCPA will commence as rulemaking occurs.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The Bank is subject to numerous laws, rules, regulations and guidance which include, but are not limited to, the following significant matters: deposit insurance coverage; equal credit opportunity; fair lending; community reinvestment; anti-money laundering; suspicious activity reporting; identity theft identification and prevention; protections for military members and their dependents; flood disaster protection; integrated mortgage disclosures; mortgage servicing rights; legal lending limits; electronic fund transfers; consumer privacy; and unfair and deceptive acts and practices. Extensive training and training resources are necessary to develop and maintain expertise on the various regulatory matters.

These U.S. Department of the Treasury's final rules on Customer Due Diligence (CDD) and Beneficial Ownership added a fifth core element to the original core elements necessary for an effective Bank Secrecy Act and Anti-Money Laundering compliance program. These rules were effective in May 2018. The CDD Final Rule is a significant step toward greater financial transparency. Prior to these new rules, the ability for individuals to hide financial activity through anonymous ownership of business entities was a weakness in the fight against financial crime. By gaining a more complete profile of entity customers, financial institutions can help further reduce the flow of illicit funds through the US banking system. The CDD and Beneficial Ownership final rules added a fifth core element to the original core elements necessary for an effective Bank Secrecy Act and Anti-Money Laundering compliance program.

The Company has implemented Basel III capital rules which began to be phased in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard.

With regard to all regulatory matters, the Bank remains committed in making good faith efforts to comply with technical requirements of the laws, rules, regulations, and guidance from both federal and state agencies which govern its activities.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes.

These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event. These policies, along with the disclosures presented in the notes to the condensed consolidated financial statements and in the management discussion and analysis of the financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the ALLL, the valuation of its Mortgage Servicing Rights and the valuation of real estate acquired through or in lieu of; loan foreclosures ("OREO Property") as the accounting areas that require the most subjective or complex judgments, and as

such could be the most subject to revision as new information becomes available.

OREO Property held for sale and is initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell.

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell.

The net income from operations of foreclosed real estate held for sale is reported either in noninterest income or noninterest expense depending upon whether the property is in a gain or loss position overall. At March 31, 2019 OREO property holdings were \$510 thousand. OREO totaled \$600 thousand and \$651 thousand as of December 31, 2018 and March 31, 2018 respectively.

The ALLL and ACL represents management's estimate of probable credit losses inherent in the Bank's loan portfolio, unfunded loan commitments, and letters of credit at the report date. The ALLL methodology is regularly reviewed for its appropriateness and is approved annually by the Board of Directors. This written methodology is consistent with Generally Accepted Accounting Principles which provides for a consistently applied analysis.

The Bank's methodology provides an estimate of the probable credit losses either by calculating a specific loss per credit or by applying a composite of historical factors over a relevant period of time with current internal and external factors which may affect credit collectability. Such factors which may influence estimated losses are the conditions of the local and national economy, local unemployment trends, and abilities of lending staff, valuation trends of fixed assets, and trends in credit delinquency, classified credits, and credit losses.

Inherent in most estimates is imprecision. The Bank's ALLL provides a margin for imprecision with an unallocated portion. Bank regulatory agencies and external auditors periodically review the Bank's methodology and adequacy of the ALLL. Any required changes in the ALLL or loan charge-offs by these agencies or auditors may have a material effect on the ALLL.

The Bank is also required to estimate the value of its mortgage servicing rights. The Bank's mortgage servicing rights relating to fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee represent an asset on the Bank's balance sheet. The valuation is completed by an independent third party.

The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced.

The Bank's mortgage servicing rights relating to loans serviced for others represent an asset. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights using the level yield method. The amortization thereof is recorded in non-interest expense. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Bank. The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Bank's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Bank of the mortgage servicing rights, the Bank receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Bank's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as

current national market interest rate levels, market forecasts and other economic conditions. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. Management, with the advice from its third party valuation firm, reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Bank's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Bank. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Bank's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

For more information regarding the estimates and calculations used to establish the ALLL please see Note 4 to the consolidated financial statements provided herewith.

## MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

The Company plans to continue in its growth mode in 2019 led by loan growth from within our newer markets. The Bank is focused on funding the loan growth with the least expensive source of deposits, sale of securities or borrowings. Growing deposits will also be a focus especially in our newer markets. The Bank decreased the level of pledged securities by offering the Insured Cash Sweep, "ICS" product accessed through the Promontory network of financial institutions as compared to a year ago. This has provided more availability for runoff of securities by the Bank if warranted to fund loan growth. Competition for deposits is intense with most competitors offering "special" rates for specific terms.

Liquidity in terms of cash and cash equivalents ended \$43.5 million higher as of March 31, 2019 than it was at yearend December 31, 2018. An increase in securities held along with increased deposits funded the \$252.2 million increase in net loans since yearend 2018. All loan portfolios increased as a result of the Limberlost acquisition with the largest loan growth having occurred in agricultural real estate and consumer portfolios. Commercial real estate and commercial and industrial portfolios also experienced large increases.

In comparing to the same prior year period, the March 31, 2019 (net of deferred fees and cost) loan balances of \$1.1 billion accounted for \$267.2 million or 32.0% increase when compared to 2018's \$834.7 million. The year over year improvement in all loan categories was made up of a combined increase of 200.6% in agricultural related loans (comprised of 185.5% in agricultural real estate loans and 15.1% in non-real estate agricultural loans). Consumer real estate loans increased by 90.9%, consumer loans by 23.5%, Industrial Development Bonds ("IDB's") by 16.3%, and commercial and industrial loans by 11.7%. The Company credits the growth not only to the Limberlost acquisition, but also the strong team of lenders focused on providing customers valuable localized services and thereby increasing our market share.

The chart below shows the breakdown of the loan portfolio category as of March 31, for the last three years, net of deferred fees and costs.

|                              | (In Thousands)      |                   |                   |
|------------------------------|---------------------|-------------------|-------------------|
|                              | March 31,<br>2019   | March 31,<br>2018 | March 31,<br>2017 |
|                              | Amount              | Amount            | Amount            |
| Consumer Real Estate         | \$ 160,489          | \$ 84,052         | \$ 84,081         |
| Agricultural Real Estate     | 192,887             | 67,569            | 62,803            |
| Agricultural                 | 115,043             | 99,954            | 87,078            |
| Commercial Real Estate       | 440,488             | 414,666           | 382,183           |
| Commercial and Industrial    | 137,976             | 123,515           | 115,516           |
| Consumer                     | 47,696              | 38,631            | 33,878            |
| Industrial Development Bonds | 7,384               | 6,350             | 5,667             |
| <b>Total Loans, net</b>      | <b>\$ 1,101,963</b> | <b>\$ 834,737</b> | <b>\$ 771,206</b> |



While the security portfolio has been utilized to fund loan growth for the last three years, additional sources have been cultivated during 2017, 2018, and 2019. The security portfolio increased \$6.2 million in the first three months 2019 from yearend 2018. The amount of pledged investment securities increased by \$1.3 million as compared to yearend and increased \$996 thousand as compared to March 31, 2018. The difference in the growth and consequently pledged securities, improves liquidity with the additional option of selling unpledged investment securities if needed to fund loan growth or other initiatives. As of March 31, 2019, pledged investment securities totaled \$83.1 million. The current portfolio is in a net unrealized loss position of \$2.0 million.

For the Bank, an additional \$31.2 million is also available from the Federal Home Loan Bank based on current collateral pledging with up to \$119 million available provided adequate collateral is pledged.

With the exception of FHLB stocks, carried at cost, which is shown as other securities, all of the Company's security portfolio is categorized as "available-for-sale" and as such is recorded at fair value.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Management feels confident that liquidity needs for future growth can be met through additional maturities and/or sales from the security portfolio, increased deposits and additional borrowings. For short term needs, the Bank has \$123.1 million of unsecured borrowing capacity through its correspondent banks.

Overall total assets increased 31.3% since yearend 2018 and grew 30.4% since March 31, 2018. The largest growth in both periods was in the loan portfolios followed by goodwill.

Deposits accounted for the largest growth within liabilities, up 27.8% or \$258.6 million since yearend and 24.6% or \$234.1 million over March 31, 2018 balances. Core deposits continue to drive the increase which provide the opportunity to generate additional noninterest income. This growth aided the increased liquidity position and funded the loan growth for the periods along with usage of purchased Federal Funds for daily borrowings.

Shareholders' equity increased by \$73.6 million as of the first quarter of 2019 compared to yearend 2018, as the acquisition of Limberlost, which included stock in the transaction, was completed on January 1, 2019 along with earnings exceeding dividend declarations in the first quarter. Accumulated other comprehensive loss decreased in loss position by \$1.4 million from December 2018. Dividends declared were the same as the fourth quarter at \$0.15 per share. Compared to March 31, 2018, shareholders' equity increased 60.8% or \$82.1 million. Profits are lower year-to-date March 2019 than year-to-date March 2018 by \$543 thousand due to acquisition expenses totaling \$1.3 million impacting 2019.

Basel III regulatory capital requirements became effective in 2016. The Bank and Company include a capital conservation buffer as a part of the transition provision. For calendar year 2016, the applicable required capital conservation buffer percentage of 0.625% was the base above which institutions avoid limitations on distributions and certain discretionary bonus payments. For the calendar year 2017, the applicable required capital conservation buffer percentage was 1.25%. For 2018, the capital conservation buffer percentage increased to 1.875%. The total buffer requirement increased to 2.5% for calendar year 2019. As of March 31, 2019, the Company and the Bank are both positioned well above the 2019 requirement.

The Bank continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show:

|                                   |        |
|-----------------------------------|--------|
| Tier I Leverage Ratio             | 10.86% |
| Risk Based Capital Tier I         | 13.13% |
| Total Risk Based Capital          | 13.74% |
| Stockholders' Equity/Total Assets | 14.80% |
| Capital Conservation Buffer       | 5.74%  |

## MATERIAL CHANGES IN RESULTS OF OPERATIONS

Comparison of Results of Interest Earnings and Expenses for three month periods ended March 31, 2019 and 2018

When comparing first quarter 2019 to first quarter 2018, average loan balances with the acquisition of Limberlost grew \$282.9 million. This represented a 34.3% increase in a one year time period. Interest income on loan balances

also experienced an increase of \$4.6 million as compared to the quarter ended March 31, 2018. Increases in the prime lending rate between the periods also contributed to the improvement in interest income and rate yield.

The higher levels of loan interest income helped to offset the available-for-sale securities portfolio, which decreased in average balances when comparing to the previous year. The decreased balances were expected as available-for-sale securities were used as a source of funds for loan growth. The income associated with the security portfolio increased \$53 thousand over first quarter 2018.

Overall, interest income for the quarter comparisons was higher for first quarter 2019 by 42.4% or \$4.7 million as to first quarter 2018.

In terms of annualized yield, for the quarter ended March 31, 2019, it was 4.80% which compares to a year ago first quarter ended March 31, 2018 of 4.28%. The following chart demonstrates the value of increased loan balances in the balance sheet mix, even if offset by lower balances in the available-for-sale security portfolio. During the current quarter, securities were sold realizing a loss of \$26 thousand to fund growth and pay off some of the FHLB advances that were derived from the acquisition of Limberlost. The yields on tax-exempt securities and the portion of the tax-exempt IDB loans included in loans have been tax adjusted based on a 21% tax rate in the charts to follow.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

| Interest Earning Assets:         | (In Thousands)  |                    | Quarter to Date Ended March 31, 2019 |                |   |
|----------------------------------|-----------------|--------------------|--------------------------------------|----------------|---|
|                                  | Average Balance | Interest/Dividends | Yield/Rate                           |                |   |
|                                  |                 |                    | March 31, 2019                       | March 31, 2018 |   |
| Loans                            | \$ 1,108,031    | \$ 14,680          | 5.30%                                | 4.90%          | % |
| Taxable investment securities    | 151,885         | 842                | 2.22%                                | 1.90%          | % |
| Tax-exempt investment securities | 34,513          | 170                | 2.49%                                | 2.44%          | % |
| Fed funds sold & other           | 31,394          | 170                | 2.17%                                | 1.53%          | % |
| Total Interest Earning Assets    | \$ 1,325,823    | \$ 15,862          | 4.80%                                | 4.28%          | % |

## Change in Interest Income Quarter to Date March 31, 2019 Compared to March 31, 2018

| Interest Earning Assets:         | (In Thousands) |          |         |
|----------------------------------|----------------|----------|---------|
|                                  | Change         | Due to   |         |
|                                  |                | Volume   | Rate    |
| Loans                            | \$4,578        | \$ 3,749 | \$ 829  |
| Taxable investment securities    | 123            | 1        | 122     |
| Tax-exempt investment securities | (70 )          | (95 )    | 25      |
| Fed funds sold & other           | 95             | 64       | 31      |
| Total Interest Earning Assets    | \$4,726        | \$ 3,719 | \$1,007 |

Offsetting some of the increase in interest income for the quarter was the increase in cost of funds in 2019. First quarter 2019 was higher by \$1.6 million than first quarter 2018. Since 2018 with the Limberlost acquisition, average interest-bearing deposit balances have increased \$172.1 million and resulted in \$1.3 million more in interest expense for the most recent quarter. During the quarter, 10- and 34-month CD specials and 31-month IRA specials have been rolled out which carry a higher interest rate, in addition to rates increasing on Kasasa II savings, account balances over \$20,000 and Ultimate checking accounts. Additionally, interest expense on FHLB borrowings was up \$267 thousand in the first quarter 2019 over the same time frame in 2018 due to borrowings taken on from the acquisition.

| Interest Bearing Liabilities: | (In Thousands)  |          | Quarter to Date Ended March 31, 2019 |                |   |
|-------------------------------|-----------------|----------|--------------------------------------|----------------|---|
|                               | Average Balance | Interest | Yield/Rate                           |                |   |
|                               |                 |          | March 31, 2019                       | March 31, 2018 |   |
| Savings deposits              | \$ 671,227      | \$ 1,527 | 0.91%                                | 0.53%          | % |
| Other time deposits           | 243,342         | 1,086    | 1.79%                                | 1.24%          | % |
| Other borrowed money          | 29,392          | 287      | 3.91%                                | 1.60%          | % |

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|  |            |          |       |      |   |
|--|------------|----------|-------|------|---|
| Fed funds purchased & securities<br>sold under agreement to repurchase | 33,794     | 185      | 2.19% | 1.83 | % |
| Total Interest Bearing Liabilities                                     | \$ 977,755 | \$ 3,085 | 1.26% | 0.75 | % |

Change in Interest Expense Quarter to Date March 31, 2019 Compared to March 31, 2018

| Interest Bearing Liabilities:  | (In Thousands) |                  |                   |
|--|----------------|------------------|-------------------|
|  | Change         | Due to<br>Volume | Due<br>to<br>Rate |
| Savings deposits   | \$786          | \$ 261           | \$525             |
| Other time deposits  | 508            | 257              | 251               |
| Other borrowed money   | 267            | 238              | 29                |
| Fed funds purchased & securities<br>sold under agreement to repurchase | 61             | 37               | 24                |
| Total Interest Bearing Liabilities                                     | \$1,622        | \$ 793           | \$829             |

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Overall, net interest spread for the first quarter 2019 is higher than last year. As the following chart illustrates, higher yields on interest and dividend income did offset the higher interest expense in the most recent quarter when comparing to the same period a year ago.

|                                | March 31,<br>2019 | % | March 31,<br>2018 | % | March 31,<br>2017 | % |
|--------------------------------|-------------------|---|-------------------|---|-------------------|---|
| Interest/Dividend income/yield | 4.80              | % | 4.28              | % | 3.98              | % |
| Interest Expense/cost          | 1.26              | % | 0.75              | % | 0.65              | % |
| Net Interest Spread            | 3.54              | % | 3.53              | % | 3.33              | % |
| Net Interest Margin            | 3.87              | % | 3.72              | % | 3.50              | % |

Net interest income was up \$3.1 million for the first quarter 2019 over the same time frame in 2018 due to the increase in loan interest income and partially offset by higher interest expense, as previously mentioned. As the new loans added in 2018 and 2019 generate more income, management expects the benefits of the Company's strategy of repositioning the balance sheet to continue to widen this margin as measured in dollars. In terms of net interest margin rate, the Bank recognizes competition for deposits have and will continue to put pressure on the margin which may lead to a tightening.

## Comparison of Noninterest Results of Operations - First Quarter 2019 to First Quarter 2018

## Provision Expense

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio class and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the ALLL is attributed to each class of the loan portfolio, as well as the percent that each particular class of the loan portfolio represents to the entire loan portfolio in the aggregate. The consumer loan portfolios accounted for the largest component of charge-offs and recoveries for first quarter of 2019 and 2018. As was mentioned in previous discussion, the commercial real estate portfolio is currently creating a large impact on the ALLL due to the loan growth.

Total provision for loan losses was \$10 thousand lower for the first quarter 2019 as compared to the same quarter 2018. Management continues to monitor asset quality, making adjustments to the provision as necessary. Loan charge-offs were \$62 thousand higher in first quarter 2019 than the same quarter 2018. Recoveries were \$1 thousand higher in first quarter 2019 as compared to first quarter 2018. Combined net charge-offs were \$61 thousand higher in first quarter 2019 than the same time period 2018. Past due loans increased \$1.1 million from March 31, 2018 as compared to March 31, 2019. The majority of the change is attributed to the increase of past due balances in the consumer real estate, agricultural, and consumer portfolios while the commercial and industrial portfolio decreased.



## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table breaks down the activity within the ALLL for each loan portfolio class and shows the contribution provided by both recoveries and the provision, along with the reduction of the allowance caused by charge-offs. The time period covered is for three months ended March 31, 2019, 2018, and 2017.

|  | (In Thousands)           |                          |                          |   |      |   |
|--|--------------------------|--------------------------|--------------------------|---|------|---|
|  | Three<br>Months<br>Ended | Three<br>Months<br>Ended | Three<br>Months<br>Ended |   |      |   |
|  | March 31,<br>2019        | March 31,<br>2018        | March 31,<br>2017        |   |      |   |
| Loans, net                                   | \$1,101,963              | \$834,737                | \$771,206                |   |      |   |
| Daily average of outstanding loans           | \$1,108,031              | \$825,109                | \$762,126                |   |      |   |
| Allowance for Loan Losses - Jan 1            | \$6,775                  | \$6,868                  | \$6,784                  |   |      |   |
| Loans Charged off:                           |                          |                          |                          |   |      |   |
| Consumer Real Estate                         | -                        | 34                       | -                        |   |      |   |
| Agriculture Real Estate                      | -                        | -                        | -                        |   |      |   |
| Agricultural                                 | -                        | -                        | -                        |   |      |   |
| Commercial Real Estate                       | -                        | 14                       | 0                        |   |      |   |
| Commercial and Industrial                    | -                        | -                        | -                        |   |      |   |
| Consumer                                     | 207                      | 97                       | 44                       |   |      |   |
|  | 207                      | 145                      | 44                       |   |      |   |
| Loan Recoveries:                             |                          |                          |                          |   |      |   |
| Consumer Real Estate                         | -                        | -                        | 10                       |   |      |   |
| Agriculture Real Estate                      | -                        | -                        | -                        |   |      |   |
| Agricultural                                 | 1                        | 3                        | 1                        |   |      |   |
| Commercial Real Estate                       | 2                        | 2                        | 2                        |   |      |   |
| Commercial and Industrial                    | 3                        | 2                        | 3                        |   |      |   |
| Consumer                                     | 32                       | 30                       | 21                       |   |      |   |
|  | 38                       | 37                       | 37                       |   |      |   |
| Net Charge Offs                              | 169                      | 108                      | 7                        |   |      |   |
| Provision for loan loss                      | 30                       | 40                       | 73                       |   |      |   |
| Acquisition provision for loan loss          | -                        | -                        | -                        |   |      |   |
| Allowance for Loan & Lease Losses            |                          |                          |                          |   |      |   |
| - March 31                                   | 6,636                    | 6,800                    | 6,850                    |   |      |   |
| Allowance for Unfunded Loan Commitments      |                          |                          |                          |   |      |   |
| & Letters of Credit - March 31               | 346                      | 265                      | 219                      |   |      |   |
| Total Allowance for Credit Losses - March 31 | \$6,982                  | \$7,065                  | \$7,069                  |   |      |   |
| Ratio of net charge-offs to average          |                          |                          |                          |   |      |   |
| Loans outstanding                            | 0.02                     | %                        | 0.01                     | % | 0.00 | % |



Ratio of the Allowance for Loan Loss to

|                      |        |   |        |   |        |   |
|----------------------|--------|---|--------|---|--------|---|
| Nonperforming Loans* | 558.92 | % | 755.19 | % | 478.96 | % |
|----------------------|--------|---|--------|---|--------|---|

\*Nonperforming loans are defined as all loans on nonaccrual, plus any loans past 90 days not on nonaccrual. The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off of a loan, whether partial loan balance or full loan balance. A charge down in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-offs may be realized as further unsecured positions are recognized.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Loans classified as nonaccrual were higher as of March 31, 2019 at \$1.2 million as compared to \$900 thousand as of March 31, 2018. The majority of the increase is in the consumer real estate portfolio.

In determining the allocation for impaired loans the Bank applies the appraised market value of the collateral securing the asset, reduced by applying a discount for estimated costs of collateral liquidation. In some instances where the discounted market value is less than the loan amount, a specific impairment allocation is assigned, which may be reduced or eliminated by the write down of the credit's active principal outstanding balance.

For the majority of the Bank's impaired loans, including all collateral dependent loans, the Bank will apply the appraised market value methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine appraised market value, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The following table presents the balances for allowance of loan losses by loan type for three months ended March 31, 2019 and March 31, 2018.

|   | (In Thousands)    |                       | (In Thousands)    |                       |
|---|-------------------|-----------------------|-------------------|-----------------------|
|   | March 31,<br>2019 |                       | March 31,<br>2018 |                       |
| Balance at End of Period Applicable To: | Amount            | % of Loan<br>Category | Amount            | % of Loan<br>Category |
| Consumer Real Estate                    | \$ 268            | 14.56 %               | \$ 254            | 10.07 %               |
| Agricultural Real Estate                | 270               | 17.50 %               | 263               | 8.10 %                |
| Agricultural                            | 706               | 10.44 %               | 706               | 11.97 %               |
| Commercial Real Estate                  | 3,203             | 39.98 %               | 3,674             | 49.67 %               |
| Commercial and Industrial               | 1,490             | 13.19 %               | 1,443             | 15.56 %               |
| Consumer                                | 496               | 4.33 %                | 431               | 4.63 %                |
| Unallocated                             | 203               | 0.00 %                | 29                | 0.00 %                |
| Allowance for Loan & Lease Losses       | 6,636             |                       | 6,800             |                       |
| Off Balance Sheet Commitments           | 346               |                       | 265               |                       |
| Total Allowance for Credit Losses       | \$ 6,982          |                       | \$ 7,065          |                       |

## Noninterest Income

Noninterest income was up \$85 thousand for the first quarter 2019 over the same time frame in 2018. The Company has seen a decrease in its mortgage production volume and the gain on the sale of these loans was \$30 thousand lower for the first quarter 2019 over the same period in 2018. Loan originations on loans held for sale for the first quarter 2019 were \$8.3 million with proceeds from sale at \$7.8 million for 2019 compared to 2018's first quarter activity of \$11.6 million in originations and \$10.0 million in sales. The mortgages sold were both 1-4 family and agricultural real estate loans originated for sale.

The largest fluctuation in noninterest income was in the combined service fee lines, which was \$141 thousand higher than the same quarter last year. The increase was due to multiple small increments in all areas rather than in one service. The Company did sell some of its available-for-sale portfolio in first quarter 2019 and recognized a \$26 thousand loss.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through noninterest income while the amortization thereof is included in non-interest expense. For the first quarter of 2019, mortgage servicing rights caused a net \$12 thousand in income, in comparison to a net \$14 thousand income for the first quarter of 2018. The slightly lower capitalized additions for 2019 are attributed to a lower loan origination level of 1-4 families combined with a higher mortgage servicing rights value being applied to originations of 1-4 families in 2019 as compared to 2018. For loans of 15 years and less, the value was 1.124% in the first quarter 2019 versus .972% in first quarter 2018. For loans over 15 years, the value was 1.309% versus 1.168% for the same periods respectively. The carrying value is well below the market value of \$3.6 million which indicates any large expense to fund the valuation allowance to be unlikely in 2019.

|  | (In Thousands) |         |
|--|----------------|---------|
|  | 2019           | 2018    |
| Beginning Balance, January 1,            | \$2,385        | \$2,299 |
| Capitalized Additions                    | \$87           | 99      |
| Amortization                             | \$(75 )        | (85 )   |
| Ending Balance, March 31,                | \$2,397        | 2,313   |
| Valuation Allowance                      | \$-            | -       |
| Mortgage Servicing Rights net, March 31, | \$2,397        | \$2,313 |

## Noninterest Expense

For the first quarter 2019, noninterest expenses were \$3.9 million higher than for the same quarter in 2018. Of this increase, \$1.3 million was third party acquisition related costs in connection with the Limberlost transaction. Salaries, wages, and employee benefits increased \$1.5 million, with the addition of the acquired offices, normal merit increases, and increased employer taxes related to the vesting of restricted stock awards and the incentive payout. Acquisition costs included in these categories were \$108 thousand. Furniture and equipment expenses increased \$189 thousand from the prior year primarily due to an increase in depreciation of \$116 thousand and maintenance contracts of \$65 thousand. Data processing charges increased \$968 thousand for first quarter 2019 attributed to \$892 thousand of acquisition expenses. Other general and administrative expenses were up \$746 thousand compared to first quarter 2018 with \$238 thousand arising from the acquisition. Core deposit intangible increased \$140 thousand, loan and collection expense increase \$25 thousand, stationary/printing expenses increased \$28 thousand and dues, subscription and membership increased \$38 thousand. These increased expenses were offset by a reduction in entertainment, education and OREO real estate taxes.

## Net Income

Results overall, net income in the first quarter of 2019 was down \$543 thousand as compared to the same quarter last year. Excluding tax adjusted acquisition costs, net income would have been approximately \$4.3 million, an increase of \$1.1 million as shown in the below table.

|   | (in thousands of dollars) |                |
|---|---------------------------|----------------|
|   | Three Months Ended        |                |
| Non-GAAP Reconciliation of Net Income     | March 31, 2019            | March 31, 2018 |
|   | (Unaudited)               |                |
| Net income as reported                    | \$3,224                   | \$ 3,767       |
| Acquisition expenses                      | 1,287                     | -              |
| Tax effect                                | (258 )                    | -              |
| Net income excluding acquisition expenses | \$4,253                   | \$ 3,767       |

The Company has done an exceptional job of growing loans while keeping past dues low. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of expansion.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

FORWARD LOOKING STATEMENTS

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as "intend," "believe," "expect," "anticipate," "should," "planned," "estimated," and "potential." Such forward-looking statements are based on current expectations, but actual results may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

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## ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of our interest rate risk arises from the instruments, positions and transactions entered into for purposes other than trading such as loans, available for sale securities, interest bearing deposits, short term borrowings and long term borrowings. Interest rate risk occurs when interest bearing assets and liabilities re-price at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates.

Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

The shocks presented below assume an immediate change of rate in the percentages and directions shown covering a twelve month period:

| Interest Rate Shock    |             |           |        | Interest Rate Shock    |             |  |
|------------------------|-------------|-----------|--------|------------------------|-------------|--|
| on Net Interest Margin |             |           |        | on Net Interest Income |             |  |
| Net Interest           | % Change to | Rate      | Rate   | Cumulative             | % Change to |  |
| Margin (Ratio)         | Flat Rate   | Direction | by     | Total                  | Flat Rate   |  |
| 4.72%                  | 16.25%      | Rising    | 3.00%  | 64,394                 | 13.26%      |  |
| 4.44%                  | 9.44%       | Rising    | 2.00%  | 61,218                 | 7.68%       |  |
| 4.16%                  | 2.49%       | Rising    | 1.00%  | 58,021                 | 2.05%       |  |
| 4.06%                  | 0.00%       | Flat      | 0.00%  | 56,855                 | 0.00%       |  |
| 3.74%                  | -8.00%      | Falling   | -1.00% | 53,190                 | -6.45%      |  |
| 3.47%                  | -14.51%     | Falling   | -2.00% | 50,277                 | -11.57%     |  |
| 3.18%                  | -21.82%     | Falling   | -3.00% | 47,234                 | -16.92%     |  |

The net interest margin represents the forecasted twelve month margin. The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months and over a 24 month time frame. It also shows the effect rate changes will have on both the margin and net interest income. The goal of the Company is to lengthen the term of some of the Bank's fixed rate liabilities or sources of funds to decrease the exposure to a rising rate environment. Of course, customer desires also impact the Bank's ability to attract longer term deposits. Some movement into the longer term time deposits has occurred. Over the past five year period, the Bank has experienced a decrease in the time balances of our deposit portfolio, and therefore, a loss of term funding. Over the past two years, the Bank has also paid off term borrowings with the last \$5 million maturing last year; however, additional borrowings were a part of the Limberlost acquisition in 2019.

The shock chart currently shows a widening net interest margin over the next twelve months in an increasing rate environment with a tightening in a falling rate environment. Cost of funds are at 1.26% so the lowest shock of 100 basis points is where the Bank can take full advantage and reprice funds to match the level of shock. Once the shocks are falling over 100 basis points, the cost of funds cannot lower to match and the loss on net interest income continues to build. Since the average duration of the majority of the assets is outside the 12 month shock period, the rising rate environment only shows improvement. The majority of the newer loans added to the commercial real estate portfolio begin with an initial fixed rate period of three to five years whose variable adjustment is outside of the current shock time frame. The Bank continues to adjust its assumptions by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as the index rates change. All shocks are within risk exposure guidelines at all levels. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

Overall, the Company must concentrate on increasing loan spreads on variable loans and extend the duration on cost of funds where possible.



## ITEM 4 CONTROLS AND PROCEDURES

As of March 31, 2019, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2019. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2019 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

## PART II OTHER INFORMATION

## ITEM 1 LEGAL PROCEEDINGS

None

## ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2018.

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

Treasury stock repurchased the quarter ended March 31, 2019.

| Period                | (a)<br>Total Number of<br>Shares Purchased | (b)<br>Average<br>Price<br>Paid per<br>Share | (c) Total<br>Number<br>of Shares<br>Purchased<br>as Part<br>of Publicly<br>Announced<br>Plan<br>or Programs<br>(1) | (d) Maximum<br>Number<br>of Shares that<br>may yet be<br>purchased<br>under the<br>Plans or<br>Programs |
|-----------------------|--|--|--|---|
| 1/1/2019 to 1/31/2019 | 911  | (2) 38.26                                    | (2) —  | 500,000   |
| 2/1/2019 to 2/28/2019 | 5,647                                      | (2) 31.53                                    | (2) —  | 500,000   |
| 3/1/2019 to 3/31/2019 | —  | —  | —  | 500,000   |
| Total                 | 6,558                                      | 32.46  | —  | 500,000   |

(1)

From time to time, the Company purchases shares in the market pursuant to a stock repurchase program publicly announced on January 18, 2019. On that date, the Board of Directors authorized the repurchase of 500,000 common shares between January 18, 2019 and December 31, 2019.

(2) Shares which were repurchased for taxes on vested stock awards are outside of this program.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

ITEM 5 OTHER INFORMATION

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ITEM 6 EXHIBITS

- 2.1 Agreement and Plan of Reorganization and Merger (incorporated by reference to Exhibit 10.1 to Registrant's Report on Form 8-K filed with the Commission on August 20, 2018).
- 3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to Registrant's Quarterly Report on Form 10-Q filed with the Commission on October 25, 2017).
- 3.2 Amended and Restated Code of Regulations of the Registrant (incorporated by reference to Exhibit 3.2 to Registrant's Quarterly Report on Form 10-Q filed with the Commission on July 26, 2017).
- 31.1 Rule 13-a-14(a) Certification - CEO
- 31.2 Rule 13-a-14(a) Certification - CFO
- 32.1 Section 1350 Certification - CEO
- 32.2 Section 1350 Certification - CFO
  
- 101.INS XBRL Instance Document (1)
- 101.SCH XBRL Taxonomy Extension Schem Document (1)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document (1)
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document (1)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document (1)

SIGNATURES

SIGNATURES

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

Farmers & Merchants Bancorp, Inc.,

Date: May 1, 2019 By: /s/ Lars B. Eller  
Lars B. Eller  
President and Chief Executive Officer

Date: May 1, 2019 By: /s/ Barbara J. Britenriker  
Barbara J. Britenriker  
Executive Vice-President and  
Chief Financial Officer