

SB FINANCIAL GROUP, INC.  
Form 10-Q  
November 13, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

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

Commission file number 1-36785

SB FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

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

401 Clinton Street, Defiance, Ohio 43512

(Address of principal executive offices)

(Zip Code)

(419) 783-8950

(Registrant's telephone number, including area code)

N/A

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

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

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

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

Large accelerated filer

Accelerated filer

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

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

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Shares, No Par Value	The NASDAQ Stock Market, LLC
<b>4,787,796</b> Outstanding at November 13, 2017	(NASDAQ Capital Market)

**SB FINANCIAL GROUP, INC.**

**FORM 10-Q**

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

SB Financial Group, Inc.

Condensed Consolidated Balance Sheets  
September 30, 2017 and December 31, 2016

(\$ in Thousands)	September 2017	December 2016
<b>ASSETS</b>	<b>(Unaudited)</b>	
Cash and due from banks	\$28,258	\$ 17,012
Securities available for sale, at fair value	85,304	90,128
Other securities - FRB and FHLB Stock	3,748	3,748
Total investment securities	89,052	93,876
Loans held for sale	7,663	4,434
Loans, net of unearned income	675,075	644,433
Allowance for loan losses	(7,760 )	(7,725 )
Net loans	667,315	636,708
Premises and equipment, net	21,271	19,129
Cash surrender value of life insurance	13,692	13,725
Goodwill & other intangibles	16,414	16,422
Foreclosed assets held for sale, net	94	994
Mortgage servicing rights	9,560	8,422
Accrued interest receivable	1,880	1,512
Other assets	5,263	3,771
Total assets	\$860,462	\$ 816,005
<b>LIABILITIES AND EQUITY</b>		
Deposits		
Non interest bearing demand	\$124,840	\$ 125,189
Interest bearing demand	130,513	131,598
Savings	103,530	95,594
Money market	140,647	122,976

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Time deposits	217,277	197,716
Total deposits	716,807	673,073
Advances from Federal Home Loan Bank	20,500	26,500
Repurchase agreements	11,343	10,532
Trust preferred securities	10,310	10,310
Accrued interest payable	611	408
Other liabilities	9,982	8,634
Total liabilities	769,553	729,457
Commitments & Contingent Liabilities	-	-
Stockholders' Equity		
Preferred stock, Series A	13,983	13,983
Common stock	12,569	12,569
Additional paid-in capital	15,335	15,362
Retained earnings	51,991	46,688
Accumulated other comprehensive income	335	51
Treasury stock, at cost	(3,304	) (2,105 )
Total equity	90,909	86,548
Total liabilities and equity	\$ 860,462	\$ 816,005

See notes to condensed consolidated financial statements (unaudited)

Note: The balance sheet at December 31, 2016 has been derived from the audited consolidated financial statements at that date

SB Financial Group, Inc.

Condensed Consolidated Statements of Income - (Unaudited)

(\$ in thousands, except share data)	Three Months Ended		Nine Months Ended	
	September 2017	September 2016	September 2017	September 2016
Interest income				
Loans				
Taxable	\$7,653	\$ 6,954	\$21,696	19,862
Nontaxable	21	22	62	55
Securities				
Taxable	532	378	1,562	1,172
Nontaxable	132	145	398	450
Total interest income	8,338	7,499	23,718	21,539
Interest expense				
Deposits	907	677	2,518	1,869
Repurchase Agreements & Other	4	5	10	14
Federal Home Loan Bank advances	86	83	235	266
Trust preferred securities	78	63	223	184
Total interest expense	1,075	828	2,986	2,333
Net interest income	7,263	6,671	20,732	19,206
Provision for loan losses	-	-	200	250
Net interest income after provision for loan losses	7,263	6,671	20,532	18,956
Noninterest income				
Wealth Management Fees	688	695	2,059	1,971
Customer service fees	674	692	1,981	2,052
Gain on sale of mtg. loans & OMSR's	2,211	2,503	5,524	6,170
Mortgage loan servicing fees, net	227	205	851	(514)
Gain on sale of non-mortgage loans	294	327	1,093	927
Data service fees	182	223	559	733
Net gain on sale of securities	119	59	119	262
Gain/(loss) on sale/disposal of assets	8	(31)	10	177
Other income	458	342	929	983
Total non-interest income	4,861	5,015	13,125	12,761
Noninterest expense				
Salaries and employee benefits	4,844	4,672	13,897	12,765
Net occupancy expense	566	523	1,678	1,612
Equipment expense	688	649	2,012	1,883
Data processing fees	429	352	1,195	996
Professional fees	502	380	1,282	1,022
Marketing expense	180	123	581	493
Telephone and communication	120	101	349	302

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Postage and delivery expense	103	154	336	513
State, local and other taxes	198	170	535	440
Employee expense	242	117	570	363
Other expenses	412	689	1,037	1,843
Total non-interest expense	8,284	7,930	23,472	22,232
Income before income tax expense	3,840	3,756	10,185	9,485
Income tax expense	1,117	1,209	3,152	3,018
Net income	\$2,723	\$ 2,547	\$7,033	\$ 6,467
Preferred Stock Dividends	244	244	731	731
Net income available to common shareholders	2,479	2,303	6,302	5,736
Common share data:				
Basic earnings per common share	\$0.52	\$ 0.47	\$1.31	\$ 1.17
Diluted earnings per common share	\$0.43	\$ 0.40	\$1.11	\$ 1.01
Average common shares outstanding (in thousands):				
Basic:	4,797	4,874	4,825	4,888
Diluted:	6,326	6,376	6,356	6,384

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



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

(\$'s in thousands)	Three Months Ended Sep. 30,		Nine Months Ended Sep. 30,	
	2017	2016	2017	2016
Net income	\$2,723	\$2,547	\$7,033	\$6,467
Other comprehensive income:				
<u>Available-for-sale investment securities:</u>				
Gross unrealized holding gain arising in the period	112	(418 )	550	1,151
Related tax expense	(38 )	142	(187 )	(391 )
Less: Reclassification for gain realized in income	(119 )	(59 )	(119 )	(262 )
Related tax expense	40	20	40	89
Net effect on other comprehensive income	(5 )	(315 )	284	587
Total comprehensive income	\$2,718	\$2,232	\$7,317	\$7,054

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

(\$'s in thousands - except per share data)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance, January 1, 2017	\$ 13,983	\$ 12,569	\$ 15,362	\$ 46,688	\$ 51	\$ (2,105 )	\$ 86,548
Net income				7,033			7,033
Other comprehensive income					284		284
Dividends on common, \$0.065 per share				(998 )			(998 )
Dividends on preferred, \$0.1625 per share				(732 )			(732 )
Restricted stock vesting			(163 )			163	-
Stock options exercised			(77 )			416	339
Stock buyback						(1,778 )	(1,778 )
Share based compensation expense			213				213
Balance, September 30, 2017	\$ 13,983	\$ 12,569	\$ 15,335	\$ 51,991	\$ 335	\$ (3,304 )	\$ 90,909

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Balance, January 1, 2016	\$ 13,983	\$ 12,569	\$ 15,438	\$ 40,059	\$ 650	\$ (1,458 )	\$ 81,241
Net income				6,467			6,467
Other comprehensive income					587		587
Dividends on common, \$0.055 per share				(862 )			(862 )
Dividends on preferred, \$0.1625 per share				(731 )			(731 )
Restricted stock vesting			(87 )			87	-
Stock options exercised			(67 )			166	99
Stock buyback						(624 )	(624 )
Share based compensation expense			86				86
Balance, September 30, 2016	\$ 13,983	\$ 12,569	\$ 15,370	\$ 44,933	\$ 1,237	\$ (1,829 )	\$ 86,263

See notes to condensed consolidated financial statements (unaudited)

SB Financial Group, Inc.

## Condensed Consolidated Statements of Cash Flows (Unaudited)

(\$'s in thousands)	Nine Months Ended	
	Sep. 30, 2017	2016
<b>Operating Activities</b>		
Net Income	\$7,033	\$6,467
Items providing/(using) cash		
Depreciation and amortization	1,152	892
Provision for loan losses	200	250
Expense of share-based compensation plan	213	86
Amortization of premiums and discounts on securities	437	688
Amortization of intangible assets	8	9
Amortization of originated mortgage servicing rights	863	879
Recapture of originated mortgage servicing rights impairment	(35 )	(71 )
Impairment of mortgage servicing rights	75	1,236
Proceeds from sale of loans held for sale	203,999	249,159
Originations of loans held for sale	(202,652)	(241,732)
Gain from sale of loans	(6,617 )	(7,098 )
(Gain)/loss on sale of assets	47	(150 )
Changes in		
Interest receivable	368	(381 )
Other assets	(2,726 )	(2,848 )
Interest payable and other liabilities	1,551	1,059
Net cash provided by operating activities	3,916	8,445
<b>Investing Activities</b>		
Purchases of available-for-sale securities	(25,785 )	(17,572 )
Proceeds from maturities of available-for-sale securities	16,234	11,923
Proceeds from sales of available-for-sale securities	14,369	2,950
Proceeds from bank owned life insurance	386	-
Net change in loans	(30,901 )	(61,932 )
Purchase of premises and equipment and software	(3,294 )	(517 )
Proceeds from sale of foreclosed assets & equipment	945	881
Net cash used in investing activities	(28,046 )	(64,267 )
<b>Financing Activities</b>		
Net increase in demand deposits, money market, interest checking and savings accounts	19,561	41,056
Net increase in certificates of deposit	24,173	34,635
Net increase/(decrease) in securities sold under agreements to repurchase	811	(1,043 )
Proceeds from FHLB Advances	5,000	2,000

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Repayments of FHLB Advances	(11,000 )	(14,000 )
Share repurchase	(1,778 )	(624 )
Net proceeds from share based compensation plans	339	99
Dividends on Common Stock	(998 )	(862 )
Dividends on Preferred Stock	(732 )	(731 )
Net cash provided by financing activities	35,376	60,530
Increase in Cash and Cash Equivalents	11,246	4,708
Cash and Cash Equivalents, Beginning of Year	17,012	20,459
Cash and Cash Equivalents, End of Period	\$28,258	\$25,167
Supplemental Cash Flows Information		
Interest paid	\$2,783	\$2,170
Income taxes paid	\$2,863	\$3,479
Transfer of loans to foreclosed assets	\$94	\$319

See notes to condensed consolidated financial statements (unaudited)

SB FINANCIAL GROUP, INC.

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

**NOTE 1—BASIS OF PRESENTATION**

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

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The financial statements reflect all adjustments that are, in the opinion of management, necessary to fairly present the financial position, results of operations and cash flows of the Company. Those adjustments consist only of normal recurring adjustments. Results of operations for the nine months ended September 30, 2017, are not necessarily indicative of results for the complete year.

The condensed consolidated balance sheet of the Company as of December 31, 2016 has been derived from the audited consolidated balance sheet of the Company as of that date.

For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

The following paragraphs summarize the impact of new accounting pronouncements:

**Accounting Standards Update (ASU) No. 2017-12: Derivatives and Hedging (Topic 815)**

This ASU better aligns an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments in this ASU are effective for reporting periods beginning after December 15, 2018, and management does not believe the changes will have a material effect on the Company's consolidated financial statements.

**ASU No. 2017-08: Premium Amortization on Purchased Callable Debt**

This ASU amends the amortization period for certain purchased callable debt securities held at a premium. The Board is shortening the amortization period to the earliest call date. Currently, entities generally amortize the Financial Accounting Standard premium as an adjustment of yield over the contractual life of the instrument. The amendments in this ASU are effective for reporting periods beginning after December 15, 2018, and management does not believe the changes will have a material effect on the Company's consolidated financial statements.

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

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

**ASU No. 2017-03: Accounting Changes and Error Corrections (Topic 250)**

This amendment includes the text of “SEC Staff Announcement: Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of a Registrant When Such Standards are Adopted in a Future Period.” This staff announcement applies to ASU No. 2014-09, ASU No. 2016-02 and ASU 2016-03. The Company has enhanced its disclosures regarding the impact that recently issued accounting standards adopted in a future period will have on its accounting and disclosures in this footnote.

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

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

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

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

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

This ASU affects all entities that issue share-based payment awards to their employees. The update is intended to simplify the accounting for these transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The Company adopted the amendments in this ASU effective for this quarterly report, and management has determined that the impact on the Company’s consolidated financial statements is immaterial.

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

This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets unless those contracts are within the scope of other standards. The core principle is that an entity should recognize revenue in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Management has determined that this update will not have a material impact on the Company's consolidated financial statements.





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Net earnings allocated to participating securities	9	6
Dividends on convertible preferred shares	731	731
Net Income allocated to common shares and participating securities	\$7,033	\$6,467
Weighted average shares outstanding for basic earnings per share	4,825	4,888
Dilutive effect of stock compensation	73	41
Dilutive effect of convertible shares	1,458	1,455
Weighted average shares outstanding for diluted earnings per share	6,356	6,384
Basic earnings per common share	\$1.31	\$1.17
Diluted earnings per common share	\$1.11	\$1.01

**Note 3 - Securities**

The amortized cost and appropriate fair values, together with gross unrealized gains and losses, of securities at September 30, 2017 and December 31, 2016 were as follows:

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
September 30, 2017				
U.S. Treasury and Government agencies	\$ 12,960	\$ 113	\$ (42 )	\$ 13,031
Mortgage-backed securities	57,876	210	(310 )	57,776
State and political subdivisions	13,891	551	(15 )	14,427
Equity securities	70	-	-	70
	\$ 84,797	\$ 874	\$ (367 )	\$ 85,304

(\$ in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities:				
December 31, 2016:				
U.S. Treasury and Government agencies	\$ 13,341	\$ 69	\$ (52 )	\$ 13,358
Mortgage-backed securities	62,035	204	(636 )	61,603
State and political subdivisions	14,606	530	(39 )	15,097
Equity securities	70	-	-	70
	\$ 90,052	\$ 803	\$ (727 )	\$ 90,128

The amortized cost and fair value of securities available for sale at September 30, 2017, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Available for Sale

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(\$ in thousands)	Amortized Fair	
	Cost	Value
Within one year	\$744	\$760
Due after one year through five years	7,470	7,577
Due after five years through ten years	11,534	11,714
Due after ten years	7,103	7,407
	26,851	27,458
Mortgage-backed securities & equity securities	57,946	57,846
Totals	\$84,797	\$85,304

The fair value of securities pledged as collateral, to secure public deposits and for other purposes, was \$44.7 million at September 30, 2017 and \$44.3 million at December 31, 2016. The fair value of securities delivered for repurchase agreements was \$14.9 million at September 30, 2017 and \$14.6 million at December 31, 2016.

For the nine months ended September 30, 2017, there were gross gains of \$0.12 million resulting from sales of available-for-sale securities, which was a reclassification from accumulated other comprehensive income (OCI) and was included in the net gain on sale of securities. The related \$0.04 million in tax expense was a reclassification from OCI and was included in the income tax expense line item in the income statement. For the nine months ended September 30, 2016, there were gross gains of \$0.26 million resulting from sales of available-for-sale securities, which was a reclassification from accumulated other comprehensive income (OCI) and was included in the net gain on sale of securities. The related \$0.09 million in tax expense was a reclassification from OCI and was included in the income tax expense line item in the income statement.

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments was \$42.5 million at September 30, 2017, and \$52.2 million at December 31, 2016, which was approximately 50 and 58 percent, respectively, of the Company's available-for-sale investment portfolio at such dates. Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

Securities with unrealized losses, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2017 and December 31, 2016 are as follows:

(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2017						
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$1,420	\$ (6 )	\$2,565	\$ (36 )	\$3,985	\$ (42 )
Mortgage-backed securities	34,939	(263 )	2,263	(47 )	37,202	(310 )
State and Political subdivisions	1,307	(15 )	-	-	1,307	(15 )
	\$37,666	\$ (284 )	\$4,828	\$ (83 )	\$42,494	\$ (367 )

(\$ in thousands)	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016						
Available-for-Sale Securities:						
U.S. Treasury and Government agencies	\$6,044	\$ (52 )	\$-	\$ -	\$6,044	\$ (52 )
Mortgage-backed securities	44,344	(607 )	703	(29 )	45,047	(636 )
State and political subdivisions	1,095	(39 )	-	-	1,095	(39 )

\$51,483 \$ (698 ) \$703 \$ (29 ) \$52,186 \$ (727 )

The total potential unrealized loss as of September 30, 2017 in the securities portfolio was \$0.37 million, which was down from the \$0.73 million unrealized loss at December 31, 2016. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost. Management has determined there is no other-than-temporary-impairment on these securities.

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

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

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

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

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

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

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

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

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



Categories of loans at September 30, 2017 and December 31, 2016 include:

(\$ in thousands)	Total Loans		Non-Accrual Loans	
	Sep. 2017	Dec. 2016	Sep. 2017	Dec. 2016
Commercial & Industrial	\$104,263	\$108,752	123	190
Commercial RE & Construction	319,764	284,084	1,029	1,194
Agricultural & Farmland	51,140	52,475	2	4
Residential Real Estate	141,296	142,452	1,074	1,162
Consumer & Other	58,152	56,335	153	187
<b>Total Loans</b>	<b>\$674,615</b>	<b>\$644,098</b>	<b>\$2,381</b>	<b>\$2,737</b>
Unearned Income	\$460	\$335		
<b>Total Loans, net of unearned income</b>	<b>\$675,075</b>	<b>\$644,433</b>		
Allowance for loan losses	\$(7,760 )	\$(7,725 )		

The following tables present the activity in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method as of September 30, 2017, December 31, 2016 and September 30, 2016.

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
<b>ALLOWANCE FOR LOAN AND LEASE LOSSES</b>						
For the Three Months Ended - September 30, 2017						
Beginning balance	\$ 995	\$ 3,452	\$ 512	\$ 1,988	\$ 878	\$7,825
Charge Offs	-	(26 )	-	(20 )	(29 )	\$(75 )
Recoveries	-	-	1	2	7	10
Provision	(138 )	195	(17 )	44	(84 )	-
Ending Balance	\$ 857	\$ 3,621	\$ 496	\$ 2,014	\$ 772	\$7,760
For the Nine Months Ended - September 30, 2017						
Beginning balance	\$ 1,204	\$ 3,321	\$ 347	\$ 1,963	\$ 890	\$7,725

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Charge Offs	(50	)	(26	)	-	(42	)	(77	)	\$(195 )
Recoveries	6		2		3	6		13		30
Provision	(303	)	324		146	87		(54	)	200
Ending Balance	\$ 857		\$ 3,621		\$ 496	\$ 2,014		\$ 772		\$7,760

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
Loans Receivable at September 30, 2017						
Allowance:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 146	\$ -	\$ 116	\$ 5	\$ 267
Ending balance:						
collectively evaluated for impairment	\$ 857	\$ 3,475	\$ 496	\$ 1,898	\$ 767	\$ 7,493
Loans:						
Ending balance:						
individually evaluated for impairment	\$ -	\$ 1,394	\$ -	\$ 1,008	\$ 201	\$ 2,603
Ending balance:						
collectively evaluated for impairment	\$ 104,263	\$ 318,370	\$ 51,140	\$ 140,288	\$ 57,951	\$ 672,012
Loans Receivable at December 31, 2016						
Allowance:						
Ending balance:						
individually evaluated for impairment	\$ 50	\$ 119	\$ -	\$ 124	\$ 7	\$ 300
Ending balance:						
collectively evaluated for impairment	\$ 1,154	\$ 3,202	\$ 347	\$ 1,839	\$ 883	\$ 7,425
Loans:						
Ending balance:						
individually evaluated for impairment	\$ 50	\$ 1,578	\$ -	\$ 1,919	\$ 248	\$ 3,795
Ending balance:						
collectively evaluated for impairment	\$ 108,702	\$ 282,506	\$ 52,475	\$ 140,533	\$ 56,087	\$ 640,303

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Three Months Ended - September 30, 2016						
Beginning balance	\$ 1,137	\$ 4,126	\$ 189	\$ 1,342	\$ 656	\$7,450
Charge Offs	(42 )	(30 )	-	-	(64 )	\$(136 )
Recoveries	1	-	1	1	3	6
Provision	155	(960 )	142	460	203	-
Ending Balance	\$ 1,251	\$ 3,136	\$ 332	\$ 1,803	\$ 798	\$7,320

(\$'s in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
ALLOWANCE FOR LOAN AND LEASE LOSSES						
For the Nine Months Ended - September 30, 2016						
Beginning balance	\$ 914	\$ 3,886	\$ 204	\$ 1,312	\$ 674	\$6,990
Charge Offs	(134 )	(30 )	-	-	(68 )	\$(232 )
Recoveries	248	6	2	1	55	312
Provision	223	(726 )	126	490	137	250
Ending Balance	\$ 1,251	\$ 3,136	\$ 332	\$ 1,803	\$ 798	\$7,320

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

#### Commercial and Agricultural

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

availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

#### Commercial Real Estate including Construction

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

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

Residential and Consumer

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

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of September 30, 2017 and December 31, 2016.

September 30, 2017 (\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
1-2	\$ 174	\$ 20	\$ 9	\$ 119	\$ 1	\$ 323
3	26,784	93,510	8,213	106,590	55,709	290,806
4	76,211	223,403	42,809	32,957	2,175	377,555
Total Pass (1 - 4)	103,169	316,933	51,031	139,666	57,885	668,684
Special Mention (5)	505	1,108	109	-	66	1,788
Substandard (6)	7	677	-	1,885	219	2,788
Doubtful (7)	582	1,046	-	(255 )	(18 )	1,355
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 104,263	\$ 319,764	\$ 51,140	\$ 141,296	\$ 58,152	\$ 674,615

December 31, 2016 (\$ in thousands)	Commercial & Industrial	Commercial RE & Construction	Agricultural & Farmland	Residential Real Estate	Consumer & Other	Total
1-2	\$ 1,149	\$ 33	\$ 9	\$ 234	\$ 3	\$ 1,428
3	28,461	89,406	9,985	113,403	53,386	294,641
4	78,517	188,007	42,481	26,510	2,625	338,140
Total Pass (1 - 4)	108,127	277,446	52,475	140,147	56,014	634,209

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Special Mention (5)	-	5,030	-	518	123	5,671
Substandard (6)	150	1,291	-	625	61	2,127
Doubtful (7)	475	317	-	1,162	137	2,091
Loss (8)	-	-	-	-	-	-
Total Loans	\$ 108,752	\$ 284,084	\$ 52,475	\$ 142,452	\$ 56,335	\$644,098

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

### **Credit Risk Profile**

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

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

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

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

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

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

The following tables present the Company's loan portfolio aging analysis as of September 30, 2017 and December 31, 2016.



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(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
September 30, 2017						
Commercial & Industrial	\$-	\$ 33	\$ 89	\$ 122	\$ 104,141	\$ 104,263
Commercial RE & Construction	68	251	778	1,097	318,667	319,764
Agricultural & Farmland	-	-	-	-	51,140	51,140
Residential Real Estate	345	343	144	832	140,464	141,296
Consumer & Other	178	87	77	342	57,810	58,152
Total Loans	\$ 591	\$ 714	\$ 1,088	\$ 2,393	\$ 672,222	\$ 674,615

(\$ in thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable
December 31, 2016						
Commercial & Industrial	\$ 35	\$ 50	\$ 104	\$ 189	\$ 108,563	\$ 108,752
Commercial RE & Construction	254	883	59	1,196	282,888	284,084
Agricultural & Farmland	-	-	-	-	52,475	52,475
Residential Real Estate	123	201	115	439	142,013	142,452
Consumer & Other	185	45	148	378	55,957	56,335
Total Loans	\$ 597	\$ 1,179	\$ 426	\$ 2,202	\$ 641,896	\$ 644,098

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

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

The following tables present impaired loan information as of and for the three and nine months ended September 30, 2017 and 2016, and for the twelve months ended December 31, 2016:

Nine Months Ended September 30, 2017 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$-	\$-	\$-	\$-	\$-
Commercial RE & Construction	705	731	-	757	29
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	454	497	-	539	20
Consumer & Other	114	114	-	130	7
All Impaired Loans < \$100,000	97	97	-	97	-
With a specific allowance recorded:					
Commercial & Industrial	-	-	-	-	-
Commercial RE & Construction	689	689	146	721	(2 )
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	554	554	116	631	20
Consumer & Other	87	87	5	95	4
Totals:					
Commercial & Industrial	\$-	\$-	\$-	\$-	\$-
Commercial RE & Construction	\$1,394	\$1,420	\$146	\$1,478	\$27
Agricultural & Farmland	\$-	\$-	\$-	\$-	\$-
Residential Real Estate	\$1,008	\$1,051	\$116	\$1,170	\$40
Consumer & Other	\$201	\$201	\$5	\$225	\$11
All Impaired Loans < \$100,000	\$97	\$97	\$-	\$97	\$-

Three Months Ended September 30, 2017 (\$'s in thousands)	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:		
Commercial & Industrial	\$ -	\$ -
Commercial RE & Construction	754	7
Agricultural & Farmland	-	-
Residential Real Estate	535	5
Consumer & Other	126	2
All Impaired Loans < \$100,000	97	-
With a specific allowance recorded:		
Commercial & Industrial	-	-
Commercial RE & Construction	689	-
Agricultural & Farmland	-	-
Residential Real Estate	625	7
Consumer & Other	92	1

Totals:

Commercial & Industrial	\$ -	\$ -
Commercial RE & Construction	\$ 1,443	\$ 7
Agricultural & Farmland	\$ -	\$ -
Residential Real Estate	\$ 1,160	\$ 12
Consumer & Other	\$ 218	\$ 3
All Impaired Loans < \$100,000	\$ 97	\$ -

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Twelve Months Ended December 31, 2016 (\$'s in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial & Industrial	\$-	\$-	\$-	\$-	\$-
Commercial RE & Construction	637	637	-	655	24
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	1,248	1,290	-	1,470	70
Consumer & Other	129	129	-	151	11
All Impaired Loans < \$100,000	452	452	-	452	-
With a specific allowance recorded:					
Commercial & Industrial	50	50	50	50	3
Commercial RE & Construction	941	941	119	1,010	45
Agricultural & Farmland	-	-	-	-	-
Residential Real Estate	671	672	124	751	30
Consumer & Other	119	118	7	123	7
Totals:					
Commercial & Industrial	\$50	\$50	\$50	\$50	\$3
Commercial RE & Construction	\$1,578	\$1,578	\$119	\$1,665	\$69
Agricultural & Farmland	\$-	\$-	\$-	\$-	\$-
Residential Real Estate	\$1,919	\$1,962	\$124	\$2,221	\$100
Consumer & Other	\$248	\$247	\$7	\$274	\$18
All Impaired Loans < \$100,000	\$452	\$452	\$-	\$452	\$-

September 30, 2016 (\$'s in thousands)	Nine Months Ended		Three Months Ended	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Commercial & Industrial	\$-	\$ -	\$-	\$ -
Commercial RE & Construction	658	16	647	6
Agricultural & Farmland	-	-	-	-
Residential Real Estate	1,195	51	1,186	17
Consumer & Other	94	6	89	2
All Impaired Loans < \$100,000	398	-	438	-
Commercial & Industrial	-	-	-	-
Commercial RE & Construction	1,404	-	1,404	-
Agricultural & Farmland	-	-	-	-
Residential Real Estate	957	29	945	10
Consumer & Other	272	11	267	2
Commercial & Industrial	\$-	\$ -	\$-	\$ -
Commercial RE & Construction	\$2,062	\$ 16	\$2,051	\$ 6
Agricultural & Farmland	\$-	\$ -	\$-	\$ -

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Residential Real Estate	\$2,152	\$ 80	\$2,131	\$ 27
Consumer & Other	\$366	\$ 17	\$356	\$ 4
All Impaired Loans < \$100,000	\$398	\$ -	\$438	\$ -

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

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

**Troubled Debt Restructured (TDR) Loans**

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

TDR Concession Types

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

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

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

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

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

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

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

During the three and nine months ended September 30, 2017, the Company had no new TDR activity and none of the TDR's modified during the past 12 months have subsequently defaulted.

For the three months ended September 30, 2016, the Company had one loan that was modified to a TDR. The loan, which was a commercial product with a principal balance of \$309,000, had its term modified. For the nine months ended September 30, 2016, there were two loans modified to a TDR. The loans, which were a consumer and commercial product, had a total principal balance of \$530,000. Both of these loans had their term modified.

## **NOTE 5 – DERIVATIVE FINANCIAL INSTRUMENTS AND REPURCHASE AGREEMENTS**

### *Risk Management Objective of Using Derivatives*

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

*Non-designated Hedges*

The Company does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously offset by interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2017 and December 31, 2016, the notional amount of customer-facing swaps was approximately \$37.0 million and \$33.2 million, respectively. The same amounts were offset with third party counterparties, as described above.

The Company has minimum collateral posting thresholds with its derivative counterparties. As of September 30, 2017 and December 31, 2016, the Company had posted cash as collateral in the amount of \$0.2 million and \$0.1 million, respectively.

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the balance sheet, as of September 30, 2017 and December 31, 2016.

(\$ in thousands)	Asset Derivatives		Liability Derivatives	
	September 30, 2017	September 30, 2017	September 30, 2017	September 30, 2017
	Balance Sheet	Fair Value	Balance Sheet	Fair Value
	Location		Location	
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 659	Other Liabilities	\$ 659

(\$ in thousands)	Asset Derivatives		Liability Derivatives	
	December 31, 2016	December 31, 2016	December 31, 2016	December 31, 2016
	Balance Sheet	Fair Value	Balance Sheet	Fair Value
	Location		Location	
Derivatives not designated as hedging instruments:				
Interest rate contracts	Other Assets	\$ 623	Other Liabilities	\$ 623

The Company's derivative financial instruments had no net effect on the income statements for the three and nine months ended September 30, 2017 and 2016.



*Securities Sold Under Repurchase Agreements*

State Bank has retail repurchase agreements to facilitate cash management transactions with commercial customers. These obligations are secured by agency and mortgage-backed securities and such collateral is held by the Federal Home Loan Bank. The agreements mature within one month. These repurchase agreements are secured by agency securities and mortgage-backed securities with corresponding liabilities of \$4.6 million and of \$10.3 million. These securities have various maturity dates beyond 2017.

## NOTE 6 – FAIR VALUE OF ASSETS AND LIABILITIES

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

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

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

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

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

### Available-for-Sale Securities

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

### Interest Rate Contracts

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

The following table presents the fair value measurements of assets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2017 and December 31, 2016.

Fair Value Measurements Using:

(\$ in thousands)	Fair Values at 9/30/17	(Level 1)	(Level 2)	(Level 3)
<b>Available-for-Sale Securities:</b>				
U.S. Treasury and Government Agencies	\$13,031	\$ -	\$13,031	\$ -
Mortgage-backed securities	57,776	-	57,776	-
State and political subdivisions	14,427	-	14,427	-
Equity securities	70	-	70	-
Interest rate contracts - assets	659	-	659	-
Interest rate contracts - liabilities	(659 )	-	(659 )	-

Fair Value Measurements Using:

(\$ in thousands)	Fair Values at 12/31/2016	(Level 1)	(Level 2)	(Level 3)
<b>Available-for-Sale Securities:</b>				
U.S. Treasury and Government Agencies	\$ 13,358	\$ -	\$13,358	\$ -
Mortgage-backed securities	61,603	-	61,603	-
State and political subdivisions	15,097	-	15,097	-
Equity securities	70	-	70	-
Interest rate contracts - assets	623	-	623	-
Interest rate contracts - liabilities	(623 )	-	(623 )	-

Level 1 – Quoted Prices in Active Markets for Identical Assets

Level 2 – Significant Other Observable Inputs

Level 3 – Significant Unobservable Inputs

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

Collateral-dependent Impaired Loans, NET of ALLL

Loans for which it is probable the Company will not collect all principal and interest due according to contractual terms are measured for impairment. The estimated fair value of collateral-dependent impaired loans is based on the appraised value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy. This method requires obtaining an independent appraisal of the collateral, which is reviewed for accuracy and consistency by Credit Administration. These appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by applying a discount factor to the value based on the Company's loan review policy. All impaired loans held by the Company were collateral dependent at September 30, 2017 and December 31, 2016.

Mortgage Servicing Rights

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

**Unobservable (Level 3) Inputs**

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

(\$ in thousands) <b>Description</b>	Fair Values at 9/30/2017	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 633	\$ -	\$ -	\$633
Mortgage Servicing Rights	3,735	-	-	3,735

(\$ in thousands) <b>Description</b>	Fair Values at 12/31/2016	(Level 1)	(Level 2)	(Level 3)
Impaired loans	\$ 786	\$ -	\$ -	\$786
Mortgage Servicing Rights	1,993	-	-	1,993

Level 1 - Quoted Prices in Active Markets for Identical Assets

Level 2 - Significant Other Observable Inputs

Level 3 - Significant Unobservable Inputs

Fair Value at	Valuation	Range (Weighted)
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(\$'s in thousands)	9/30/2017	Technique	Unobservable Inputs	Average)	
Collateral-dependent impaired loans	\$ 633	Market comparable properties	Comparability adjustments (%)	Not available	
Mortgage servicing rights	3,735	Discounted cash flow	Discount Rate	9.52	%
			Constant prepayment rate	8.43	%
			P&I earnings credit	1.23	%
			T&I earnings credit	1.88	%
			Inflation for cost of servicing	1.50	%

(\$'s in thousands)	Fair Value at 12/31/2016	Valuation Technique	Unobservable Inputs	Range (Weighted Average)	
Collateral-dependent impaired loans	\$ 786	Market comparable properties	Comparability adjustments (%)	Not available	
Mortgage servicing rights	1,993	Discounted cash flow	Discount Rate	9.65	%
			Constant prepayment rate	7.61	%
			P&I earnings credit	0.76	%
			T&I earnings credit	1.60	%
			Inflation for cost of servicing	1.50	%

There were no changes in the inputs or methodologies used to determine fair value at September 30, 2017 as compared to December 31, 2016.

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

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

The carrying amount approximates the fair value.

Loans Held for Sale

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

Loans

The estimated fair value for loans receivable is based on estimates of the rate State Bank would charge for similar loans at September 30, 2017 and December 31, 2016, applied for the time period until the loans are assumed to re-price or be paid.

Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models associated with the servicing rights and discounting the cash flows using discount market rates, prepayment speeds and default rates. The servicing portfolio has been valued using all relevant positive and negative cash flows including servicing fees, miscellaneous income and float; marginal costs



of servicing; the cost of carry of advances; and foreclosure losses; and applying certain prevailing assumptions used in the marketplace. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy. These mortgage servicing rights are tested for impairment on a quarterly basis.

#### Deposits, FHLB advances & Repurchase agreements

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates the fair value. The estimated fair value for fixed-maturity time deposits, as well as borrowings, is based on estimates of the rate State Bank could pay on similar instruments with similar terms and maturities at September 30, 2017 and December 31, 2016.

#### Loan Commitments

The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The estimated fair values for other financial instruments and off-balance-sheet loan commitments approximate cost at September 30, 2017 and December 31, 2016 and are not considered significant to this presentation.

#### Trust Preferred Securities

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

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

	September 30, 2017			
	Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
(\$ in thousands)				
Financial assets				
Cash and cash equivalents	\$ 28,258	\$28,258	\$-	\$-
Loans held for sale	7,663	-	7,835	-
Loans, net of allowance for loan losses	667,315	-	-	669,568
Federal Reserve and FHLB Bank stock	3,748	-	3,748	-
Mortgage servicing rights	9,560	-	-	10,562
Accrued interest receivable	1,880	-	1,880	-
Financial liabilities				
Deposits	\$ 716,807	\$124,840	\$595,111	\$-
FHLB advances	20,500	-	20,491	-
Repurchase agreements	11,343	-	11,343	-
Trust preferred securities	10,310	-	8,866	-
Accrued interest payable	611	-	611	-
	December 31, 2016			
	Carrying Amount	Fair Value Measurements Using		
		(Level 1)	(Level 2)	(Level 3)
(\$ in thousands)				
Financial assets				
Cash and due from banks	\$ 17,012	\$17,012	\$-	\$-
Loans held for sale	4,434	-	4,503	-
Loans, net of allowance for loan losses	636,708	-	-	636,909
Federal Reserve and FHLB Bank stock, at cost	3,748	-	3,748	-
Mortgage servicing rights	8,422	-	-	9,656
Accrued interest receivable	1,512	-	1,512	-
Financial liabilities				
Deposits	\$ 673,073	\$125,189	\$550,990	\$-
FHLB advances	26,500	-	26,477	-

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Repurchase agreements	10,532	-	10,532	-
Trust preferred securities	10,310	-	7,422	-
Accrued interest payable	408	-	408	-

**NOTE 7 – MORTGAGE SERVICING RIGHTS**

Mortgage loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balance of mortgage loans serviced for others approximated \$979.3 million at September 30, 2017 and \$899.7 million at December 31, 2016. Contractually specified servicing fees of approximately \$1.8 million and \$1.5 million were included in mortgage loan servicing fees in the income statement for the periods ending September 30, 2017 and 2016, respectively.

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

(\$ in thousands)	2017	2016
Carrying amount, January 1	\$8,422	\$7,152
Mortgage servicing rights capitalized during the year	2,042	1,779
Mortgage servicing rights amortization during the year	(864 )	(879 )
Net change in valuation allowance	(40 )	(1,165)
Carrying amount, September 30	\$9,560	\$6,887
Valuation allowance:		
January 1	\$228	\$296
Increase/(reduction)	40	1,165
September 30	\$268	\$1,461

**NOTE 8 – SHARE BASED COMPENSATION**

In April 2008, the Company’s shareholders approved a share-based incentive compensation plan, the SB Financial Group, Inc. 2008 Stock Incentive Plan (the “2008 Plan”). The 2008 Plan permits the grant or award of incentive stock options, nonqualified stock options; stock appreciation rights (“SARs”) and restricted stock for up to 250,000 Common shares of the Company. Option awards are granted with an exercise price equal to the market price of the Company’s stock at the date of grant and those option awards vest based on 5 years of continuous service and have 10-year contractual terms. The fair value of each option award was estimated on the date of grant using the Black-Scholes valuation model. No options were granted in 2017.

A summary of incentive option activity under the Company’s 2008 plan as of September 30, 2017 and changes during the period then ended, is presented below:

	Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Term	Aggregate Intrinsic Value
Outstanding, December 31, 2016	145,894	\$ 7.85		
Granted	-	-		
Exercised	(38,017 )	10.16		
Forfeited	-	-		
Expired	(10,127 )	11.50		
Outstanding, September 30, 2017	97,750	6.97	2.65	\$ 681,318
Exercisable, September 30, 2017	97,750	6.97	2.65	\$ 681,318

During 2017, the 38,017 option shares exercised had a total intrinsic value of \$0.39 million and the cash received from these exercised options was \$0.34 million. The tax benefit from these transactions was immaterial. As of September 30, 2017, there was no unrecognized compensation cost related to incentive option share-based compensation arrangements granted under the 2008 Plan.

On February 5, 2013, the Company adopted a Long Term Incentive (LTI) Plan. The Plan awards restricted stock in the Company to certain key executives under the 2008 Plan. These restricted stock awards vest over a four-year period and are intended to assist the Company in retention of key executives. During 2016, the Company met certain performance targets and restricted stock awards were approved and issued in February of 2017. The compensation cost charged against income for the Long Term Incentive (LTI) Plan was \$0.1 million, with a total income tax benefit recognized in the income statement of \$0.03 million.

As of September 30, 2017, there was \$0.75 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements related to the restricted stock awards under the 2008 Plan which were granted in accordance with the Long Term Incentive (LTI) plan. That cost is expected to be recognized over a weighted-average period of 3.0 years.

A summary of restricted stock activity under the Company's plans as of September 30, 2017 and changes during the period then ended, is presented below:

	Shares	Weighted-Average Value per Share
Nonvested, December 31, 2016	35,498	\$ 9.44
Granted	30,252	18.36
Vested	(13,429)	9.04
Forfeited	(750 )	(9.63 )
Nonvested, September 30, 2017	51,571	\$ 14.85

In April, 2017, the Company's shareholders approved a new equity-based incentive compensation plan, the 2017 Stock Incentive Plan (the "2017 Plan"). The 2017 Plan permits the company to grant stock options, restricted stock and other equity-based awards and cash-based awards to employees and directors of the Company and its subsidiaries. A total of 500,000 common shares of the Company are available for grants of awards under the 2017 Plan. As of September 30, 2017, no awards had been granted under the 2017 Plan.

#### **NOTE 9 – GENERAL LITIGATION**

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

**Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement Regarding Forward-Looking Information**

This Quarterly Report on Form 10-Q, including Management’s Discussion and Analysis of Financial Condition and Results of Operations, contains certain forward-looking statements that are provided to assist in the understanding of anticipated future financial performance. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance. Examples of forward-looking statements include: (a) projections of income or expense, earnings per share, the payment or non-payment of dividends, capital structure and other financial items; (b) statements of plans and objectives of the Company or our management or Board of Directors, including those relating to products or services; (c) statements of future economic performance; (d) statements regarding future customer attraction or retention; and (e) statements of assumptions underlying such statements. Words such as “anticipates”, “believes”, “plans”, “intends”, “expects”, “projects”, “estimates”, “should”, “may”, “will allow”, “will likely result”, “will continue”, “will remain”, or other similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying those statements. Forward-looking statements are based on management’s expectations and are subject to a number of risks and uncertainties. Although management believes that the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially from those expressed or implied in such statements. Risks and uncertainties that could cause actual results to differ materially include, without limitation, risks and uncertainties inherent in the national and regional banking industry, changes in economic conditions in the market areas in which the Company and its subsidiaries operate, changes in policies and supervisory and enforcement activities by regulatory agencies, changes in accounting standards and policies, changes in tax laws, fluctuations in interest rates, demand for loans in the market areas in which the Company and its subsidiaries operate, increases in FDIC insurance premiums, changes in the competitive environment, losses of significant customers, geopolitical events and the loss of key personnel. Additional detailed information concerning a number of important factors which could cause actual results to differ materially from the forward-looking statements contained in Management’s Discussion and Analysis of Financial Condition and Results of Operations is available in the Company’s filings with the Securities and Exchange Commission, including the risks identified under the heading “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2016. Undue reliance should not be placed on the forward-looking statements, which speak only as of the date hereof. Except as may be required by law, the Company undertakes no obligation to update any forward-looking statement to reflect unanticipated events or circumstances after the date on which the statement is made.

**Overview of SB Financial**

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



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

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

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

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

### **Critical Accounting Policies**

Note 1 to the Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2016 describes the significant accounting policies used in the development and presentation of the Company’s financial statements. The accounting and reporting policies of the Company are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The Company’s financial position and results of operations can be affected by these estimates and assumptions and are integral to the understanding of reported results. Critical accounting policies are those policies that management believes are the most important to the portrayal of the Company’s financial condition and results, and they require management to make estimates that are difficult, subjective, and/or complex.

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

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

Regardless of the extent of the Company’s analysis of customer performance, portfolio trends or risk management processes, certain inherent but undetected losses are probable within the loan portfolio. This is due to several factors, including inherent delays in obtaining information regarding a customer’s financial condition or changes in their unique business conditions, the subjective nature of individual loan evaluations, collateral assessments and the

interpretation of economic trends. Volatility of economic or customer-specific conditions affecting the identification and estimation of losses for larger non-homogeneous credits and the sensitivity of assumptions utilized to establish allowances for homogenous groups of loans are also factors. The Company estimates a range of inherent losses related to the existence of these exposures. The estimates are based upon the Company's evaluation of imprecise risk associated with the commercial and consumer allowance levels and the estimated impact of the current economic environment. To the extent that actual results differ from management's estimates, additional loan loss provisions may be required that could adversely impact earnings for future periods.

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

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**Three Months Ended September 30, 2017 compared to Three Months Ended September 30, 2016**

**Net Income:** Net income for the third quarter of 2017 was \$2.7 million compared to net income of \$2.5 million for the third quarter of 2016, an increase of 6.9 percent. Earnings per diluted share (EPS) of \$0.43 were up 7.5 percent from the \$0.40 for the third quarter of 2016.

**Provision for Loan Losses:** The third quarter provision for loan losses was \$0.0 million compared to \$0.0 million for the year-ago quarter. Net charge offs for the quarter were \$0.065 million compared to net charge offs of \$0.13 million for the year-ago quarter. Total delinquent loans ended the quarter at \$2.4 million, which is down \$0.36 million from the prior year or 0.35 percent of outstanding loans.

<b>Asset Quality Review – For the Period Ended</b>	Sep.	Sep.
	30,	30,
<i>(\$'s in Thousands)</i>	2017	2016
Net charge-offs	\$65	\$130
Nonaccruing loans	2,381	2,889
Accruing Trouble Debt Restructures	1,258	1,588
Nonaccruing and restructured loans	3,639	4,477
OREO / OAO	94	73
Nonperforming assets	3,733	4,550
Nonperforming assets/Total assets	0.43 %	0.57 %
Allowance for loan losses/Total loans	1.15 %	1.18 %
Allowance for loan losses/Nonperforming loans	213.3 %	163.5 %

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$12.1 million for the third quarter of 2017, an increase of \$0.4 million, or 3.5 percent, from the \$11.7 million generated during the 2016 third quarter.

Net interest income was \$7.3 million, which is up \$0.6 million from the prior year third quarter's \$6.7 million. The Company's earning assets increased \$64.0 million, coupled with a 7 basis point increase in the yield on earning assets. The net interest margin for the third quarter of 2017 was 3.81 percent compared to 3.82 percent for the third quarter of 2016. Funding costs for interest bearing liabilities for the third quarter of 2017 were 0.68 percent compared to 0.56 percent for the prior year third quarter.

Noninterest income was \$4.9 million for the 2017 third quarter, which is down \$0.1 million from the prior year third quarter's \$5.0 million. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$0.3 million, no change from the same period in 2016. Noninterest income as a percentage of average assets for the third quarter of 2017 was 2.27 percent compared to 2.52 percent for the prior year third quarter.

State Bank originated \$89.2 million of mortgage loans during the third quarter of 2017, of which \$76.9 million of loans were sold with the remainder of loans held for investment. This compares to \$117.2 million of loans originated during for the third quarter of 2016, of which \$101.1 million of loans were sold with the remainder in loans held for investment. These third quarter 2017 originations and subsequent sales resulted in \$2.2 million of gains, down 11.6 percent from \$ 2.5 million of gains for the third quarter of 2016. Net mortgage banking revenue was \$2.4 million for the third quarter of 2017 compared to \$2.7 million for the third quarter of 2016 due to higher sales volume in 2016. The 2017 third quarter included a \$0.04 million valuation impairment on our mortgage servicing rights, due to increased prepayment speeds in the portfolio.

**Consolidated Noninterest Expense:** Noninterest expense for the third quarter of 2017 was \$8.3 million, which is up \$0.4 million compared to \$7.9 million in the prior-year third quarter. The increase was due mainly to staffing growth in mortgage and support areas.

**Income Taxes:** Income taxes for the third quarter of 2017 were \$1.1 million (effective rate 29.1 percent) compared to \$1.2 million (effective rate 32.2 percent) for the third quarter of 2016. This decrease in the effective tax rate was the result of the adoption of ASU 2016-09 – Stock Compensation, which lowered taxable income.

#### **Nine Months Ended September 30, 2017 compared to Nine Months Ended September 30, 2016**

**Net Income:** Net income for the first nine months of 2017 was \$7.0 million compared to net income of \$6.5 million for the first nine months of 2016, an increase of 8.8 percent. Earnings per diluted share (EPS) for the period of \$1.11 were up 9.9 percent from the \$1.01 for the prior year nine-month period.

**Provision for Loan Losses:** The provision for loan losses for the first nine-months of 2017 was \$0.2 million compared to \$0.25 million for the prior year first nine months. Net charge-offs for the period were \$0.17 million compared to net recoveries of \$0.08 million for the prior year nine-month period.

**Consolidated Revenue:** Total revenue, consisting of net interest income and noninterest income, was \$33.9 million for the first nine months of 2017, an increase of \$1.9 million, or 5.9 percent, from the \$32.0 million generated during the 2016 first nine months.

Net interest income was \$20.7 million, which is up \$1.5 million from net interest income of \$19.2 million for the prior year first nine months. The Company's earning assets increased \$64.6 million, and had a 2 basis point increase in the

yield on earning assets for the first nine months of 2017. The net interest margin for the first nine months of 2017 was 3.71 percent compared to 3.77 percent for the first nine months of 2016. Funding cost for interest bearing liabilities for the first nine months of 2017 were 0.64 percent compared to 0.54 percent for the prior year first nine months.

Noninterest income was \$13.1 million for the 2017 first nine months, which is up \$0.4 million from noninterest income of \$12.8 million for the prior year first nine months. In addition to the mortgage revenue detailed below, gains from the sale of non-mortgage loans was \$1.1 million, compared to \$0.9 million for the same period in 2016.

State Bank originated \$243.7 million of mortgage loans during the first nine months of 2017, of which \$207.4 million of loans were sold with the remainder of loans held for investment. These levels were down 18.6 and 18.9 percent respectively as compared to the prior year first nine months. The 2017 first nine months had a slight negative valuation impairment (\$0.04 million) on our mortgage servicing rights compared to a \$1.2 million negative valuation impairment in the prior year period.

**Consolidated Noninterest Expense:** Noninterest expense for the first nine months of 2017 was \$23.5 million, which is up \$1.2 million compared to \$22.2 million in the prior-year first nine months. The increase in noninterest expenses compared to the prior year was solely due to increased staffing, primarily in our mortgage, wealth management and retail divisions.

**Income Taxes:** Income taxes for the first nine months of 2017 were \$3.2 million (effective rate 30.9 percent) compared to \$3.0 million (effective rate 31.8 percent) for the first nine months of 2016. This increase was driven by the increase in pretax income for the Company.

**Changes in Financial Condition**

Total assets at September 30, 2017 were \$860.5 million, an increase of \$44.5 million or 5.5 percent since 2016 year end. Total loans, net of unearned income, were \$675.1 million as of September 30, 2017, up \$30.6 million from year end, an increase of 4.8 percent.

Total deposits at September 30, 2017 were \$716.8 million, an increase of \$43.7 million or 6.5 percent since 2016 year end. Borrowed funds (consisting of FHLB advances, and REPOs) totaled \$31.8 million at September 30, 2017. This is down from year end when borrowed funds totaled \$37.0 million due to a decrease in FHLB advances of \$6.0 million. Total equity for the Company of \$90.9 million now stands at 10.6 percent of total assets, which is up from the December 31, 2016 level of \$86.5 million.

The allowance for loan loss of \$7.8 million is up from the 2016 year end by \$0.1 million. This increase combined with the loan growth results in an allowance to loans of 1.15 percent. The 1.15 percent level is considered appropriate by management given the risk profile of the portfolio. The allowance to loan loss level at September 30, 2016 was 1.18 percent. The decline from the prior year was the result of higher loan growth and lower provision expenses due to improved asset quality.

**Capital Resources**

As of September 30, 2017, based on the computations in its call report the State Bank is classified as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the State Bank must maintain capital ratios as set forth in the table below. There are no conditions or events since June 30, 2017 that management believes have changed the State Bank’s capital classification.

State Bank’s actual capital levels and ratios as of September 30, 2017 and December 31, 2016 are presented in the following table. Capital levels are presented for State Bank only as the Company is now exempt from quarterly reporting on capital levels at the holding company level (\$’s in thousands):

	To Be Well Capitalized Under Prompt Corrective
For Capital Adequacy	



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(\$ in thousands)	Actual		Purposes		Action Procedures	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2017						
Tier I Capital to average assets	\$79,285	9.45 %	\$34,265	4.0 %	\$42,831	5.0 %
Tier I Common equity capital to risk-weighted assets	79,285	10.39%	34,331	4.5 %	49,589	6.5 %
Tier I Capital to risk-weighted assets	79,285	10.39%	45,774	6.0 %	61,032	8.0 %
Total Risk-based capital to risk-weighted assets	87,045	11.41%	61,032	8.0 %	76,291	10.0%
As of December 31, 2016						
Tier I Capital to average assets	\$74,183	9.31 %	\$31,875	4.0 %	\$39,844	5.0 %
Tier I Common equity capital to risk-weighted assets	74,183	10.28%	32,477	4.5 %	46,912	6.5 %
Tier I Capital to risk-weighted assets	74,183	10.28%	43,303	6.0 %	57,737	8.0 %
Total Risk-based capital to risk-weighted assets	81,908	11.35%	57,738	8.0 %	72,172	10.0%

Effective January 1, 2015 new regulatory capital requirements, commonly referred to as “Basel III”, were implemented and will phase in over a four-year period (beginning at 40 percent on January 1, 2015, and an additional 20 percent per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016, at the rate of .0625 percent and will continue to phase in over a four-year period (increasing by that amount on each subsequent January 1 until it reaches 2.5 percent on January 1, 2019). As of September 30, 2017 the Bank exceeded the minimum buffer requirement. Management opted out of the accumulated other comprehensive income treatment under the new requirements and, as such unrealized gains and losses from available-for-sale securities will continue to be excluded from State Bank regulatory capital.

## **LIQUIDITY**

Liquidity relates primarily to the Company’s ability to fund loan demand, meet deposit customers’ withdrawal requirements and provide for operating expenses. Assets used to satisfy these needs consist of cash and due from banks, federal funds sold, interest-earning deposits in other financial institutions, securities available-for-sale and loans held for sale. These assets are commonly referred to as liquid assets. Liquid assets were \$121.3 million at September 30, 2017, compared to \$111.6 million at December 31, 2016.

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

The Company’s commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolio of \$512.2 million at September 30, 2017 and \$479.0 million at December 31, 2016, which can and has been used to collateralize borrowings, is an additional source of liquidity. Management believes the Company’s current liquidity level, without these borrowings, is sufficient to meet its liquidity needs. At September 30, 2017, all eligible commercial real estate, first mortgage residential and multi-family mortgage loans were pledged under an FHLB blanket lien.

The cash flow statements for the periods presented provide an indication of the Company’s sources and uses of cash, as well as an indication of the ability of the Company to maintain an adequate level of liquidity. A discussion of the cash flow statements for the nine months ended September 30, 2017 and 2016 follows.

The Company experienced positive cash flows from operating activities for the nine months ended September 30, 2017 and September 30, 2016. Net cash provided by operating activities was \$3.9 million for the nine months ended September 30, 2017 and \$8.4 million was provided for the nine months ended September 30, 2016. Highlights for the current year include \$204.0 million in proceeds from the sale of loans, which is down \$45.2 million from the prior year. Originations of loans held for sale was a use of cash of \$202.7 million, which is also down from the prior year, by \$39.0 million. For the nine months ended September 30, 2017, there was a gain on sale of loans of \$6.6 million, and depreciation and amortization of \$1.2 million.

The Company experienced negative cash flows from investing activities for the nine months ended September 30, 2017 and September 30, 2016. Net cash flows used in investing activities was \$28.0 million for the nine months ended September 30, 2017 and \$64.3 million for the nine months ended September 30, 2016. Highlights for the nine months ended September 30, 2017 include \$25.8 million in purchases of available-for-sale securities. These cash payments were offset by \$30.6 million in proceeds from maturities and sales of securities, which is up \$15.7 million from the prior year nine-month period. The Company experienced a \$30.9 million increase in loans, which is down \$31.0 million from the prior year nine-month period.

The Company experienced positive cash flows from financing activities for the nine months ended September 30, 2017 and September 30, 2016. Net cash flow provided by financing activities was \$35.4 million for the nine months ended September 30, 2017 and \$60.5 million for the nine months ended September 30, 2016. Highlights for the current period include a \$19.6 million increase in transaction deposits for the nine months ended September 30, 2017, which is down from the \$41.1 million increase for the prior year nine-month period. Certificates of deposit increased by \$24.2 million in the current year compared to an increase of \$34.6 million for the prior year.

ALCO uses an economic value of equity (“EVE”) analysis to measure risk in the balance sheet incorporating all cash flows over the estimated remaining life of all balance sheet positions. The EVE analysis calculates the net present value of the Company’s assets and liabilities in rate shock environments that range from -400 basis points to +400 basis points. The likelihood of a decrease in rates as of September 30, 2017 and December 31, 2016 was considered unlikely given the current interest rate environment and therefore, only the minus 100 basis point rate change was included in this analysis. The results of this analysis are reflected in the following tables for September 30, 2017 and December 31, 2016.

### **September 30, 2017**

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

##### **(\$’s in thousands)**

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	\$171,230	\$27,525	19.15 %
+300 basis points	165,824	22,119	15.39
+200 basis points	159,756	16,051	11.17
+100 basis points	152,246	8,541	5.94
Base Case	143,705	-	-
-100 basis points	133,843	(9,862 )	(6.86 )

### **December 31, 2016**

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

##### **(\$’s in thousands)**

Change in Rates	\$ Amount	\$ Change	% Change
+400 basis points	\$169,809	\$26,322	18.34 %
+300 basis points	164,815	21,328	14.86
+200 basis points	159,285	15,798	11.01
+100 basis points	152,119	8,632	6.02
Base Case	143,487	-	-
-100 basis points	134,175	(9,312 )	(6.49 )

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

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

The Company's commercial real estate, first mortgage residential, agricultural and multi-family mortgage portfolios in the aggregate amount of \$512.2 million have been pledged to meet FHLB collateralization requirements as of September 30, 2017. Based on the current collateralization requirements of the FHLB, the Company had approximately \$58.9 million of additional borrowing capacity at September 30, 2017. The Company also had \$38.0 million in unpledged securities that may be used to pledge for additional borrowings.

The Company's contractual obligations as of September 30, 2017 were comprised of long-term debt obligations, other debt obligations, operating lease obligations and other long-term liabilities. Long-term debt obligations are comprised of FHLB Advances of \$20.5 million, and Trust Preferred Securities of \$10.3 million. Total time deposits at September 30, 2017 were \$217.3 million, of which \$111.8 million matures beyond one year.

Also, as of September 30, 2017, the Company had commitments to sell mortgage loans totaling \$19.0 million. The Company believes that it has adequate resources to fund commitments as they arise and that it can adjust the rate on savings certificates to retain deposits in changing interest rate environments. If the Company requires funds beyond its internal funding capabilities, advances from the FHLB of Cincinnati and other financial institutions are available.

## **ASSET LIABILITY MANAGEMENT**

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

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

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

**The Federal Reserve Board** together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Company adopted a Joint Agency Policy Statement on interest rate risk effective June 26, 1996. The policy statement provides guidance to examiners and bankers on sound practices for managing interest rate risk, which will form the basis for ongoing evaluation of the adequacy of interest rate risk management at supervised institutions. The

policy statement also outlines fundamental elements of sound management that have been identified in prior Federal Reserve guidance and discusses the importance of these elements in the context of managing interest rate risk. Specifically, the guidance emphasizes the need for active board of director and senior management oversight and a comprehensive risk management process that effectively identifies, measures and controls interest rate risk.

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

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

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

Management believes there has been no material change in the Company's market risk from the information contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC") for the year ended December 31, 2016.

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

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

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

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

information required to be disclosed by the Company in this Quarterly Report on Form 10-Q and other reports which the Company files or submits under the Exchange Act would be recorded, processed, summarized and reported within



the time periods specified in the SEC's rules and forms; and

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

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the Company's fiscal quarter ended September 30, 2017, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There are certain risks and uncertainties in our business that could cause our actual results to differ materially from those anticipated. A detailed discussion of our risk factors is included in “Item 1A. Risk Factors” of Part I of the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. There have been no material changes to the risk factors as presented in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

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

(a) Not Applicable

(b) Not Applicable

(c) **Repurchases of Common Shares**

Total # of Shares	Weighted Avg. Price per	Total # of Shares Purchased Under	Maximum # of Shares yet to be Purchased Under
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	Purchased	Share	Program	Program
07/01/17 - 07/31/17	9,650	\$ 17.10	179,493	20,507
08/01/17 - 08/31/17	7,347	\$ 16.74	186,840	13,160
09/01/17 - 09/30/17	3,997	\$ 16.50	190,837	9,163

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Mine Safety Disclosures**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

Exhibits

- 31.1 Rule 13a-14(a)/15d-14(a) Certification (Principal Executive Officer)
- 31.2 Rule 13a-14(a)/15d-14(a) Certification (Principal Financial Officer)
- 32.1 Section 1350 Certification (Principal Executive Officer)
- 32.2 Section 1350 Certification (Principal Financial Officer)
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema Document.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document.
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document.
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.



**SIGNATURES**

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

SB FINANCIAL GROUP, INC.

Date: November 13, 2017 By: /s/ Mark A. Klein  
Mark A. Klein  
Chairman, President & CEO

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