

CITY HOLDING CO  
Form 10-Q  
May 03, 2018  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For The Quarterly Period Ended March 31, 2018

OR

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

For The Transition Period From \_\_\_\_\_ To \_\_\_\_\_.

Commission File Number 0-11733

CITY HOLDING COMPANY

(Exact name of registrant as specified in its charter)

West Virginia

55-0619957

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

25 Gatewater Road

Charleston, West Virginia

25313

(Address of principal executive offices)

(Zip Code)

(304) 769-1100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant has (1) 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.

YesNo

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).

YesNo

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Emerging growth company [ ]

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

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

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

Common stock, \$2.50 Par Value – 15,434,993 shares as of April 30, 2018.

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## FORWARD-LOOKING STATEMENTS

All statements other than statements of historical fact included in this Quarterly Report on Form 10-Q, including statements in Management's Discussion and Analysis of Financial Condition and Results of Operations are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such information involves risks and uncertainties that could result in the Company's actual results differing materially from those projected in the forward-looking statements. Important factors that could cause actual results to differ materially from those discussed in such forward-looking statements include, but are not limited to, (1) the Company may incur additional loan loss provision due to negative credit quality trends in the future that may lead to a deterioration of asset quality; (2) the Company may incur increased charge-offs in the future; (3) the Company could have adverse legal actions of a material nature; (4) the Company may face competitive loss of customers; (5) the Company may be unable to manage its expense levels; (6) the Company may have difficulty retaining key employees; (7) changes in the interest rate environment may have results on the Company's operations materially different from those anticipated by the Company's market risk management functions; (8) changes in general economic conditions and increased competition could adversely affect the Company's operating results; (9) changes in regulations and government policies affecting bank holding companies and their subsidiaries, including changes in monetary policies, could negatively impact the Company's operating results; (10) the Company may experience difficulties growing loan and deposit balances; (11) deterioration in the financial condition of the U.S. banking system may impact the valuations of investments the Company has made in the securities of other financial institutions resulting in either actual losses or other than temporary impairments on such investments; (12) the effects of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the regulations promulgated and to be promulgated thereunder, which may subject the Company and its subsidiaries to a variety of new and more stringent legal and regulatory requirements which adversely affect their respective businesses; (13) the impact of new minimum capital thresholds established as a part of the implementation of Basel III; and (14) other risk factors relating to the banking industry or the Company as detailed from time to time in the Company's reports filed with the Securities and Exchange Commission, including those risk factors included in the disclosures under the heading "Item 1A Risk Factors" of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017. Forward-looking statements made herein reflect management's expectations as of the date such statements are made. Such information is provided to assist stockholders and potential investors in understanding current and anticipated financial operations of the Company and is included pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances that arise after the date such statements are made.

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City Holding Company and Subsidiaries

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Part I - FINANCIAL INFORMATION

Item 1 - Financial Statements

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## Consolidated Balance Sheets

## City Holding Company and Subsidiaries

(in thousands)

|   | (Unaudited)       |                      |
|---|-------------------|----------------------|
|   | March 31,<br>2018 | December 31,<br>2017 |
| <b>Assets</b>   |                   |                      |
| Cash and due from banks   | \$97,495          | \$ 54,450            |
| Interest-bearing deposits in depository institutions  | 26,283            | 28,058               |
| Cash and Cash Equivalents   | 123,778           | 82,508               |
| Investment securities available for sale, at fair value   | 545,628           | 550,389              |
| Investment securities held-to-maturity, at amortized cost (approximate fair value at March 31, 2018 and December 31, 2017 - \$62,146 and \$65,646, respectively)  | 62,277            | 64,449               |
| Other securities  | 22,165            | 14,147               |
| Total Investment Securities   | 630,070           | 628,985              |
| Gross loans   | 3,137,681         | 3,127,410            |
| Allowance for loan losses   | (18,381           | ) (18,836            |
| Net Loans   | 3,119,300         | 3,108,574            |
| Bank owned life insurance   | 104,052           | 103,440              |
| Premises and equipment, net   | 72,920            | 72,682               |
| Accrued interest receivable   | 9,528             | 9,223                |
| Net deferred tax asset  | 14,467            | 11,913               |
| Goodwill and other intangible assets, net   | 78,468            | 78,595               |
| Other assets  | 47,432            | 36,361               |
| Total Assets  | \$4,200,015       | \$ 4,132,281         |
| <b>Liabilities</b>  |                   |                      |
| <b>Deposits:</b>  |                   |                      |
| Noninterest-bearing   | \$703,209         | \$ 666,639           |
| Interest-bearing:   |                   |                      |
| Demand deposits   | 816,976           | 769,245              |
| Savings deposits  | 816,245           | 796,275              |
| Time deposits   | 1,110,532         | 1,083,475            |
| Total Deposits  | 3,446,962         | 3,315,634            |
| Short term borrowings:  |                   |                      |
| Federal funds purchased   | —                 | 54,000               |
| Customer repurchase agreements  | 195,375           | 198,219              |
| Long-term debt  | 16,495            | 16,495               |
| Other liabilities   | 49,306            | 45,426               |
| Total Liabilities   | 3,708,138         | 3,629,774            |
| <b>Shareholders' Equity</b>   |                   |                      |
| Preferred stock, par value \$25 per share: 500,000 shares authorized; none issued   | —                 | —                    |
| Common stock, par value \$2.50 per share: 50,000,000 shares authorized; 19,047,548 shares issued at March 31, 2018 and December 31, 2017, less 3,608,051 and 3,429,519 shares in treasury, respectively | 47,619            | 47,619               |

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|   |             |             |
|---|-------------|-------------|
| Capital surplus                                     | 140,547     | 140,960     |
| Retained earnings                                   | 457,650     | 444,481     |
| Cost of common stock in treasury                    | (137,420 )  | (124,909 )  |
| Accumulated other comprehensive income (loss):      |             |             |
| Unrealized (loss) on securities available-for-sale  | (11,486 )   | (611 )      |
| Underfunded pension liability                       | (5,033 )    | (5,033 )    |
| Total Accumulated Other Comprehensive Income (Loss) | (16,519 )   | (5,644 )    |
| Total Shareholders' Equity                          | 491,877     | 502,507     |
| Total Liabilities and Shareholders' Equity          | \$4,200,015 | \$4,132,281 |
| See notes to consolidated financial statements.     |             |             |

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Consolidated Statements of Income (Unaudited)  
City Holding Company and Subsidiaries  
(in thousands, except earnings per share data)

|   | Three months<br>ended March 31, |          |
|---|---------------------------------|----------|
|   | 2018                            | 2017     |
| Interest Income                                     |                                 |          |
| Interest and fees on loans                          | \$32,918                        | \$30,104 |
| Interest and dividends on investment securities:    |                                 |          |
| Taxable   | 3,981                           | 3,444    |
| Tax-exempt  | 703                             | 663      |
| Interest on deposits in depository institutions     | 42                              | 3        |
| Total Interest Income                               | 37,644                          | 34,214   |
| Interest Expense                                    |                                 |          |
| Interest on deposits                                | 4,326                           | 3,429    |
| Interest on short-term borrowings                   | 460                             | 157      |
| Interest on long-term debt                          | 211                             | 181      |
| Total Interest Expense                              | 4,997                           | 3,767    |
| Net Interest Income                                 | 32,647                          | 30,447   |
| Provision for loan losses                           | 181                             | 681      |
| Net Interest Income After Provision for Loan Losses | 32,466                          | 29,766   |
| Non-Interest Income                                 |                                 |          |
| Net gains on sale of investment securities          | —                               | 4,276    |
| Service charges                                     | 6,862                           | 6,730    |
| Bankcard revenue                                    | 4,334                           | 4,140    |
| Trust and investment management fee income          | 1,568                           | 1,386    |
| Bank owned life insurance                           | 821                             | 1,229    |
| Other income  | 907                             | 746      |
| Total Non-Interest Income                           | 14,492                          | 18,507   |
| Non-Interest Expense                                |                                 |          |
| Salaries and employee benefits                      | 13,151                          | 12,948   |
| Occupancy related expense                           | 2,404                           | 2,473    |
| Equipment and software related expense              | 1,831                           | 1,890    |
| FDIC insurance expense                              | 315                             | 375      |
| Advertising   | 787                             | 733      |
| Bankcard expenses                                   | 1,076                           | 943      |
| Postage, delivery, and statement mailings           | 578                             | 555      |
| Office supplies                                     | 313                             | 361      |
| Legal and professional fees                         | 450                             | 449      |
| Telecommunications                                  | 500                             | 484      |
| Repossessed asset losses, net of expenses           | 370                             | 336      |
| Other expenses                                      | 3,162                           | 3,053    |
| Total Non-Interest Expense                          | 24,937                          | 24,600   |
| Income Before Income Taxes                          | 22,021                          | 23,673   |
| Income tax expense                                  | 4,405                           | 7,647    |
| Net Income Available to Common Shareholders         | \$17,616                        | \$16,026 |

|                            |         |          |
|----------------------------|---------|----------|
| Total Comprehensive Income | \$9,398 | \$16,899 |
|----------------------------|---------|----------|

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|                                     |         |         |
|-------------------------------------|---------|---------|
| Average shares outstanding, basic   | 15,414  | 15,252  |
| Effect of dilutive securities       | 22      | 25      |
| Average shares outstanding, diluted | 15,436  | 15,277  |
| Basic earnings per common share     | \$ 1.13 | \$ 1.04 |
| Diluted earnings per common share   | \$ 1.13 | \$ 1.04 |
| Dividends declared per common share | \$ 0.46 | \$ 0.44 |

See notes to consolidated financial statements.

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Consolidated Statements of Comprehensive Income (Unaudited)  
 City Holding Company and Subsidiaries  
 (in thousands)

|  | Three Months<br>Ended<br>March 31, |          |
|--|------------------------------------|----------|
|  | 2018                               | 2017     |
| Net income   | \$17,616                           | \$16,026 |
| Unrealized (losses) gains on available-for-sale securities arising during the period | (10,712 )                          | 5,660    |
| Reclassification adjustment for gains  | —                                  | (4,276 ) |
| Other comprehensive (loss) income before income taxes                                | (10,712 )                          | 1,384    |
| Tax effect   | 2,494                              | (511 )   |
| Other comprehensive income (loss), net of tax  | (8,218 )                           | 873      |
| Comprehensive Income, Net of Tax   | \$9,398                            | \$16,899 |

See notes to consolidated financial statements.

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Consolidated Statements of Changes in Shareholders' Equity (Unaudited)  
City Holding Company and Subsidiaries  
Three Months Ended March 31, 2018 and 2017  
(in thousands)

|  | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|--|-----------------|--------------------|----------------------|-------------------|--|----------------------------------|
| Balance at December 31, 2016               | \$46,518        | \$112,873          | \$417,017            | \$(126,958)       | \$ (7,012 )  | \$ 442,438                       |
| Net income                                 | —               | —                  | 16,026               | —                 | —  | 16,026                           |
| Other comprehensive income                 | —               | —                  | —                    | —                 | 873  | 873                              |
| Cash dividends declared (\$0.44 per share) | —               | —                  | (6,917 )             | —                 | —  | (6,917 )                         |
| Stock-based compensation expense           | —               | 780                | —                    | —                 | —  | 780                              |
| Restricted awards granted                  | —               | (638 )             | —                    | 638               | —  | —                                |
| Issuance of 440,604 shares of common stock | 1,101           | 27,307             | —                    | —                 | —  | 28,408                           |
| Exercise of 1,250 stock options            | —               | (17 )              | —                    | 55                | —  | 38                               |
| Balance at March 31, 2017                  | \$47,619        | \$140,305          | \$426,126            | \$(126,265)       | \$ (6,139 )  | \$ 481,646                       |

|   | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|---|-----------------|--------------------|----------------------|-------------------|--|----------------------------------|
| Balance at December 31, 2017                          | \$47,619        | \$140,960          | \$444,481            | \$(124,909)       | \$ (5,644 )  | \$ 502,507                       |
| Net income  | —               | —                  | 17,616               | —                 | —  | 17,616                           |
| Other comprehensive income                            | —               | —                  | —                    | —                 | (8,218 )   | (8,218 )                         |
| Adoption of new accounting pronouncement (see Note B) | —               | —                  | 2,657                | —                 | (2,657 )   | —                                |
| Cash dividends declared (\$0.46 per share)            | —               | —                  | (7,104 )             | —                 | —  | (7,104 )                         |
| Stock-based compensation expense                      | —               | 793                | —                    | —                 | —  | 793                              |
| Restricted awards granted                             | —               | (1,135 )           | —                    | 1,135             | —  | —                                |
| Exercise of 7,388 stock options                       | —               | (71 )              | —                    | 351               | —  | 280                              |
| Purchase of 204,327 treasury shares                   | —               | —                  | —                    | (13,997 )         | —  | (13,997 )                        |
| Balance at March 31, 2018                             | \$47,619        | \$140,547          | \$457,650            | \$(137,420)       | \$ (16,519 )   | \$ 491,877                       |

See notes to consolidated financial statements.

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Consolidated Statements of Cash Flows (Unaudited)  
City Holding Company and Subsidiaries  
(in thousands)

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2018                            | 2017      |
| Net income  | \$17,616                        | \$16,026  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |           |
| Accretion and amortization  | 410                             | 361       |
| Provision for loan losses   | 181                             | 681       |
| Depreciation of premises and equipment  | 1,270                           | 1,525     |
| Deferred income tax expense   | 287                             | 2,931     |
| Net periodic employee benefit cost  | 111                             | 114       |
| Realized investment securities gains  | —                               | (4,276 )  |
| Stock-compensation expense  | 793                             | 780       |
| Excess tax benefit from stock-compensation expense                                | (155 )                          | (189 )    |
| Proceeds from life insurance  | 210                             | 1,137     |
| Increase in value of bank-owned life insurance                                    | (612 )                          | (749 )    |
| Loans originated for sale   | (2,606 )                        | (3,951 )  |
| Proceeds from the sale of loans originated for sale                               | 2,874                           | 6,118     |
| Gain on sale of loans   | (79 )                           | (167 )    |
| Change in accrued interest receivable   | (305 )                          | (236 )    |
| Change in other assets  | (11,128 )                       | (131 )    |
| Change in other liabilities   | 3,504                           | 383       |
| Net Cash Provided by Operating Activities   | 12,371                          | 20,357    |
| Proceeds from sales of securities available-for-sale                              | —                               | 5,576     |
| Proceeds from maturities and calls of securities available-for-sale               | 21,230                          | 23,390    |
| Proceeds from maturities and calls of securities held-to-maturity                 | 2,142                           | 2,823     |
| Purchases of securities available-for-sale  | (35,721 )                       | (39,747 ) |
| Net increase in loans   | (10,827 )                       | (30,826 ) |
| Purchases of premises and equipment   | (1,561 )                        | (2,111 )  |
| Disposals of premises and equipment   | 55                              | 1,781     |
| Net Cash (Used in) Investing Activities   | (24,682 )                       | (39,114 ) |
| Net increase in non-interest-bearing deposits                                     | 36,570                          | 42,505    |
| Net increase in interest-bearing deposits   | 94,758                          | 118,616   |
| Net (decrease) in short-term borrowings   | (56,844 )                       | (61,619 ) |
| Proceeds from issuance of common stock  | —                               | 28,408    |
| Purchases of treasury stock   | (13,997 )                       | —         |
| Proceeds from exercise of stock options   | 280                             | 38        |
| Dividends paid  | (7,186 )                        | (6,518 )  |
| Net Cash Provided by Financing Activities   | 53,581                          | 121,430   |
| Increase in Cash and Cash Equivalents   | 41,270                          | 102,673   |
| Cash and cash equivalents at beginning of period                                  | 82,508                          | 88,139    |
| Cash and Cash Equivalents at End of Period  | \$123,778                       | \$190,812 |

See notes to consolidated financial statements.



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Notes to Consolidated Financial Statements (Unaudited)  
March 31, 2018

Note A –Background and Basis of Presentation

City Holding Company ("City Holding"), a West Virginia corporation headquartered in Charleston, West Virginia, is a registered financial holding company under the Bank Holding Company Act and conducts its principal activities through its wholly-owned subsidiary, City National Bank of West Virginia ("City National"). City National is a retail and consumer-oriented community bank with 86 banking offices in West Virginia (57), Virginia (14), Kentucky (12) and southeastern Ohio (3). City National provides credit, deposit, and trust and investment management services to its customers in a broad geographical area that includes many rural and small community markets in addition to larger cities including Charleston (WV), Huntington (WV), Martinsburg (WV), Winchester (VA), Staunton (VA), Virginia Beach (VA), Ashland (KY) and Lexington (KY). In addition to its branch network, City National's delivery channels include automated-teller-machines ("ATMs"), interactive-teller machines ("ITMs"), mobile banking, debit cards, interactive voice response systems, and Internet technology. The Company's business activities are currently limited to one reportable business segment, which is community banking.

The accompanying consolidated financial statements, which are unaudited, include all of the accounts of City Holding Company and its wholly-owned subsidiaries (collectively, the "Company"). All material intercompany transactions have been eliminated. The consolidated financial statements include all adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations and financial condition for each of the periods presented. Such adjustments are of a normal recurring nature. The results of operations for the three months ended March 31, 2018 are not necessarily indicative of the results of operations that can be expected for the year ending December 31, 2018. The Company's accounting and reporting policies conform with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Such policies require management to make estimates and develop assumptions that affect the amounts reported in the consolidated financial statements and related footnotes. Actual results could differ from management's estimates.

The consolidated balance sheet as of December 31, 2017 has been derived from audited financial statements included in the Company's 2017 Annual Report to Shareholders. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted. These financial statements should be read in conjunction with the financial statements and notes thereto included in the 2017 Annual Report of the Company.

Certain amounts in the financial statements have been reclassified. Such reclassifications had no impact on shareholders' equity or net income for any period.

Note B - Recent Accounting Pronouncements

Recently Adopted:

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." This standard clarifies the principles for recognizing revenue and developed a common revenue standard. The core principle of the standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. To achieve that core principle, an entity should apply the following steps: (i) identifying the contract or contracts with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize



revenue when (or as) the entity satisfies a performance obligation. The FASB also issued several amendments to the standard, including clarifications relating to performance obligations and licensing implementation guidance and reporting gross versus net revenue. The Company adopted the standard effective January 1, 2018 using the modified retrospective approach, but did not record a cumulative effect adjustment to opening retained earnings given the immaterial impact. As part of the adoption, the Company evaluated the terms of the contracts that supported each of the revenue streams that were within the scope of ASU 2014-09 and determined that the adoption did not significantly change the way the Company recognizes revenue from each stream.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." This standard makes several modifications to Subtopic 825-10 including the elimination of the available-for-sale classification of equity investments, and requires equity investments with readily determinable fair values to be measured at fair value with changes in fair value recognized in net income. This ASU became effective for the Company for interim and annual periods on January 1, 2018. The adoption of ASU No. 2016-01 did not have a

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material impact on the Company's financial statements. During the three months ended March 31, 2018, a \$0.2 million gain was recognized in other income in the consolidated statements of income as a result of the change in the fair value of equity and perpetual preferred securities due to the adoption of ASU 2016-01. Additionally, \$2.7 million, net of deferred taxes, was reclassified from other comprehensive income to retained earnings on the consolidated balance sheets to recognize the prior period unrealized gain position of these securities (see Note C Investments and Note J Accumulated Other Comprehensive Loss).

In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business." This amendment clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This ASU became effective for the Company on January 1, 2018. The adoption of ASU No. 2017-01 did not have a material impact on the Company's financial statements.

In March 2017, the FASB issued ASU No. 2017-07, "Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." This amendment requires that an employer disaggregate the service cost component from the other components of net benefit cost and also provides explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement. This ASU became effective for the Company on January 1, 2018. The adoption of ASU No. 2017-07 did not have a material impact on the Company's financial statements.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting." This amendment provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in ASU No. 2016-09. This ASU became effective for the Company on January 1, 2018. The adoption of ASU No. 2017-09 did not have a material impact on the Company's financial statements.

In September 2017, the FASB issued ASU No. 2017-13, "Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842)." This amendment provides modifications to previously issued ASUs 2014-09 and 2016-02. The adoption of ASU No. 2017-13 did not have a material impact on the Company's financial statements.

In November 2017, the FASB issued ASU No. 2017-14, "Income Statement—Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606)." This amendment supersedes various SEC paragraphs and amends an SEC paragraph pursuant to the issuance of Staff Accounting Bulletin No. 116. The adoption of ASU No. 2017-14 did not have a material impact on the Company's financial statements.

Pending Adoption:

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." This standard requires organizations to recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing requirements for leases that were historically classified as operating leases under previous generally accepted accounting principals. This ASU will become effective for the Company for interim and annual periods on January 1, 2019. The Company's preliminary evaluation indicates that the adoption of ASU 2016-02 will have an immaterial impact on the Company's consolidated balance sheet. However, the Company continues to evaluate the extent of the potential impact the new guidance will have on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." This standard replaces the incurred loss impairment methodology in current

GAAP 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 require a financial asset (or a group of financial assets) measured at amortized cost basis to be presented at the net amount expected to be collected. The new current expected credit losses model (CECL) will apply to the allowance for loan losses, available-for-sale and held to maturity debt securities, purchased financial assets with credit deterioration and certain off-balance sheet credit exposures. This ASU will become effective for the Company for interim and annual periods on January 1, 2020. Management is currently evaluating the potential impact of ASU No. 2016-13 on the Company's financial statements.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." This amendment simplifies the measurement of goodwill by eliminating Step 2 from the goodwill impairment test. This ASU will become effective for the Company on January 1, 2020. The adoption of ASU No. 2017-04 is not expected to have a material impact on the Company's financial statements.

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In March 2017, the FASB issued ASU No. 2017-08, "Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." The amendments in this update shorten the amortization period for certain callable debt securities held at a premium and require the premium to be amortized to the earliest call date. This ASU will become effective for the Company on January 1, 2019. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company's financial statements.

In August 2017, the FASB issued ASU No. 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." This amendment expands and refines hedge accounting for both nonfinancial and financial risk components and aligns the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. This ASU will become effective for the Company on January 1, 2019. The adoption of ASU No. 2017-12 is not expected to have a material impact on the Company's financial statements.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." This amendment permits entities to reclassify tax effects stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act ("TCJA") to retained earnings. The guidance is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permissible. The Company elected to early adopt this amendment as of December 31, 2017 and the December 31, 2017 balance sheet reflects this adoption.

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## Note C –Investments

The amortized cost and estimated fair values of the Company's securities are shown in the following table (in thousands):

|  | March 31, 2018 |                        |                         |                      | December 31, 2017 |                        |                         |                      |
|--|----------------|------------------------|-------------------------|----------------------|-------------------|------------------------|-------------------------|----------------------|
|  | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Securities available-for-sale:                   |                |                        |                         |                      |                   |                        |                         |                      |
| U.S. Treasuries and U.S. government agencies     | \$1            | \$ —                   | \$ —                    | \$1                  | \$2               | \$ —                   | \$ —                    | \$2                  |
| Obligations of states and political subdivisions | 94,474         | 709                    | 1,010                   | 94,173               | 94,552            | 2,051                  | 407                     | 96,196               |
| Mortgage-backed securities:                      |                |                        |                         |                      |                   |                        |                         |                      |
| U.S. government agencies                         | 442,044        | 462                    | 15,112                  | 427,394              | 425,559           | 1,093                  | 7,305                   | 419,347              |
| Private label                                    | 599            | 3                      | —                       | 602                  | 649               | 3                      | —                       | 652                  |
| Trust preferred securities                       | 4,767          | 26                     | —                       | 4,793                | 4,764             | 26                     | 54                      | 4,736                |
| Corporate securities <sup>(1)</sup>              | 17,102         | 98                     | —                       | 17,200               | 21,916            | 475                    | 123                     | 22,268               |
| Total Debt Securities                            | 558,987        | 1,298                  | 16,122                  | 544,163              | 547,442           | 3,648                  | 7,889                   | 543,201              |
| Marketable equity securities                     |                |                        |                         |                      |                   |                        |                         |                      |
| Investment funds                                 | 1,525          | —                      | 60                      | 1,465                | 1,525             | —                      | 36                      | 1,489                |
| Total Securities                                 |                |                        |                         |                      |                   |                        |                         |                      |
| Available-for-Sale                               | \$560,512      | \$ 1,298               | \$ 16,182               | \$545,628            | \$551,103         | \$ 7,211               | \$ 7,925                | \$550,389            |
| Securities held-to-maturity:                     |                |                        |                         |                      |                   |                        |                         |                      |
| Mortgage-backed securities:                      |                |                        |                         |                      |                   |                        |                         |                      |
| U.S. government agencies                         | \$58,277       | \$88                   | \$219                   | \$58,146             | \$60,449          | \$1,222                | \$25                    | \$61,646             |
| Trust preferred securities                       | 4,000          | —                      | 4,000                   | 4,000                | —                 | —                      | 4,000                   | —                    |
| Total Securities                                 |                |                        |                         |                      |                   |                        |                         |                      |
| Held-to-Maturity                                 | \$62,277       | \$88                   | \$219                   | \$62,146             | \$64,449          | \$1,222                | \$25                    | \$65,646             |
| Other investment securities:                     |                |                        |                         |                      |                   |                        |                         |                      |
| Non-marketable equity securities                 | \$11,581       | \$—                    | \$11,581                | \$14,147             | \$—               | \$—                    | \$—                     | \$14,147             |
| Marketable equity securities <sup>(1)</sup>      | 6,947          | —                      | 10,584                  | —                    | —                 | —                      | —                       | —                    |
| Total Other Investment                           |                |                        |                         |                      |                   |                        |                         |                      |
| Securities                                       | \$18,528       | \$—                    | \$22,165                | \$14,147             | \$—               | \$—                    | \$—                     | \$14,147             |

<sup>(1)</sup> Effective January 1, 2018, the Company's equity and perpetual preferred securities are measured at fair value through net income.

Marketable equity securities consist of investments made by the Company in equity positions of various regional community banks. Included within this portfolio are ownership positions in the following community bank holding companies: First National Corporation (FXNC) (4%) and Eagle Financial Services, Inc. (EFSI) (1.5%). Securities with limited marketability, such as stock in the Federal Reserve Bank ("Federal Reserve") and the Federal Home Loan Bank ("FHLB"), are carried at cost and are reported as non-marketable equity securities in the table above.

Certain investment securities owned by the Company were in an unrealized loss position (i.e., amortized cost basis exceeded the estimated fair value of the securities). The following table shows the gross unrealized losses and fair value of the Company's investments aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):



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|  | March 31, 2018          |                 |                          |                 |                      |                 |
|--|-------------------------|-----------------|--------------------------|-----------------|----------------------|-----------------|
|  | Less Than Twelve Months |                 | Twelve Months or Greater |                 | Total                |                 |
|  | Estimated Fair Value    | Unrealized Loss | Estimated Fair Value     | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Securities available-for-sale:                   |                         |                 |                          |                 |                      |                 |
| Obligations of states and political subdivisions | \$24,204                | \$ 211          | \$18,955                 | \$ 799          | \$43,159             | \$ 1,010        |
| Mortgage-backed securities:                      |                         |                 |                          |                 |                      |                 |
| U.S. Government agencies                         | 266,824                 | 7,208           | 134,047                  | 7,904           | 400,871              | 15,112          |
| Corporate securities                             | —                       | —               | —                        | —               | —                    | —               |
| Investment funds                                 | 1,500                   | 60              | —                        | —               | 1,500                | 60              |
| Total available-for-sale                         | \$292,528               | \$ 7,479        | \$153,002                | \$ 8,703        | \$445,530            | \$ 16,182       |
| Securities held-to-maturity:                     |                         |                 |                          |                 |                      |                 |
| Mortgage-backed securities                       |                         |                 |                          |                 |                      |                 |
| U.S. Government Agencies                         | \$39,433                | \$ 219          | \$—                      | \$ —            | \$39,433             | \$ 219          |
| Total held-to-maturity                           | \$39,433                | \$ 219          | \$—                      | \$ —            | \$39,433             | \$ 219          |
|  |                         |                 |                          |                 |                      |                 |
|  | December 31, 2017       |                 |                          |                 |                      |                 |
|  | Less Than Twelve Months |                 | Twelve Months or Greater |                 | Total                |                 |
|  | Estimated Fair Value    | Unrealized Loss | Estimated Fair Value     | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| Securities available-for-sale:                   |                         |                 |                          |                 |                      |                 |
| Obligations of states and political subdivisions | \$4,913                 | \$ 28           | \$19,440                 | \$ 379          | \$24,353             | \$ 407          |
| Mortgage-backed securities:                      |                         |                 |                          |                 |                      |                 |
| U.S. Government agencies                         | 172,807                 | 1,887           | 140,226                  | 5,418           | 313,033              | 7,305           |
| Trust preferred securities                       | 4,475                   | 54              | —                        | —               | 4,475                | 54              |
| Corporate securities                             | 3,357                   | 49              | 2,350                    | 74              | 5,707                | 123             |
| Investment funds                                 | 1,500                   | 36              | —                        | —               | 1,500                | 36              |
| Total available-for-sale                         | \$187,052               | \$ 2,054        | \$162,016                | \$ 5,871        | \$349,068            | \$ 7,925        |
| Securities held-to-maturity                      |                         |                 |                          |                 |                      |                 |
| Mortgage-backed securities                       |                         |                 |                          |                 |                      |                 |
| U.S. Government agencies                         | \$7,182                 | \$ 25           | \$—                      | \$ —            | \$7,182              | \$ 25           |
| Total held-to-maturity                           | \$7,182                 | \$ 25           | \$—                      | \$ —            | \$7,182              | \$ 25           |

During the three months ended March 31, 2018 and 2017, the Company had no investment impairment losses. At March 31, 2018, the cumulative amount of credit-related investment impairment losses that have been recognized by the Company on investments that remain in the Company's investment portfolio as of that date was \$1.8 million (\$0.2 million related to the Company's debt securities and \$1.6 million related to the Company's equity securities).

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary would be reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers, among other things (i) the length of time and the extent to which the fair value has

been less than cost; (ii) the financial condition, capital strength, and near-term (within 12 months) prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; (iii) the historical volatility in the market value of the investment and/or the liquidity or illiquidity of the investment; (iv) adverse conditions specifically related to the security, an industry, or a geographic area; and (v) the intent to sell the investment security and if it's more likely than not that the Company will not have to sell the security before recovery of its cost basis. In addition, management also employs a continuous monitoring process in regards to its marketable equity securities, specifically its portfolio of regional community bank holdings. Although the regional community bank stocks that are owned by the Company are publicly traded, the trading activity for these stocks is minimal, with trading volumes of less than 0.4% of each respective company being traded on



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a daily basis. As part of management's review process for these securities, management reviews the financial condition of each respective regional community bank for any indications of financial weakness.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature, at which time the Company expects to receive full value for the securities. Furthermore, as of March 31, 2018, management does not intend to sell an impaired security and it is not more than likely that it will be required to sell the security before the recovery of its amortized cost basis. The unrealized losses on debt securities are primarily the result of interest rate changes, credit spread fluctuations on agency-issued mortgage related securities, general financial market uncertainty and unprecedented market volatility. These conditions should not prohibit the Company from receiving its contractual principal and interest payments on its debt securities. The fair value is expected to recover as the securities approach their maturity date or repricing date. As of March 31, 2018, management believes the unrealized losses detailed in the table above are temporary and no additional impairment loss has been recognized in the Company's consolidated income statement. 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 will be recognized in net income in the period the other-than-temporary impairment is identified, while any noncredit loss will be recognized in other comprehensive income.

The amortized cost and estimated fair value of debt securities at March 31, 2018, by contractual maturity, are shown in the following table (in thousands). Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties. Mortgage-backed securities have been allocated to their respective maturity groupings based on their contractual maturity.

|  | Amortized<br>Cost | Estimated<br>Fair<br>Value |
|--|-------------------|----------------------------|
| <b>Securities Available-for-Sale</b>   |                   |                            |
| Due in one year or less                | \$ 2,715          | \$ 2,715                   |
| Due after one year through five years  | 13,888            | 13,850                     |
| Due after five years through ten years | 76,197            | 73,698                     |
| Due after ten years                    | 470,998           | 458,604                    |
| Total                                  | \$ 563,798        | \$ 548,867                 |
| <b>Securities Held-to-Maturity</b>     |                   |                            |
| Due in one year or less                | \$ —              | \$ —                       |
| Due after one year through five years  | —                 | —                          |
| Due after five years through ten years | —                 | —                          |
| Due after ten years                    | 62,277            | 62,146                     |
| Total                                  | \$ 62,277         | \$ 62,146                  |

Gross gains and gross losses realized by the Company from investment security transactions are summarized in the table below (in thousands).

|   | Three<br>months<br>ended<br>March 31,<br>2018 | 2017  |
|---|---|-------|
| Equity and perpetual preferred security unrealized gains recognized | \$ 180  | \$ —  |
| Gross realized gains on securities sold                             | —   | 4,276 |

|  |     |         |
|--|-----|---------|
| Gross realized losses on securities sold | —   | —       |
| Net investment security gains            | \$— | \$4,276 |

During the three months ended March 31, 2018 a \$0.2 million unrealized gain was recognized in other income in the consolidated statements of income as a result of the change in the fair value of equity and perpetual preferred securities due to the adoption of ASU 2016-01. Additionally, \$2.7 million, net of deferred taxes, was reclassified from other comprehensive income to retained earnings on the consolidated balance sheets to recognize the prior period fair value impact of these securities.

During the three months ended March 31, 2017 the Company realized \$4.3 million of investment gains. These gains represented partial recoveries of impairment charges previously recognized on pooled trust preferred securities. As a result of these sales, the Company no longer holds any pooled trust preferred securities in its investment portfolio.

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The carrying value of securities pledged to secure public deposits and for other purposes as required or permitted by law approximated \$448 million and \$429 million at March 31, 2018 and December 31, 2017, respectively.

## Note D –Loans

The following summarizes the Company's major classifications for loans (in thousands):

|                           | March 31,<br>2018 | December 31,<br>2017 |
|---------------------------|-------------------|----------------------|
| Residential real estate   | \$1,465,215       | \$1,468,278          |
| Home equity               | 138,477           | 139,499              |
| Commercial and industrial | 204,592           | 208,484              |
| Commercial real estate    | 1,296,304         | 1,277,576            |
| Consumer                  | 29,570            | 29,162               |
| DDA overdrafts            | 3,523             | 4,411                |
| Gross loans               | 3,137,681         | 3,127,410            |
| Allowance for loan losses | (18,381 )         | (18,836 )            |
| Net loans                 | \$3,119,300       | \$3,108,574          |

Construction loans of \$26.6 million and \$25.3 million are included within residential real estate loans at March 31, 2018 and December 31, 2017, respectively. Construction loans of \$30.9 million and \$28.9 million are included within commercial real estate loans at March 31, 2018 and December 31, 2017, respectively. The Company's commercial and residential real estate construction loans are primarily secured by real estate within the Company's principal markets. These loans were originated under the Company's loan policy, which is focused on the risk characteristics of residential and commercial real estate lending, including specific risks related to construction lending. Adequate consideration has been given to these loans in establishing the Company's allowance for loan losses.

## Note E – Allowance For Loan Losses

Management systematically monitors the loan portfolio and the adequacy of the allowance for loan losses on a quarterly basis to provide for probable losses inherent in the portfolio. Management assesses the risk in each loan type based on historical trends, the general economic environment of its local markets, individual loan performance and other relevant factors.

Individual credits are selected throughout the year for detailed loan reviews, which are utilized by management to assess the risk in the portfolio and the adequacy of the allowance. Due to the nature of commercial lending, evaluation of the adequacy of the allowance as it relates to these loan types is often based more upon specific credit reviews, with consideration given to the potential impairment of certain credits and historical loss rates, adjusted for economic conditions and other inherent risk factors.

The following table summarizes the activity in the allowance for loan loss, by portfolio loan classification, for the three months ended March 31, 2018 and 2017 (in thousands). The allocation of a portion of the allowance in one portfolio segment does not preclude its availability to absorb losses in other portfolio segments. The following table also presents the balance in the allowance for loan loss disaggregated on the basis of the Company's impairment measurement method and the related recorded investment in loans, by portfolio segment, as of March 31, 2018 and December 31, 2017 (in thousands).

Commercial Residential

DDA

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|                                   | Commercial<br>and<br>Industrial | Real Estate | Real Estate | Home<br>Equity | Consumer | Overdrafts | Total      |
|-----------------------------------|---------------------------------|-------------|-------------|----------------|----------|------------|------------|
| Three months ended March 31, 2018 |                                 |             |             |                |          |            |            |
| Allowance for loan loss           |                                 |             |             |                |          |            |            |
| Beginning balance                 | \$ 4,571                        | \$ 6,183    | \$ 5,212    | \$ 1,138       | \$ 62    | \$ 1,670   | \$ 18,836  |
| Charge-offs                       | (339                            | ) (157      | ) (131      | ) (71          | ) (99    | ) (636     | ) (1,433 ) |
| Recoveries                        | 2                               | 223         | 106         | —              | 46       | 420        | 797        |
| Provision for acquired loans      | —                               | —           | —           | —              | —        | —          | —          |

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|   |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
|---|-----------|-------------|-------------|-----------|----------|---------|-------------|-----|-----|---|------|---|--------|---|
| Provision                                 | 529       | (480        | )           | (244      | )        | 133     | 203         | 40  | 181 |   |      |   |        |   |
| Ending balance                            | \$4,763   | \$5,769     | \$4,943     | \$1,200   | \$212    | \$1,494 | \$18,381    |     |     |   |      |   |        |   |
| Three months ended March 31, 2017         |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Allowance for loan loss                   |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Beginning balance                         | \$4,206   | \$6,573     | \$6,680     | \$1,417   | \$82     | \$772   | \$19,730    |     |     |   |      |   |        |   |
| Charge-offs                               | (53       | )           | (180        | )         | (626     | )       | (121        | )   | (6  | ) | (636 | ) | (1,622 | ) |
| Recoveries                                | 2         | 11          | 25          | —         | 11       | 371     | 420         |     |     |   |      |   |        |   |
| Provision for acquired loans              | —         | (19         | )           | —         | —        | —       | (19         | )   |     |   |      |   |        |   |
| Provision                                 | 128       | (381        | )           | 644       | 3        | (23     | )           | 329 | 700 |   |      |   |        |   |
| Ending balance                            | \$4,283   | \$6,004     | \$6,723     | \$1,299   | \$64     | \$836   | \$19,209    |     |     |   |      |   |        |   |
| As of March 31, 2018                      |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Allowance for loan loss                   |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Evaluated for impairment:                 |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Individually                              | \$—       | \$172       | \$—         | \$—       | \$—      | \$—     | \$172       |     |     |   |      |   |        |   |
| Collectively                              | 4,759     | 5,530       | 4,843       | 1,200     | 208      | 1,494   | 18,034      |     |     |   |      |   |        |   |
| Acquired with deteriorated credit quality | 4         | 67          | 100         | —         | 4        | —       | 175         |     |     |   |      |   |        |   |
| Total                                     | \$4,763   | \$5,769     | \$4,943     | \$1,200   | \$212    | \$1,494 | \$18,381    |     |     |   |      |   |        |   |
| Loans                                     |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Evaluated for impairment:                 |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Individually                              | \$849     | \$8,757     | \$—         | \$—       | \$—      | \$—     | \$9,606     |     |     |   |      |   |        |   |
| Collectively                              | 203,537   | 1,282,064   | 1,462,622   | 138,477   | 29,454   | 3,523   | 3,119,677   |     |     |   |      |   |        |   |
| Acquired with deteriorated credit quality | 206       | 5,483       | 2,593       | —         | 116      | —       | 8,398       |     |     |   |      |   |        |   |
| Total                                     | \$204,592 | \$1,296,304 | \$1,465,215 | \$138,477 | \$29,570 | \$3,523 | \$3,137,681 |     |     |   |      |   |        |   |
| As of December 31, 2017                   |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Allowance for loan loss                   |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Evaluated for impairment:                 |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Individually                              | \$—       | \$647       | \$—         | \$—       | \$—      | \$—     | \$647       |     |     |   |      |   |        |   |
| Collectively                              | 4,567     | 5,313       | 5,112       | 1,138     | 58       | 1,670   | 17,858      |     |     |   |      |   |        |   |
| Acquired with deteriorated credit quality | 4         | 223         | 100         | —         | 4        | —       | 331         |     |     |   |      |   |        |   |
| Total                                     | \$4,571   | \$6,183     | \$5,212     | \$1,138   | \$62     | \$1,670 | \$18,836    |     |     |   |      |   |        |   |
| Loans                                     |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Evaluated for impairment:                 |           |             |             |           |          |         |             |     |     |   |      |   |        |   |
| Individually                              | \$849     | \$8,818     | \$—         | \$—       | \$—      | \$—     | \$9,667     |     |     |   |      |   |        |   |
| Collectively                              | 207,429   | 1,263,076   | 1,465,685   | 139,499   | 29,046   | 4,411   | 3,109,146   |     |     |   |      |   |        |   |
| Acquired with deteriorated credit quality | 206       | 5,682       | 2,593       | —         | 116      | —       | 8,597       |     |     |   |      |   |        |   |
| Total                                     | \$208,484 | \$1,277,576 | \$1,468,278 | \$139,499 | \$29,162 | \$4,411 | \$3,127,410 |     |     |   |      |   |        |   |

## Credit Quality Indicators

All commercial loans within the portfolio are subject to internal risk grading. All non-commercial loans are evaluated based on payment history. The Company's internal risk ratings for commercial loans are: Pass, Special Mention, Substandard and Doubtful. Each internal risk rating is defined in the loan policy using the following criteria: balance sheet yields; ratios and leverage; cash flow spread and coverage; prior history; capability of management; market position/industry; potential impact of changing economic, legal, regulatory or environmental conditions; purpose; structure; collateral support; and guarantor support. Risk grades are generally assigned by the primary lending officer and are periodically evaluated by the Company's

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internal loan review process. Based on an individual loan's risk grade, estimated loss percentages are applied to the outstanding balance of the loan to determine the amount of probable loss.

The Company categorizes loans into risk categories based on relevant information regarding the customer's debt service ability, capacity, overall collateral position along with other economic trends, and historical payment performance. The risk grades for each credit are updated when the Company receives current financial information, the loan is reviewed by the Company's internal loan review and credit administration departments, or the loan becomes delinquent or impaired. The risk grades are updated a minimum of annually for loans rated exceptional, good, acceptable, or pass/watch. Loans rated special mention, substandard or doubtful are reviewed at least quarterly. The Company uses the following definitions for its risk ratings:

| Risk Rating        | Description  |
|--------------------|--|
| Pass ratings:      |  |
| (a)<br>Exceptional | Loans classified as exceptional are secured with liquid collateral conforming to the internal loan policy. Loans rated within this category pose minimal risk of loss to the bank.   |
| (b) Good           | Loans classified as good have similar characteristics that include a strong balance sheet, satisfactory debt service coverage ratios, strong management and/or guarantors, and little exposure to economic cycles. Loans in this category generally have a low chance of loss to the bank.   |
| (c)<br>Acceptable  | Loans classified as acceptable have acceptable liquidity levels, adequate debt service coverage ratios, experienced management, and have average exposure to economic cycles. Loans within this category generally have a low risk of loss to the bank.  |
| (d)<br>Pass/watch  | Loans classified as pass/watch have erratic levels of leverage and/or liquidity, cash flow is volatile and the borrower is subject to moderate economic risk. A borrower in this category poses a low to moderate risk of loss to the bank.  |
| Special<br>mention | Loans classified as special mention have a potential weakness(es) that deserves management's close attention. The potential weakness could result in deterioration of the loan repayment or the bank's credit position at some future date. A loan rated in this category poses a moderate loss risk to the bank.                                |
| Substandard        | Loans classified as substandard reflect a customer with a well defined weakness that jeopardizes the liquidation of the debt. Loans in this category have the possibility that the bank will sustain some loss if the deficiencies are not corrected and the bank's collateral value is weakened by the financial deterioration of the borrower. |
| Doubtful           | Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that make collection of the full contract amount highly improbable. Loans rated in this category are most likely to cause the bank to have a loss due to a collateral shortfall or a negative capital position. |

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The following table presents the Company's commercial loans by credit quality indicators, by portfolio loan classification (in thousands):

|                   | Commercial<br>and<br>Industrial | Commercial<br>Real Estate | Total        |
|-------------------|---------------------------------|---------------------------|--------------|
| March 31, 2018    |                                 |                           |              |
| Pass              | \$ 171,815                      | \$ 1,252,937              | \$ 1,424,752 |
| Special mention   | 25,524                          | 7,078                     | 32,602       |
| Substandard       | 7,253                           | 36,289                    | 43,542       |
| Doubtful          | —                               | —                         | —            |
| Total             | \$ 204,592                      | \$ 1,296,304              | \$ 1,500,896 |
| December 31, 2017 |                                 |                           |              |
| Pass              | \$ 175,951                      | \$ 1,231,256              | \$ 1,407,207 |
| Special mention   | 25,872                          | 8,068                     | 33,940       |
| Substandard       | 6,661                           | 38,252                    | 44,913       |
| Doubtful          | —                               | —                         | —            |
| Total             | \$ 208,484                      | \$ 1,277,576              | \$ 1,486,060 |

The following table presents the Company's non-commercial loans by payment performance, by portfolio loan classification (in thousands):

|                         | Performing   | Non-Performing | Total        |
|-------------------------|--------------|----------------|--------------|
| March 31, 2018          |              |                |              |
| Residential real estate | \$ 1,461,802 | \$ 3,413       | \$ 1,465,215 |
| Home equity             | 138,341      | 136            | 138,477      |
| Consumer                | 29,570       | —              | 29,570       |
| DDA overdrafts          | 3,523        | —              | 3,523        |
| Total                   | \$ 1,633,236 | \$ 3,549       | \$ 1,636,785 |
| December 31, 2017       |              |                |              |
| Residential real estate | \$ 1,465,445 | \$ 2,833       | \$ 1,468,278 |
| Home equity             | 139,239      | 260            | 139,499      |
| Consumer                | 29,162       | —              | 29,162       |
| DDA overdrafts          | 4,411        | —              | 4,411        |
| Total                   | \$ 1,638,257 | \$ 3,093       | \$ 1,641,350 |

## Aging Analysis of Accruing and Non-Accruing Loans

Interest income on loans is accrued and credited to operations based upon the principal amount outstanding, using methods that generally result in level rates of return. Loan origination fees, and certain direct costs, are deferred and amortized as an adjustment to the yield over the term of the loan. The accrual of interest generally is discontinued when a loan becomes 90 days past due as to principal or interest for all loan types. However, any loan may be placed on non-accrual status if the Company receives information that indicates a borrower is unable to meet the contractual terms of its respective loan agreement. Other indicators considered for placing a loan on non-accrual status include the borrower's involvement in bankruptcies, foreclosures, repossessions, litigation and any other situation resulting in doubt as to whether full collection of contractual principal and interest is attainable. When interest accruals are discontinued, unpaid interest recognized in income in the current year is reversed, and interest accrued in prior years is



charged to the allowance for loan losses. Management may elect to continue the accrual of interest when the net realizable value of collateral exceeds the principal balance and related accrued interest, and the loan is in the process of collection.

Generally for all loan classes, interest income during the period the loan is non-performing is recorded on a cash basis after recovery of principal is reasonably assured. Cash payments received on nonperforming loans are typically applied directly against the outstanding principal balance until the loan is fully repaid. Generally, loans are restored to accrual status when the

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obligation is brought current, the borrower has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Generally, all loan types are considered past due when the contractual terms of a loan are not met and the borrower is 30 days or more past due on a payment. Furthermore, residential and home equity loans are generally subject to charge-off when the loan becomes 120 days past due, depending on the estimated fair value of the collateral less cost to dispose, versus the outstanding loan balance. Commercial loans are generally charged off when the loan becomes 120 days past due. Open-end consumer loans are generally charged off when the loan becomes 180 days past due.

The following table presents an aging analysis of the Company's accruing and non-accruing loans, by portfolio loan classification (in thousands):

|                           | March 31, 2018 |               |               |                    |             | Total       |
|---------------------------|----------------|---------------|---------------|--------------------|-------------|-------------|
|                           | Accruing       |               |               |                    |             |             |
|                           | Current        | 30-59<br>days | 60-89<br>days | Over<br>90<br>days | Non-accrual |             |
| Residential real estate   | \$1,456,243    | \$4,353       | \$1,206       | \$82               | \$ 3,331    | \$1,465,215 |
| Home equity               | 137,727        | 458           | 157           | 1                  | 134         | 138,477     |
| Commercial and industrial | 203,468        | 61            | —             | —                  | 1,063       | 204,592     |
| Commercial real estate    | 1,289,722      | 1,520         | —             | —                  | 5,062       | 1,296,304   |
| Consumer                  | 29,549         | 21            | —             | —                  | —           | 29,570      |
| DDA overdrafts            | 3,092          | 422           | 1             | 8                  | —           | 3,523       |
| Total                     | \$3,119,801    | \$6,835       | \$1,364       | \$91               | \$ 9,590    | \$3,137,681 |

|                           | December 31, 2017 |               |               |                    |             | Total       |
|---------------------------|-------------------|---------------|---------------|--------------------|-------------|-------------|
|                           | Accruing          |               |               |                    |             |             |
|                           | Current           | 30-59<br>days | 60-89<br>days | Over<br>90<br>days | Non-accrual |             |
| Residential real estate   | \$1,458,746       | \$5,990       | \$709         | \$19               | \$ 2,814    | \$1,468,278 |
| Home equity               | 138,480           | 671           | 88            | 92                 | 168         | 139,499     |
| Commercial and industrial | 206,447           | 549           | 1             | 142                | 1,345       | 208,484     |
| Commercial real estate    | 1,269,520         | 1,841         | 245           | —                  | 5,970       | 1,277,576   |
| Consumer                  | 29,108            | 39            | 13            | 2                  | —           | 29,162      |
| DDA overdrafts            | 3,849             | 541           | 14            | 7                  | —           | 4,411       |
| Total                     | \$3,106,150       | \$9,631       | \$1,070       | \$262              | \$ 10,297   | \$3,127,410 |

The following table presents the Company's impaired loans, by class (in thousands). The difference between the unpaid principal balance and the recorded investment generally reflects amounts that have been previously charged-off. There are no impaired residential, home equity, or consumer loans.

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|                                     | March 31, 2018              |                                    |        | December 31, 2017           |                                    |        |
|-------------------------------------|-----------------------------|------------------------------------|--------|-----------------------------|------------------------------------|--------|
|                                     | Recorded Investment Balance | Unpaid Principal Related Allowance |        | Recorded Investment Balance | Unpaid Principal Related Allowance |        |
| With no related allowance recorded: |                             |                                    |        |                             |                                    |        |
| Commercial and industrial           | \$849                       | \$3,013                            | \$ —   | \$849                       | \$3,013                            | \$ —   |
| Commercial real estate              | 5,782                       | 7,607                              | —      | 3,036                       | 4,861                              | —      |
| Total                               | \$6,631                     | \$10,620                           | \$ —   | \$3,885                     | \$7,874                            | \$ —   |
| With an allowance recorded:         |                             |                                    |        |                             |                                    |        |
| Commercial and industrial           | \$—                         | \$—                                | \$ —   | \$—                         | \$—                                | \$ —   |
| Commercial real estate              | 2,975                       | 2,975                              | 172    | 5,782                       | 5,782                              | 647    |
| Total                               | \$2,975                     | \$2,975                            | \$ 172 | \$5,782                     | \$5,782                            | \$ 647 |

The following table presents information related to the average recorded investment and interest income recognized on the Company's impaired loans, by class (in thousands):

|                                     | Three months ended March 31, 2018 |                            | 2017                        |                            |
|-------------------------------------|-----------------------------------|----------------------------|-----------------------------|----------------------------|
|                                     | Average Recorded Investment       | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded: |                                   |                            |                             |                            |
| Commercial and industrial           | \$774                             | —                          | \$1,365                     | —                          |
| Commercial real estate              | 3,008                             | 3                          | 3,118                       | 5                          |
| Total                               | \$3,782                           | \$ 3                       | \$4,483                     | \$ 5                       |
| With an allowance recorded:         |                                   |                            |                             |                            |
| Commercial and industrial           | \$—                               | \$ —                       | \$—                         | \$ —                       |
| Commercial real estate              | 5,750                             | 52                         | 2,832                       | 19                         |
| Total                               | \$5,750                           | \$ 52                      | \$2,832                     | \$ 19                      |

Approximately \$0.1 million and \$0.2 million of interest income would have been recognized during the three months ended March 31, 2018 and 2017, respectively, if such loans had been current in accordance with their original terms. There were no commitments to provide additional funds on non-accrual, impaired or other potential problem loans at March 31, 2018.

**Loan Modifications**

The Company's policy on loan modifications typically does not allow for modifications that would be considered a concession from the Company. However, when there is a modification, the Company evaluates each modification to determine if the modification constitutes a troubled debt restructuring ("TDR") in accordance with ASU 2011-02, whereby a modification of a loan would be considered a TDR when both of the following conditions are met: (1) a borrower is experiencing financial difficulty and (2) the modification constitutes a concession. When determining whether the borrower is experiencing financial difficulties, the Company reviews whether the borrower is currently in payment default on any of its debt or whether it is probable that the borrower would be in payment default in the foreseeable future without the modification. Other indicators of financial difficulty include whether the borrower has declared or is in the process of declaring bankruptcy, the borrower's ability to continue as a going concern, and the borrower's projected cash flow to service its debt (including principal and interest) in accordance with the contractual terms for the foreseeable future, without a modification.

Regulatory guidance requires loans to be accounted for as collateral-dependent loans when borrowers have filed Chapter 7 bankruptcy, the debt has been discharged by the bankruptcy court, and the borrower has not reaffirmed the debt. The filing of bankruptcy is deemed to be evidence that the borrower is in financial difficulty and the discharge of the debt by the bankruptcy court is deemed to be a concession granted to the borrower.

The following tables set forth the Company's TDRs (in thousands):

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|                           | March 31, 2018 |              |           | December 31, 2017 |              |           |
|---------------------------|----------------|--------------|-----------|-------------------|--------------|-----------|
|                           | Accruing       | Non-Accruing | Total     | Accruing          | Non-Accruing | Total     |
| Commercial and industrial | \$ 125         | \$ —         | \$ 125    | \$ 135            | \$ —         | \$ 135    |
| Commercial real estate    | 8,324          | —            | 8,324     | 8,381             | —            | 8,381     |
| Residential real estate   | 20,786         | 256          | 21,042    | 21,005            | 84           | 21,089    |
| Home equity               | 3,015          | 40           | 3,055     | 3,047             | 50           | 3,097     |
| Consumer                  | —              | —            | —         | —                 | —            | —         |
| Total                     | \$ 32,250      | \$ 296       | \$ 32,546 | \$ 32,568         | \$ 134       | \$ 32,702 |

## New TDRs

|                           | Three months ended March 31, 2018 |                               | 2017                         |                               |
|---------------------------|-----------------------------------|-------------------------------|------------------------------|-------------------------------|
|                           | Pre Modification Outstanding      | Post Modification Outstanding | Pre Modification Outstanding | Post Modification Outstanding |
|                           | Number of Contracts               | Investment                    | Number of Contracts          | Investment                    |
| Commercial and industrial | —                                 | \$ —                          | —                            | \$ —                          |
| Commercial real estate    | —                                 | —                             | 1                            | 3,015                         |
| Residential real estate   | 7                                 | 412                           | 9                            | 1,130                         |
| Home equity               | 4                                 | 77                            | 2                            | 58                            |
| Consumer                  | —                                 | —                             | —                            | —                             |
| Total                     | 11                                | \$ 489                        | 12                           | \$ 4,203                      |

## Note F – Long-Term Debt

The components of long-term debt are summarized below (in thousands):

|  | March 31, 2018 | December 31, 2017 |
|--|----------------|-------------------|
| Junior subordinated debentures owed to City Holding Capital Trust III, due 2038, interest at a rate of 5.62% and 5.09%, respectively | \$ 16,495      | \$ 16,495         |

The Company formed a statutory business trust, City Holding Capital Trust III (“Capital Trust III”), under the laws of Delaware. Capital Trust III was created for the exclusive purpose of (i) issuing trust-preferred capital securities (“Capital Securities”), which represent preferred undivided beneficial interests in the assets of the trust, (ii) using the proceeds from the sale of the Capital Securities to acquire junior subordinated debentures (“Debentures”) issued by the Company, and (iii) engaging in only those activities necessary or incidental thereto. The trust is considered a variable interest entity for which the Company is not the primary beneficiary. Accordingly, the accounts of the trust are not included in the Company’s consolidated financial statements.

Distributions on the Debentures are cumulative and will be payable quarterly at an interest rate of 3.50% over the three month LIBOR rate, reset quarterly. Interest payments are due in March, June, September and December each year until maturity. The Debentures are redeemable prior to maturity at the option of the Company (i) in whole at any time or in part from time to time, or (ii) in whole, but not in part, at any time within 90 days following the occurrence and during the continuation of certain predefined events.

Payments of distributions on the Capital Securities and payments on redemption of the Capital Securities are guaranteed by the Company. The Company also entered into an agreement as to expenses and liabilities with the trust pursuant to which it agreed, on a subordinated basis, to pay any cost, expenses or liabilities of the trust other than those arising under the Capital Securities. The obligations of the Company under the Debentures, the related indentures, the trust agreement establishing the trust, the guarantees and the agreements as to expenses and liabilities, in the aggregate, constitute a full and unconditional guarantee by the Company of the trust's obligations under the Capital Securities. The Capital Securities issued by the statutory business trust qualify as Tier 1 capital for the Company under current Federal Reserve Board guidelines.

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## Note G –Derivative Instruments

The Company enters into derivative transactions principally to protect against the risk of adverse price or interest rate movements on the value of certain assets and liabilities on future cash flows. As of March 31, 2018 and December 31, 2017, the Company has derivative financial instruments not included in hedge relationships. These derivatives consist of interest rate swaps and floors used for interest rate management purposes and derivatives executed with commercial banking customers to facilitate their interest rate management strategies. For the majority of these instruments the Company acts as an intermediary for its customers. Changes in the fair value of the underlying derivative contracts for the most part offset each other and do not significantly impact the Company's results of operations. The Company also has an interest rate swap that serves as a fair value hedge for changes in long term fixed interest rates related to commercial real estate loans. Hedge ineffectiveness is assessed quarterly and any ineffectiveness is recorded as non-interest expense. For the three months ended March 31, 2018 and 2017, hedge ineffectiveness was less than \$0.1 million and the change in fair value was less than \$0.1 million, for each respective period.

The following table summarizes the notional and fair value of these derivative instruments (in thousands):

|   | March 31, 2018     |               | December 31, 2017  |               |
|---|--------------------|---------------|--------------------|---------------|
|   | Notional<br>Amount | Fair<br>Value | Notional<br>Amount | Fair<br>Value |
| Non-hedging interest rate derivatives:          |                    |               |                    |               |
| Customer counterparties:                        |                    |               |                    |               |
| Loan interest rate swap - assets                | \$86,856           | \$2,039       | \$225,480          | \$4,877       |
| Loan interest rate swap - liabilities           | 426,241            | 19,452        | 314,450            | 9,513         |
| Financial institution counterparties:           |                    |               |                    |               |
| Loan interest rate swap - assets                | 432,755            | 19,620        | 320,949            | 9,591         |
| Loan interest rate swap - liabilities           | 86,856             | 2,039         | 218,924            | 4,877         |
| Derivatives designated as hedges of fair value: |                    |               |                    |               |
| Financial institution counterparties:           |                    |               |                    |               |
| Loan interest rate swap - assets                | 3,961              | 93            | 4,326              | 34            |

The following table summarizes the change in fair value of these derivative instruments (in thousands):

|   | Three<br>months<br>ended<br>March<br>31,<br>2018 |      | 2017 |  |
|---|--|------|------|--|
| Change in fair value non-hedging interest rate derivatives: |  |      |      |  |
| Other expense   | \$90   | \$45 |      |  |
| Change in fair value hedging interest rate derivatives:     |  |      |      |  |
| Other expense   | 1  | (4)  |      |  |

Certain financial instruments, including derivatives, may be eligible for offset in the consolidated balance sheet and/or subject to master netting arrangements. The Company's derivative transactions with financial institution counterparties are generally executed under International Swaps and Derivative Association ("ISDA") master agreements which

include "right of setoff" provisions. In such cases there is generally a legally enforceable right to offset recognized amounts and there may be an intention to settle such amounts on a net basis. Nonetheless, the Company does not generally offset financial instruments for financial reporting purposes. Information about financial instruments that are eligible for offset in the consolidated balance sheet as of March 31, 2018 is presented in the following tables (in thousands):

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| Description  | Gross<br>Amounts<br>of<br>Recognized<br>Assets<br>(a) | Gross<br>Amounts<br>Offset<br>in the<br>Statement<br>of<br>Financial<br>Position<br>(b) | Net<br>Amounts<br>of Assets<br>Presented<br>in<br>the<br>Statement<br>of<br>Financial<br>Position<br>(c)<br>=(a)-(b) | Gross<br>Amounts<br>Not Offset in<br>the<br>Balance<br>Sheet | Netting<br>Adjustment<br>per<br>Applicable<br>Master<br>Netting<br>Agreements<br>(d) | Total<br>of Gross<br>Amounts<br>Not<br>Offset in<br>the<br>Statement<br>of<br>Financial<br>Position<br>Including<br>Applicable<br>Netting<br>Agreement<br>and Fair<br>Value of<br>Collateral<br>Net<br>Amount<br>(c)-(d) * |
|--|---|---|--|--|--|--|
|  |   |   |  |  |  | Netting<br>Adjustment<br>per<br>Applicable<br>Master<br>Netting<br>Agreements<br>(d)   |
| <b>Non-hedging derivative assets:</b>                                |   |   |  |  |  |  |
| Interest rate swap agreements - customer counterparties              | \$ 2,039  | \$  | -\$ 2,039  | \$ -2,039  | \$ 2,039   | \$—  |
| Interest rate swap agreements - financial institution counterparties | \$ 19,620   | \$  | -\$ 19,620   | \$ —   | \$ —   | \$ 19,620  |
| <b>Hedging derivative assets:</b>                                    |   |   |  |  |  |  |
| Interest rate swap agreements - financial institution counterparties | \$ 93   | \$  | -\$ 93   | \$ -70   | \$ 70  | \$ 23  |
| <b>Non-hedging derivative liabilities:</b>                           |   |   |  |  |  |  |
| Interest rate swap agreements - customer counterparties              |   | \$ 19,452   | \$ 19,452  | \$ 19,452  | \$ 19,452  | \$—  |
| Interest rate swap agreements - financial institution counterparties |   | \$ 2,039  | \$ 2,039   | \$ 14,671  | \$ 14,671  | \$—  |

\*

For instances where the fair value of financial collateral meets or exceeds the amounts presented in the Consolidated Balance Sheets, no value is displayed to represent full collateralization.



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Note H –Employee Benefit Plans

Pursuant to the terms of the City Holding Company 2003 Incentive Plan and the City Holding Company 2013 Incentive Plan (the "2003 Plan" and "2013 Plan", respectively), the Compensation Committee of the Board of Directors, or its delegate, may, from time to time, grant stock options, stock appreciation rights ("SARs"), or restricted stock awards to employees, directors and individuals who provide service to the Company (collectively, "Plan Participants"). The 2003 Plan expired in April of 2013 and the 2013 Plan was approved by the Company's shareholders in April 2013. A maximum of 750,000 shares of the Company's common stock may be issued upon the exercise of stock options, SARs and stock awards under the 2013 Plan. These limitations may be adjusted in the event of a change in the number of outstanding shares of common stock by reason of a stock dividend, stock split or other similar event. Specific terms of options and SARs awarded, including vesting periods, exercise prices (stock price at date of grant) and expiration dates are determined at the date of grant and are evidenced by agreements between the Company and the awardee. The exercise price of the option grants equals the market price of the Company's common stock on the date of grant. All incentive stock options and SARs will be exercisable up to 10 years from the date granted and all options and SARs are exercisable for the period specified in the individual agreement. As of March 31, 2018, approximately 541,000 shares were still available to be issued under the 2013 Plan.

Each award from the 2003 Plan and 2013 Plan is evidenced by an award agreement that specifies the option price, the duration of the option, the number of shares to which the option pertains, and such other provisions as the Compensation Committee, or its delegate, determines. The option price for each grant is equal to the fair market value of a share of the Company's common stock on the date of the grant. Options granted expire at such time as the Compensation Committee, or its delegate, determines at the date of the grant and in no event does the exercise period exceed a maximum of ten years. Upon a change-in-control of the Company, as defined in the 2003 Plan and 2013 Plan, all outstanding options and awards shall immediately vest.

Certain stock options and restricted stock awards granted pursuant to the 2013 Plan have performance-based vesting requirements. These shares will vest in three separate annual installments of approximately 33.33% per installment on the third, fourth and fifth anniversaries of the grant date, subject further to performance-based vesting requirements. To meet the performance-based vesting requirement, the Company's mean return on average assets of the three, four and five year period prior to the respective vesting date must meet or exceed the median return on average assets over the 20 year period immediately preceding the vesting date of all FDIC insured depository institutions. The mean return on average assets excludes merger and acquisition expenses and other nonrecurring items as determined by the Board of Directors of the Company.

In 2018, the Board of Directors granted the named executive officers ("NEOs") restricted stock units ("RSUs") and performance share units ("PSUs"). The RSUs will vest in three separate annual installments of approximately 33.33% per installment on the first, second and third anniversaries of the grant date, subject to a two-year holding period. The PSUs will vest on the third anniversary of the grant date. The payout for the PSUs will be determined based on (1) the Company's three-year relative average return on assets ("ROA") during the three-year performance period relative to the ROA for the selected peer companies and (2) the Company's total shareholder return ("TSR") relative to the TSR of the selected peer companies during the three-year performance period. If the three-year relative ROA is at or below the 25th percentile, 0% of the PSU grant will be earned; at the 50th percentile, 100% of the PSU grant will be earned; or at the 100th percentile, 200% of the PSU grant will be earned. The payout of the PSUs will be increased or decreased as determined by a modifier based on the Company's TSR. If the three-year relative TSR is at or below the 25th percentile, the number of PSUs granted will be reduced by 25%; at the 50th percentile, the number of PSUs granted will not be adjusted; or at or above the 75th percentile, the number of PSUs granted will be increased by 25%.



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Stock Options

A summary of the Company's stock option activity and related information is presented below:

|                          | Three months ended March 31,<br>2018 |                                    | 2017    |                                    |
|--------------------------|--------------------------------------|------------------------------------|---------|------------------------------------|
|                          | Options                              | Weighted-Average<br>Exercise Price | Options | Weighted-Average<br>Exercise Price |
| Outstanding at January 1 | 87,605                               | \$ 47.15                           | 86,613  | \$ 41.08                           |
| Granted                  | —                                    | —                                  | 17,631  | 66.32                              |
| Exercised                | (7,387)                              | 37.85                              | (1,250) | 30.38                              |
| Outstanding at March 31  | 80,218                               | \$ 48.00                           | 102,994 | \$ 45.53                           |
| Exercisable at March 31  | 24,943                               | \$ 40.38                           | 23,276  | \$ 36.70                           |

Information regarding stock option exercises and stock-based compensation expense associated with stock options is provided in the following table (in thousands):

|   | Three<br>months<br>ended<br>March 31,<br>2018 2017 |      |
|---|--|------|
| Proceeds from stock option exercises  | \$280  | \$38 |
| Intrinsic value of stock options exercised  | 220  | 44   |
| Stock-based compensation expense associated with stock options                            | \$54   | \$65 |
| At period-end:  | March<br>31,<br>2018                               |      |
| Unrecognized stock-based compensation expense associated with stock options               | \$328  |      |
| Weighted average period (in years) in which the above amount is expected to be recognized | 2.4  |      |

Shares issued in connection with stock option exercises are issued from available treasury shares. If no treasury shares are available, new shares would be issued from available authorized shares. During the three months ended March 31, 2018 and 2017, all shares issued in connection with stock option exercises were issued from available treasury stock. For the stock options that have performance-based criteria, management has evaluated those criteria and has determined that, as of March 31, 2018, the criteria were probable of being met.

Additional information regarding stock options outstanding and exercisable at March 31, 2018 is provided in the following table:

| Ranges of<br>Exercise<br>Prices | No. of<br>Options<br>Outstanding | Weighted-Average<br>Exercise<br>Price | Weighted-Average<br>Contractual Life (Years) | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) | No. of<br>Options<br>Currently<br>Exercisable | Weighted-Average<br>Exercise<br>Price of<br>Options<br>Currently<br>Exercisable | Weighted-Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Aggregate<br>Intrinsic<br>Value of<br>Options<br>Currently<br>Exercisable (in<br>thousands) |
|---------------------------------|----------------------------------|---------------------------------------|--|--|---|---|---|---|
|                                 | 500                              | \$ 30.38                              | 0.7  | \$ 19  | 500   | \$ 30.38  | 0.7   | \$ 19   |

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|               |        |       |     |          |        |       |     |        |
|---------------|--------|-------|-----|----------|--------|-------|-----|--------|
| 35.00 - 39.99 | 15,475 | 37.74 | 4.9 | 477      | 15,475 | 37.74 | 4.9 | 477    |
| 40.00 - 44.99 | 33,651 | 43.92 | 7.4 | 829      | 4,650  | 44.43 | 6.0 | 112    |
| 45.00 - 49.99 | 12,961 | 46.61 | 6.9 | 284      | 4,318  | 46.61 | 6.9 | 95     |
| 50.00 - 70.00 | 17,631 | 66.32 | 8.9 | 40       | —      | —     | —   | —      |
|               | 80,218 |       |     | \$ 1,649 | 24,943 |       |     | \$ 703 |

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The fair value of the options is estimated at the date of grant using a Black-Scholes option-pricing model. The following weighted average assumptions were used to estimate the fair value of options granted:

|                         |   |       |
|-------------------------|---|-------|
|                         | Three<br>months<br>ended<br>March 31,<br>2017 |       |
| Risk-free interest rate | 2.12  | %     |
| Expected dividend yield | 2.60  | %     |
| Volatility factor       | 25.80   | %     |
| Expected life of option | 7.0   | years |

## Restricted Shares

The Company records compensation expense with respect to restricted shares in an amount equal to the fair value of the common stock covered by each award on the date of grant. The restricted shares awarded become fully vested after various periods of continued employment from the respective dates of grant. The Company is entitled to an income tax deduction in an amount equal to the taxable income reported by the holders of the restricted shares when the restrictions are released and the shares are issued. Compensation is being charged to expense over the respective vesting periods.

Restricted shares are forfeited if the awardee officer or employee terminates his employment with the Company prior to the lapsing of restrictions. The Company records forfeitures of restricted stock as treasury share repurchases and any compensation cost previously recognized is reversed in the period of forfeiture. Recipients of restricted shares do not pay any cash consideration to the Company for the shares, and have the right to vote all shares subject to such grant and receive all dividends with respect to such shares, whether or not the shares have vested. For restricted shares that have performance-based criteria, management has evaluated those criteria and has determined that, as of March 31, 2018, the criteria were probable of being met.

A summary of the Company's restricted shares activity and related information is presented below:

|                          | Three months ended March 31, |                                     |                      |                                     |
|--------------------------|------------------------------|-------------------------------------|----------------------|-------------------------------------|
|                          | 2018                         |                                     | 2017                 |                                     |
|                          | Restricted<br>Awards         | Average<br>Market Price at<br>Grant | Restricted<br>Awards | Average<br>Market Price at<br>Grant |
| Outstanding at January 1 | 170,033                      | \$ 44.34                            | 180,622              | \$ 39.31                            |
| Granted                  | 23,163                       | 68.63                               | 10,609               | 66.33                               |
| Forfeited                | —                            | —                                   | (750)                | 42.05                               |
| Vested                   | (20,864)                     | 40.44                               | (18,438)             | 37.50                               |
| Outstanding at March 31  | 172,332                      | \$ 48.08                            | 172,043              | \$ 41.16                            |

Information regarding stock-based compensation associated with restricted shares is provided in the following table (in thousands):

Three  
months

|   |             |
|---|-------------|
|   | ended       |
|   | March 31,   |
|   | 2018 2017   |
| Stock-based compensation expense associated with restricted shares                        | \$379 \$355 |
|   |             |
| At period-end:  | March       |
|   | 31,         |
|   | 2018        |
| Unrecognized stock-based compensation expense associated with restricted shares           | \$4,432     |
| Weighted average period (in years) in which the above amount is expected to be recognized | 3.5         |

Shares issued in connection with restricted stock awards are issued from available treasury shares. If no treasury shares are available, new shares would be issued from available authorized shares. During the three months ended March 31, 2018 and 2017, all shares issued in connection with restricted stock awards were issued from available treasury stock.



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## Benefit Plans

The Company provides retirement benefits to its employees through the City Holding Company 401(k) Plan and Trust (the "401(k) Plan"), which is intended to be compliant with Employee Retirement Income Security Act (ERISA) section 404(c). The Company also maintains two frozen defined benefit pension plans (the "Defined Benefit Plans"), which were inherited from the Company's acquisition of the plan sponsors (Horizon Bancorp, Inc. and Community Financial Corporation). During 2017, the Company initiated the process to terminate the Community Defined Benefit plan. The Company anticipates making a \$1.6 million contribution in late 2018 or early 2019 (which has been accrued at March 31, 2018), when the termination process is expected to be completed.

The following table presents details of the Company's activities pursuant to these plans (in thousands):

|                                    | Three<br>months<br>ended<br>March 31,<br>2018 2017 |        |
|------------------------------------|--|--------|
| Components of net periodic cost:   |  |        |
| Interest cost                      | \$ 147   | \$ 193 |
| Expected return on plan assets     | (270 )   | (294 ) |
| Net amortization and deferral      | 218  | 215    |
| Net Periodic Pension Cost          | \$95   | \$ 114 |
| 401(k) Plan expense                | \$218  | \$251  |
| Defined Benefit Plan contributions | \$—  | \$—    |

The components of net periodic benefit cost are included in the line item "other expenses" in the consolidated statements of income.

## Note I -Commitments and Contingencies

The Company is a party to certain financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. The Company has entered into agreements with certain customers to extend credit or provide a conditional commitment to provide payment on drafts presented in accordance with the terms of the underlying credit documents. The Company also provides overdraft protection to certain demand deposit customers that represent an unfunded commitment. Overdraft protection commitments, which are included with other commitments below, are uncollateralized and are paid at the Company's discretion. Conditional commitments generally include standby and commercial letters of credit. Standby letters of credit represent an obligation of the Company to a designated third party contingent upon the failure of a customer of the Company to perform under the terms of the underlying contract between the customer and the third party. Commercial letters of credit are issued specifically to facilitate trade or commerce. Under the terms of a commercial letter of credit, drafts will be drawn when the underlying transaction is consummated, as intended, between the customer and a third party. The funded portion of these financial instruments is reflected in the Company's balance sheet, while the unfunded portion of these commitments is not reflected in the balance sheet. The table below presents a summary of the contractual obligations of the Company resulting from significant commitments (in thousands):

|  | March 31, | December 31, |
|--|-----------|--------------|
|  | 2018      | 2017         |

Commitments to extend credit:

|                              |            |            |
|------------------------------|------------|------------|
| Home equity lines            | \$ 196,946 | \$ 194,477 |
| Commercial real estate       | 45,832     | 66,901     |
| Other commitments            | 159,622    | 184,895    |
| Standby letters of credit    | 7,098      | 7,151      |
| Commercial letters of credit | 863        | 831        |

Loan commitments and standby and commercial letters of credit have credit risks essentially the same as those involved in extending loans to customers and are subject to the Company's standard credit policies. Collateral is obtained based on

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management's credit assessment of the customer. Management does not anticipate any material losses as a result of these commitments.

The Company is engaged in various legal actions that it deems to be in the ordinary course of business. As these legal actions are resolved, the Company could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately resolved. There can be no assurance that current legal actions will have an immaterial impact on financial results, either positive or negative, or that no material legal actions may be presented in the future.

## Note J –Accumulated Other Comprehensive Loss

The activity in accumulated other comprehensive loss is presented in the tables below (in thousands). All amounts are shown net of tax, which is calculated using a combined federal and state income tax rate approximating 23% for the three months ended March 31, 2018 and 37% for the three months ended March 31, 2017.

|   | Accumulated Other Comprehensive<br>Income (Loss) |                                  |               |
|---|--|----------------------------------|---------------|
|   | Unrealized<br>Gains (Losses) on                  |                                  |               |
|   | Defined<br>Benefit<br>Pension<br>Plans           | Securities<br>Available-for-Sale | Total         |
| Balance at December 31, 2016                        | \$ (4,660)                                       | \$ (2,352)                       | ) \$ (7,012 ) |
| Other comprehensive income before reclassifications | —  | 3,571                            | 3,571         |
| Amounts reclassified from other comprehensive loss  | —  | (2,698)                          | ) (2,698 )    |
|   | —  | 873                              | 873           |
| Balance at March 31, 2017                           | \$ (4,660)                                       | \$ (1,479)                       | ) \$ (6,139 ) |
| Balance at December 31, 2017                        | \$ (5,033)                                       | \$ (611)                         | ) \$ (5,644 ) |
| Other comprehensive loss before reclassifications   | —  | (8,218)                          | ) (8,218 )    |
| Amounts reclassified from other comprehensive loss  | —  | —                                | —             |
|   | —  | (8,218)                          | ) (8,218 )    |
| Adoption of new accounting pronouncement            | —  | (2,657)                          | ) (2,657 )    |
| Balance at March 31, 2018                           | \$ (5,033)                                       | \$ (11,486)                      | ) \$ (16,519) |

As a result of the adoption of ASU 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," the Company reclassified \$2.7 million of unrealized gains and losses net of tax, relating to its equity and perpetual preferred securities, from other comprehensive income to retained earnings on January 1, 2018.

Amount  
reclassified  
from Other

Comprehensive  
Loss  
Three months  
ended  
March 31,  
2017 Affected line item  
in the Statements  
of Income

Securities available-for-sale:

|   |               |                         |
|---|---------------|-------------------------|
| Net unrealized securities gains (losses) reclassified into earnings | \$ \$(4,276 ) | Security gains (losses) |
| Related income tax expense  | —1,578        | Income tax expense      |
| Net effect on accumulated other comprehensive loss                  | \$ \$(2,698 ) |                         |

Note K –Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share using the two class method (in thousands, except per share data):

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|  | Three months<br>ended March 31, |          |
|--|---------------------------------|----------|
|  | 2018                            | 2017     |
| Net income available to common shareholders          | \$17,616                        | \$16,026 |
| Less: earnings allocated to participating securities | (195 )                          | (177 )   |
| Net earnings allocated to common shareholders        | \$17,421                        | \$15,849 |
| Distributed earnings allocated to common stock       | \$7,023                         | \$6,782  |
| Undistributed earnings allocated to common stock     | 10,398                          | 9,067    |
| Net earnings allocated to common shareholders        | \$17,421                        | \$15,849 |
| Average shares outstanding                           | 15,414                          | 15,252   |
| Effect of dilutive securities:                       |                                 |          |
| Employee stock awards                                | 22                              | 25       |
| Shares for diluted earnings per share                | 15,436                          | 15,277   |
| Basic earnings per share                             | \$1.13                          | \$1.04   |
| Diluted earnings per share                           | \$1.13                          | \$1.04   |

Options to purchase approximately 2,000 shares and 1,000 shares of common stock were outstanding during the three months ended March 31, 2018 and 2017, respectively, but were not included in the computation of diluted earnings per share because the effect would have been anti-dilutive.

## Note L –Fair Value Measurements

Fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

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

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

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

The Company bases fair value of assets and liabilities on quoted market prices, prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data. If such information is not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management

believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amount presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Financial Assets and Liabilities

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The Company used the following methods and significant assumptions to estimate fair value for financial assets and liabilities measured on a recurring basis.

**Securities Available for Sale.** Securities available for sale are reported at fair value utilizing Level 1, Level 2, and Level 3 inputs. The fair value of securities available for sale is determined by utilizing a market approach by obtaining quoted prices on nationally recognized securities exchanges (other than forced or distressed transactions) that occur in sufficient volume or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. If such measurements are unavailable, the security is classified as Level 3. Significant judgment is required to make this determination.

The Company utilizes a third party pricing service provider to value its Level 1 and Level 2 investment securities. Annually, the Company obtains an independent auditor's report from its third party pricing service provider regarding its controls over investment securities. Although no control deficiencies were noted, the report did contain caveats and disclaimers regarding the pricing information, such as the Company should review fair values for reasonableness. On a quarterly basis, the Company selects a sample of its debt securities and reprices those securities with a third party that is independent of the primary pricing service provider to verify the reasonableness of the fair values. In addition, the Company selects a sample of securities and reviews the underlying support from the primary pricing service provider.

**Derivatives.** Derivatives are reported at fair value utilizing Level 2 inputs. The Company utilizes a market approach by obtaining dealer quotations to value its customer interest rate swaps. The Company's derivatives are included within its Other Assets and Other Liabilities in the accompanying consolidated balance sheets. Derivative assets are typically secured through securities with financial counterparties or cross collateralization with a borrowing customer. Derivative liabilities are typically secured through the Company pledging securities to financial counterparties or, in the case of a borrowing customer, by the right of setoff. The Company considers factors such as the likelihood of default by itself and its counterparties, right of setoff, and remaining maturities in determining the appropriate fair value adjustments. All derivative counterparties approved by the Company's Asset and Liability Committee ("ALCO") are regularly reviewed, and appropriate business action is taken to adjust the exposure to certain counterparties, if necessary. Counterparty exposure is evaluated by netting positions that are subject to master netting agreements, as well as considering the amount of marketable collateral securing the position. This approach used to estimate impacted exposures to counterparties is also used by the Company to estimate its own credit risk in derivative liability positions. To date, no material losses have been incurred due to a counterparty's inability to pay any undercollateralized position. There was no significant change in the value of derivative assets and liabilities attributed to credit risk that would have resulted in a derivative credit risk valuation adjustment at March 31, 2018.

The Company may be required, from time to time, to measure certain financial assets and financial liabilities at fair value on a nonrecurring basis. Financial assets measured at fair value on a nonrecurring basis include impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data for real estate collateral or Level 3 inputs for non-real estate collateral. The following table presents assets and liabilities measured at fair value (in thousands):

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|  | Total    | Level<br>1 | Level 2 | Level<br>3 | Total<br>Gains<br>(Losses) |
|--|----------|------------|---------|------------|----------------------------|
| March 31, 2018                                   |          |            |         |            |                            |
| Recurring fair value measurements                |          |            |         |            |                            |
| Financial Assets                                 |          |            |         |            |                            |
| U.S. Government agencies                         | \$ 1     | \$         | —       | \$ 1       | \$—                        |
| Obligations of states and political subdivisions | 94,173   | —          | 94,173  | —          |                            |
| Mortgage-backed securities:                      |          |            |         |            |                            |
| U.S. Government agencies                         | 427,394  | —          | 427,394 | —          |                            |
| Private label                                    | 602      | —          | 602     | —          |                            |
| Trust preferred securities                       | 4,793    | —          | 4,532   | 261        |                            |
| Corporate securities                             | 17,200   | —          | 17,200  | —          |                            |
| Marketable equity securities                     | 10,584   | 10,584     | —       | —          |                            |
| Investment funds                                 | 1,465    | 1,465      | —       | —          |                            |
| Derivative assets                                | 21,752   | —          | 21,752  | —          |                            |
| Financial Liabilities                            |          |            |         |            |                            |
| Derivative liabilities                           | 21,491   | —          | 21,491  | —          |                            |
| Nonrecurring fair value measurements             |          |            |         |            |                            |
| Financial Assets                                 |          |            |         |            |                            |
| Impaired loans                                   | \$ 9,434 | \$         | —       | \$ 9,434   | \$ (172 )                  |
| Non-Financial Assets                             |          |            |         |            |                            |
| Other real estate owned                          | 3,912    | —          | —       | 3,912      | (225 )                     |
| December 31, 2017                                |          |            |         |            |                            |
| Recurring fair value measurements                |          |            |         |            |                            |
| Financial Assets                                 |          |            |         |            |                            |
| U.S. Government agencies                         | \$ 2     | \$         | —       | \$ 2       | \$—                        |
| Obligations of states and political subdivisions | 96,196   | —          | 96,196  | —          |                            |
| Mortgage-backed securities:                      |          |            |         |            |                            |
| U.S. Government agencies                         | 419,347  | —          | 419,347 | —          |                            |
| Private label                                    | 652      | —          | 652     | —          |                            |
| Trust preferred securities                       | 4,736    | —          | 4,475   | 261        |                            |
| Corporate securities                             | 22,268   | —          | 22,268  | —          |                            |
| Marketable equity securities                     | 5,699    | 5,699      | —       | —          |                            |
| Investment funds                                 | 1,489    | 1,489      | —       | —          |                            |
| Derivative assets                                | 14,502   | —          | 14,502  | —          |                            |
| Financial Liabilities                            |          |            |         |            |                            |
| Derivative liabilities                           | 14,390   | —          | 14,390  | —          |                            |
| Nonrecurring fair value measurements             |          |            |         |            |                            |
| Financial Assets                                 |          |            |         |            |                            |
| Impaired loans                                   | \$ 9,020 | \$         | —       | \$ 9,020   | \$ (647 )                  |
| Non-Financial Assets                             |          |            |         |            |                            |
| Other real estate owned                          | 3,585    | —          | —       | 3,585      | (374 )                     |
| Other assets                                     | —        | —          | —       | —          | (170 )                     |



The table below presents a reconciliation of the Company's financial assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3), which consist solely of trust preferred securities (in thousands):

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|  | Three months<br>ended March<br>31,<br>2018 2017 |          |
|--|---|----------|
| Beginning balance                      | \$261   | \$2,535  |
| Included in other comprehensive income | —   | (977 )   |
| Dispositions                           | —   | (1,300 ) |
| Transfers into Level 3                 | —   | —        |
| Ending balance                         | \$261   | \$258    |

The Company utilizes a third party model to compute the present value of expected cash flows which considers the structure and term of pooled trust preferred securities and the financial condition of the underlying issuers. Specifically, the third party model details interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. For issuing banks that have defaulted, management generally assumes no recovery. For issuing banks that have deferred interest payments, management excludes the collateral balance associated with these banks and assumes no recoveries of such collateral balance in the future. The exclusion of such issuing banks in a current deferral position is based on such bank experiencing a certain level of financial difficulty that raises doubt about its ability to satisfy its contractual debt obligation, and accordingly, the Company excludes the associated collateral balance from its estimate of expected cash flows. Other assumptions used in the estimate of expected cash flows include expected future default rates and prepayments.

The table below presents a reconciliation of the Company's financial assets and liabilities measured at fair value on a nonrecurring basis using significant unobservable inputs (Level 3), which solely relates to impaired loans that were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral (in thousands). The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows. The significant unobservable inputs used in the fair value measurement of collateral for collateral-dependent impaired loans primarily relate to discounts applied to the customers' reported amount of collateral. The amount of collateral discount depends upon the marketability of the underlying collateral. During the three months ended March 31, 2018 and 2017, collateral discounts ranged from 20% to 30%. During the three months ended March 31, 2018 and 2017, the Company had no Level 2 financial assets and liabilities that were measured on a nonrecurring basis.

|  | Three months ended March 31, |          |
|--|------------------------------|----------|
|  | 2018                         | 2017     |
| Beginning balance  | \$ 9,020                     | \$ 6,916 |
| Loans classified as impaired during the period                                       | —                            | 3,015    |
| Specific valuation allowance allocations   | —                            | —        |
| Loans classified as impaired during the period, net of specific valuation allowances | —                            | 3,015    |

|  |      |       |      |       |
|--|------|-------|------|-------|
| (Additional) reduction<br>in specific valuation<br>allowance allocations | (474 | )     | (29  | )     |
| Paydowns, payoffs,<br>other activity                                     | 888  |       | (301 | )     |
| Ending balance   | \$   | 9,434 | \$   | 9,601 |

Non-Financial Assets and Liabilities

The Company has no non-financial assets or liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include other real estate owned (“OREO”), which is measured at the lower of cost or fair value, and goodwill and other intangible assets, which are measured at fair value for impairment assessments. The table below presents OREO that was remeasured and reported at fair value based on significant unobservable inputs (Level 3) (in thousands):

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|  | Three months<br>ended March<br>31,<br>2018    2017 |         |
|--|--|---------|
| Beginning balance  | \$3,585  | \$4,588 |
| OREO remeasured at initial recognition:                    |  |         |
| Carrying value of foreclosed assets prior to remeasurement | 1,218  | 1,226   |
| Charge-offs recognized in the allowance for loan losses    | (353)  | (442)   |
| Fair value   | 865  | 784     |
| OREO remeasured subsequent to initial recognition:         |  |         |
| Carrying value of foreclosed assets prior to remeasurement | 1,362  | 1,464   |
| Fair value   | 1,137  | 1,273   |
| Write-downs included in other non-interest expense         | (225)  | (191)   |
| Disposed   | (313)  | (776)   |
| Ending balance   | \$3,912  | \$4,405 |

ASC Topic 825 “Financial Instruments”, as amended, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including discount rates and estimate of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. ASC Topic 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The following methods and assumptions were used in estimating fair value for financial instruments:

**Cash and cash equivalents:** Due to their short-term nature, the carrying amounts reported in the consolidated balance sheets approximate fair value.

**Securities:** The fair value of securities, both available-for-sale and held-to-maturity, are generally based on quoted market prices or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities’ relationship to other benchmark quoted securities.

**Net loans:** The fair value of the loan portfolio is estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made to borrowers for the same remaining maturities, the credit risk associated with such loans and other market factors, including liquidity. Loans were first segregated by type such as commercial, real estate and consumer, and were then further segmented into fixed, adjustable and variable rate categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

**Deposits:** The fair values of demand deposits (i.e., interest and noninterest-bearing deposits, regular savings and other money market demand accounts) are, by definition, equal to their carrying values. The fair values of time deposits

were estimated using discounted cash flow analyses. The discount rates used were based on rates currently offered for deposits with similar remaining maturities. The fair values of the time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

Short-term debt: Securities sold under agreements to repurchase represent borrowings with original maturities of less than 90 days. The carrying amount of borrowings under purchase agreements approximate their fair value.

Long-term debt: The fair value of long-term borrowings is estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements and market conditions of similar debt instruments.

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Commitments and letters of credit: The fair values of commitments are estimated based on fees currently charged to enter into similar agreements, taking into consideration the remaining terms of the agreements and the counterparties' credit standing. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. The amounts of fees currently charged on commitments and letters of credit are deemed insignificant, and therefore, the estimated fair values and carrying values have not been reflected in the table below.

The following table represents the estimates of fair value of financial instruments (in thousands). This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as noninterest-bearing demand, interest-bearing demand and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

|                               | Carrying<br>Amount | Fair<br>Value | Level 1    | Level 2   | Level 3   |
|-------------------------------|--------------------|---------------|------------|-----------|-----------|
| March 31, 2018                |                    |               |            |           |           |
| Assets:                       |                    |               |            |           |           |
| Cash and cash equivalents     | \$ 123,778         | \$ 123,778    | \$ 123,778 | \$ —      | —         |
| Securities available-for-sale | 545,628            | 545,628       | 1,465      | 543,902   | 261       |
| Securities held-to-maturity   | 62,277             | 62,146        | —          | 62,146    | —         |
| Other securities              | 22,165             | 22,165        | 10,584     | 11,581    | —         |
| Net loans                     | 3,119,300          | 3,076,380     | —          | —         | 3,076,380 |
| Accrued interest receivable   | 9,528              | 9,528         | 9,528      | —         | —         |
| Derivative assets             | 21,752             | 21,752        | —          | 21,752    | —         |
| Liabilities:                  |                    |               |            |           |           |
| Deposits                      | 3,446,962          | 3,437,168     | 2,336,430  | 1,100,738 | —         |
| Short-term debt               | 195,375            | 195,375       | —          | 195,375   | —         |
| Long-term debt                | 16,495             | 16,432        | —          | 16,432    | —         |
| Derivative liabilities        | 21,491             | 21,491        | —          | 21,491    | —         |
| December 31, 2017             |                    |               |            |           |           |
| Assets:                       |                    |               |            |           |           |
| Cash and cash equivalents     | 82,508             | 82,508        | 82,508     | —         | —         |
| Securities available-for-sale | 550,389            | 550,389       | 7,188      | 542,940   | 261       |
| Securities held-to-maturity   | 64,449             | 65,646        | —          | 65,646    | —         |
| Other securities              | 14,147             | 14,147        | —          | 14,147    | —         |
| Net loans                     | 3,108,574          | 3,014,425     | —          | —         | 3,014,425 |
| Accrued interest receivable   | 9,223              | 9,223         | 9,223      | —         | —         |
| Derivative assets             | 14,502             | 14,502        | —          | 14,502    | —         |
| Liabilities:                  |                    |               |            |           |           |
| Deposits                      | 3,315,634          | 3,309,910     | 2,232,159  | 1,077,751 | —         |
| Short-term debt               | 252,219            | 252,219       | —          | 252,219   | —         |
| Long-term debt                | 16,495             | 16,444        | —          | 16,444    | —         |
| Derivative liabilities        | 14,390             | 14,390        | —          | 14,390    | —         |



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## Note M –Contracts with Customers

The Company's largest source of revenue is comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASC Topic 606, Revenue from Contracts with Customers ("ASC 606"), and non-interest income. The Company's significant sources of non-interest income are: service charges, bankcard revenue, trust and investment management fee income and bank owned life insurance (which was also excluded from the ASC 606).

The following table shows the Company's total non-interest income segregated between those within the scope of ASC 606 and those with the scope of other GAAP Topics (in thousands):

|   | Three<br>months<br>ended<br>March<br>31,<br>2018 |
|---|--|
| Non-interest income                                       |  |
| Non-interest income from contracts with customers         | \$ 13,465  |
| Non-interest income within the scope of other GAAP topics | 1,027  |
| Total non-interest income                                 | \$ 14,492  |

The Company's significant policies related to contracts with customers are discussed below.

**Service Charges:** Service charges consist of service charges on deposit accounts (monthly service fees, account analysis fees, non-sufficient funds ("NSF") fees and other deposit account related fees). For transaction based fees, the Company's performance obligation is generally satisfied, and the related revenue recognized, at a point in time. For nontransaction based fees, the Company's performance obligation is generally satisfied, and the related revenue recognized, over the period in which the service is provided (typically a month). Generally, payments are received immediately through a direct charge to the customer's account.

**Bankcard Revenue:** Bankcard revenue is primarily comprised of debit card income and ATM fees. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit cards are processed through card payment networks such as Mastercard. ATM fees are primarily generated when a non-Company cardholder uses a Company ATM or when a Company cardholder uses a non-Company ATM. The Company's performance obligation for bankcard revenue is generally satisfied, and the related revenue recognized, when the services are rendered. Generally, payments are received immediately or in the following month.

**Trust and Investment Management Fee Income:** Trust and investment management fee income is primarily comprised of fees earned from the management and administration of customer assets. The Company's performance obligation is generally satisfied over time (typically a quarter), and the related revenue recognized, based upon the quarter-end market value of the assets under management and the applicable fee rate. Generally, payments are received a few days after quarter-end through a direct charge to the customer's account.

The following table illustrates the disaggregation by the Company's major revenue streams (in thousands):

| Point of Revenue | Three<br>months<br>ended |
|------------------|--------------------------|
|------------------|--------------------------|



|   | Recognition                    | March<br>31,<br>2018 |
|---|--------------------------------|----------------------|
| Major revenue streams                                     |                                |                      |
| Service charges   | At a point in time & over time | \$6,862              |
| Bankcard revenue  | At a point in time             | 4,334                |
| Trust and investment management fee income                | Over time                      | 1,568                |
| Other income  | At a point in time & over time | 701                  |
| Net revenue from contracts with customers                 |                                | 13,465               |
| Non-interest income within the scope of other GAAP topics |                                | 1,027                |
| Total non-interest income                                 |                                | \$14,492             |

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

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## Critical Accounting Policies

The accounting policies of the Company conform with U.S. generally accepted accounting principles and require management to make estimates and develop assumptions that affect the amounts reported in the financial statements and related footnotes. These estimates and assumptions are based on information available to management as of the date of the financial statements. Actual results could differ significantly from management's estimates. As this information changes, management's estimates and assumptions used to prepare the Company's financial statements and related disclosures may also change. The most significant accounting policies followed by the Company are presented in Note One to the audited financial statements included in the Company's 2017 Annual Report to Shareholders. The information included in this Quarterly Report on Form 10-Q, including the Consolidated Financial Statements, Notes to Consolidated Financial Statements, and Management's Discussion and Analysis of Financial Condition and Results of Operations, should be read in conjunction with the financial statements and notes thereto included in the 2017 Annual Report of the Company. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses and income taxes to be the accounting areas that require the most subjective or complex judgments and, as such, could be most subject to revision as new information becomes available.

The section Allowance and Provision for Loan Losses provides management's analysis of the Company's allowance for loan losses and related provision. The allowance for loan losses is maintained at a level that represents management's best reasonable estimate of probable losses in the loan portfolio. Management's determination of the adequacy of the allowance for loan losses is based upon an evaluation of individual credits in the loan portfolio, historical loan loss experience, current economic conditions, and other relevant factors. This determination is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The allowance for loan losses related to loans considered to be impaired is generally evaluated based on the discounted cash flows using the impaired loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans.

The Company is subject to federal and state income taxes in the jurisdictions in which it conducts business. In computing the provision for income taxes, management must make judgments regarding interpretation of laws in those jurisdictions. Because the application of tax laws and regulations for many types of transactions is susceptible to varying interpretations, amounts reported in the financial statements could be changed at a later date upon final determinations by taxing authorities. On a quarterly basis, the Company estimates its annual effective tax rate for the year and uses that rate to provide for income taxes on a year-to-date basis. The amount of unrecognized tax benefits could change over the next twelve months as a result of various factors. However, management cannot currently estimate the range of possible change. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2014 through 2016 and various state taxing authorities.

## Financial Summary

Three months ended March 31, 2018 vs. 2017

The Company's financial performance is summarized in the following table:

|  | Three months ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2018                            | 2017     |
| Net income available to common shareholders (in thousands) | \$17,616                        | \$16,026 |

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|  |        |        |   |
|--|--------|--------|---|
| Earnings per common share, basic       | \$1.13 | \$1.04 |   |
| Earnings per common share, diluted     | \$1.13 | \$1.04 |   |
| Dividend payout ratio                  | 40.8   | %42.4  | % |
| ROA*                                   | 1.69   | %1.60  | % |
| ROE*                                   | 14.0   | %13.7  | % |
| Average equity to average assets ratio | 12.0   | %11.7  | % |

\*ROA (Return on Average Assets) is a measure of the effectiveness of asset utilization. ROE (Return on Average Equity) is a measure of the return on shareholders' investment.

The Company's net interest income for the three months ended March 31, 2018 increased \$2.2 million compared to the three months ended March 31, 2017 (see Net Interest Income). The Company recorded a provision for loan losses of \$0.2 million

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for the three months ended March 31, 2018 compared to \$0.7 million for the three months ended March 31, 2017 (see Allowance and Provision for Loan Losses). As further discussed under the caption Non-Interest Income and Non-Interest Expense, non-interest income decreased \$4.0 million and non-interest expense increased \$0.3 million for the three months ended March 31, 2018 from the three months ended March 31, 2017.

## Balance Sheet Analysis

Selected balance sheet fluctuations from the year ended December 31, 2017 are summarized in the following table (in millions):

|                           | March<br>31,<br>2018 | December<br>31,<br>2017 | \$<br>Change | %<br>Change |   |
|---------------------------|----------------------|-------------------------|--------------|-------------|---|
| Cash and cash equivalents | \$ 123.8             | \$ 82.5                 | \$ 41.3      | 50.1        | % |
| Gross loans               | 3,137.7              | 3,127.4                 | 10.3         | 0.3         | % |
| Other assets              | 47.4                 | 36.4                    | 11.0         | 30.2        | % |
| Total deposits            | 3,447.0              | 3,315.6                 | 131.4        | 4.0         | % |
| Federal Funds purchased   | —                    | 54.0                    | (54.0)       | (100.0)     | % |
| Shareholders' Equity      | 491.9                | 502.5                   | (10.6)       | (2.1)       | % |

Cash and cash equivalents increased \$41.3 million from December 31, 2017 to \$123.8 million at March 31, 2018 primarily due to an increase in cash on-hand (see Consolidated Statements of Cash Flows).

Gross loans increased \$10.3 million (0.3%) from December 31, 2017 to \$3.14 billion at March 31, 2018, primarily due to an increase in commercial real estate loans of \$18.7 million (1.5%). This increase was partially offset by decreases in commercial and industrial loans (\$3.9 million), residential real estate loans (\$3.1 million) and home equity loans (\$1.0 million).

Other assets increased \$11.0 million (30.2%) from December 31, 2017 to \$47.4 million at March 31, 2018 primarily due to an increase in the loan swap asset of \$7.25 million due primarily to increases in the fair value of loan swap contracts.

Total deposits increased \$131.4 million from December 31, 2017 to \$3.45 billion at March 31, 2018 due to growth in demand deposits of \$47.7 million, non-interest bearing deposits of \$36.6 million, time deposits of \$27.1 million, and savings deposits of \$20.0 million during the quarter ended March 31, 2018.

Federal Funds purchased decreased \$54.0 million from December 31, 2017, as the Company's deposit growth outpaced the Company's loan and securities growth.

Shareholders' equity decreased \$10.6 million due to the repurchase of 204,000 common shares at a weighted average price of \$68.50 per share (\$14.0 million) as part of a one million share repurchase plan authorized by the Board of Directors in September 2014, an increase in other comprehensive loss of \$8.2 million due to a decrease in the fair value of available for sale securities, and cash dividends declared of \$7.1 million. These decreases in stockholders equity were partially offset by net income of \$17.6 million and an increase due to stock based compensation of \$1.1

million.

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Net Interest Income

Three months ended March 31, 2018 vs. 2017

The Company's net interest income increased from \$32.4 million during the fourth quarter of 2017 to \$32.6 million during the first quarter of 2018. \$2.0 million, or 6.6%, from \$30.8 million for the three months ended March 31, 2017 to \$32.8 million for the three months ended March 31, 2018. The Company's tax equivalent net interest income increased \$2.0 million, or 6.6%, from \$30.8 million for the three months ended March 31, 2017 to \$32.8 million for the three months ended March 31, 2018. The increase was primarily due to higher interest rates on commercial loans which increased income by \$1.4 million, higher interest rates on residential real estate loans which increased income \$0.9 million, and higher average balances on commercial loans which increased income by \$0.6 million as compared to the three months ended March 31, 2017. In addition, higher average investment balances increased investment income by \$0.7 million. These increases were partially offset by increased interest expense on interest bearing accounts (\$1.2 million), primarily due to an increase in the cost of funds, and decreased interest yields on investments (\$0.3 million). The Company's reported net interest margin increased from 3.45% for the three months ended March 31, 2017 to 3.51% for the three months ended March 31, 2018. Excluding the favorable impact of accretion, the net interest margin for the three months ended March 31, 2018 and 2017 would have been 3.48% and 3.42%, respectively.

Table One

Average Balance Sheets and Net Interest Income  
(in thousands)

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| Assets  | Three months ended March 31, |          |                |                    |          |                |
|---|------------------------------|----------|----------------|--------------------|----------|----------------|
|   | 2018                         |          |                | 2017               |          |                |
|   | Average<br>Balance           | Interest | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate |
| Loan portfolio <sup>(1)</sup> :                       |                              |          |                |                    |          |                |
| Residential real estate <sup>(2)</sup>                | \$1,603,911                  | \$16,479 | 4.17%          | \$1,591,254        | \$15,479 | 3.95%          |
| Commercial, financial, and agriculture <sup>(2)</sup> | 1,496,817                    | 15,608   | 4.23           | 1,429,075          | 13,584   | 3.85           |
| Installment loans to individuals <sup>(2),(3)</sup>   | 33,076                       | 504      | 6.18           | 35,650             | 595      | 6.77           |
| Previously securitized loans <sup>(4)</sup>           | ***                          | 327      | ***            | ***                | 447      | ***            |
| Total loans   | 3,133,804                    | 32,918   | 4.26           | 3,055,979          | 30,105   | 4.00           |
| Securities:   |                              |          |                |                    |          |                |
| Taxable   | 536,714                      | 3,981    | 3.01           | 458,295            | 3,444    | 3.05           |
| Tax-exempt <sup>(5)</sup>                             | 91,722                       | 890      | 3.94           | 84,784             | 1,019    | 4.87           |
| Total securities                                      | 628,436                      | 4,871    | 3.14           | 543,079            | 4,463    | 3.33           |
| Deposits in depository institutions                   | 29,648                       | 42       | 0.57           | 16,826             | 3        | 0.07           |
| Total interest-earning assets                         | 3,791,888                    | 37,831   | 4.05           | 3,615,884          | 34,571   | 3.88           |
| Cash and due from banks                               | 71,480                       |          |                | 81,629             |          |                |
| Bank premises and equipment                           | 72,716                       |          |                | 74,768             |          |                |
| Other assets  | 245,721                      |          |                | 253,378            |          |                |
| Less: allowance for loan losses                       | (19,420 )                    |          |                | (20,150 )          |          |                |
| Total assets  | \$4,162,385                  |          |                | \$4,005,509        |          |                |
| Liabilities   |                              |          |                |                    |          |                |
| Interest-bearing demand deposits                      | \$782,499                    | \$357    | 0.19%          | \$708,434          | \$157    | 0.09%          |
| Savings deposits                                      | 801,504                      | 341      | 0.17           | 831,639            | 324      | 0.16           |
| Time deposits <sup>(2)</sup>                          | 1,096,157                    | 3,628    | 1.34           | 1,052,218          | 2,948    | 1.14           |
| Short-term borrowings                                 | 236,605                      | 460      | 0.79           | 195,626            | 157      | 0.33           |
| Long-term debt  | 16,495                       | 211      | 5.19           | 16,495             | 181      | 4.45           |
| Total interest-bearing liabilities                    | 2,933,260                    | 4,997    | 0.69           | 2,804,412          | 3,767    | 0.54           |
| Noninterest-bearing demand deposits                   | 681,150                      |          |                | 690,243            |          |                |
| Other liabilities                                     | 46,426                       |          |                | 43,655             |          |                |
| Stockholders' equity                                  | 501,549                      |          |                | 467,199            |          |                |
| Total liabilities and stockholders' equity            | \$4,162,385                  |          |                | \$4,005,509        |          |                |
| Net interest income                                   |                              | \$32,834 |                |                    | \$30,804 |                |
| Net yield on earning assets                           |                              |          | 3.51%          |                    |          | 3.45%          |

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For purposes of this table, non-accruing loans have  
 (1) been included in average balances and loan fees,  
 which are immaterial, have been included in  
 interest income.

Included in the above table are the following  
 amounts for the accretion of the fair value  
 (2) adjustments related to the acquisitions of Virginia  
 Savings Bancorp, Inc., Community Financial  
 Corporation and American Founders Bank, Inc.:

|                                       | Three<br>months<br>ended<br>March 31,<br>2018 2017 |       |
|---------------------------------------|--|-------|
| Residential real estate               | \$110  | \$138 |
| Commercial, financial and agriculture | 150  | 175   |
| Installment loans to individuals      | 10   | 9     |
| Time deposits                         | —  | 16    |
|                                       | \$270  | \$338 |

(3) Includes the Company's consumer and DDA  
 overdrafts loan categories.  
 Effective January 1, 2012, the carrying value of the  
 (4) Company's previously securitized loans was  
 reduced to \$0.  
 Computed on a fully federal tax-equivalent basis  
 assuming a tax rate of approximately 21% for the  
 (5) period ending March 31, 2018 and 35% for the  
 periods ending December 31, 2017 and March 31,  
 2017.

Table Two  
 Rate/Volume Analysis of Changes in Interest Income and Interest Expense  
 (in thousands)

|  | Three months ended<br>March 31, 2018 vs. 2017<br>Increase (Decrease) |       |         |
|--|--|-------|---------|
| Interest-earning assets:               | Due to Change In:  |       |         |
|  | Volume   | Rate  | Net     |
| Loan portfolio                         |  |       |         |
| Residential real estate                | \$123  | \$877 | \$1,000 |
| Commercial, financial, and agriculture | 644  | 1,380 | 2,024   |
| Installment loans to individuals       | (43)   | (48)  | (91)    |
| Previously securitized loans           | —  | (120) | (120)   |
| Total loans                            | 724  | 2,089 | 2,813   |
| Securities:                            |  |       |         |
| Taxable                                | 589  | (52)  | 537     |



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|                                     |         |         |         |
|-------------------------------------|---------|---------|---------|
| Tax-exempt <sup>(1)</sup>           | 83      | (212 )  | (129 )  |
| Total securities                    | 672     | (264 )  | 408     |
| Deposits in depository institutions | 2       | 37      | 39      |
| Total interest-earning assets       | \$1,398 | \$1,862 | \$3,260 |
| Interest-bearing liabilities:       |         |         |         |
| Interest-bearing demand deposits    | \$16    | \$184   | \$200   |
| Savings deposits                    | (12 )   | 29      | 17      |
| Time deposits                       | 123     | 557     | 680     |
| Short-term borrowings               | 33      | 270     | 303     |
| Long-term debt                      | —       | 30      | 30      |
| Total interest-bearing liabilities  | \$160   | \$1,070 | \$1,230 |
| Net Interest Income                 | \$1,238 | \$792   | \$2,030 |

(1) Fully federal taxable equivalent using a tax rate of approximately 21%.

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## Table Three

## Non-GAAP Financial Measures

Management of the Company uses measures in its analysis of the Company's performance other than those in accordance with generally accepted accounting principals in the United States of America ("GAAP"). These measures are useful when evaluating the underlying performance of the Company's operations. The Company's management believes that these non-GAAP measures enhance comparability of results with prior periods and demonstrate the effects of significant gains and charges in the current period. The Company's management believes that investors may use these non-GAAP financial measures to evaluate the Company's financial performance without the impact of those items that may obscure trends in the Company's performance. These disclosures should not be viewed as a substitute for financial measures determined in accordance with GAAP, nor are they comparable to non-GAAP financial measures that may be presented by other companies. The following table reconciles fully taxable equivalent net interest income and fully taxable equivalent net interest income excluding accretion with net interest income as derived from the Company's financial statements (in thousands):

|   | Three months ended March |             |    |
|---|--------------------------|-------------|----|
|   | 31,                      | 2017        |    |
|   | 2018                     |             |    |
| Net interest income (GAAP)                    | \$32,647                 | \$30,447    |    |
| Taxable equivalent adjustment                 | 187                      | 357         |    |
| Net interest income, fully taxable equivalent | \$32,834                 | \$30,804    |    |
| <br>  |                          |             |    |
| Average interest earning assets               | \$3,791,888              | \$3,615,884 |    |
| <br>  |                          |             |    |
| Net interest margin                           | 3.51                     | % 3.45      | %  |
| Accretion related to fair value adjustments   | (0.03)                   | )(0.03      | )% |
| Net interest margin (excluding accretion)     | 3.48                     | % 3.42      | %  |
| <br>  |                          |             |    |
| ROATCE*                                       | 16.7                     | % 16.5      | %  |

\*ROATCE (Return on Average Tangible Common Equity) is a measure of the return on shareholders' equity, less intangible assets.

## Loans

## Table Four

## Loan Portfolio

The composition of the Company's loan portfolio as of the dates indicated follows (in thousands):

|                           | March 31,   | December    | March 31,   |
|---------------------------|-------------|-------------|-------------|
|                           | 2018        | 31, 2017    | 2017        |
| Residential real estate   | \$1,465,215 | \$1,468,278 | \$1,444,795 |
| Home equity               | 138,477     | 139,499     | 139,165     |
| Commercial and industrial | 204,592     | 208,484     | 205,011     |
| Commercial real estate    | 1,296,304   | 1,277,576   | 1,250,106   |
| Consumer                  | 29,570      | 29,162      | 32,043      |
| DDA overdrafts            | 3,523       | 4,411       | 3,053       |
| Total loans               | \$3,137,681 | \$3,127,410 | \$3,074,173 |

Loan balances increased \$10.3 million from December 31, 2017 to March 31, 2018.

Residential real estate loans decreased \$3.1 million from December 31, 2017 to March 31, 2018. Residential real estate loans represent loans to consumers that are secured by a first lien on residential property. Residential real estate loans provide for the purchase or refinance of a residence and first-lien home equity loans allow consumers to borrow against the equity in their home. These loans primarily consist of single family 3 and 5 year adjustable rate mortgages with terms that amortize up to 30 years. The Company also offers fixed-rate residential real estate loans that are sold in the secondary market that are not included on the Company's balance sheet; the Company does not retain the servicing rights to these loans. Residential mortgage loans are generally underwritten to comply with Fannie Mae guidelines, while the home equity loans are underwritten with typically less documentation, but with lower loan-to-value ratios and shorter maturities. At March 31, 2018, \$26.6 million of the residential real estate loans were for properties under construction.

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Home equity loans decreased \$1.0 million during the first three months of 2018. The Company's home equity loans represent loans to consumers that are secured by a second (or junior) lien on a residential property. Home equity loans allow consumers to borrow against the equity in their home without paying off an existing first lien. These loans consist of home equity lines of credit ("HELOC") and amortized home equity loans that require monthly installment payments. Home equity loans are underwritten with less documentation, lower loan-to-value ratios and for shorter terms. The amount of credit extended is directly related to the value of the real estate at the time the loan is made.

The commercial and industrial ("C&I") loan portfolio consists of loans to corporate borrowers that are primarily in small to mid-size industrial and commercial companies. Collateral securing these loans includes equipment, machinery, inventory, receivables and vehicles. C&I loans are considered to contain a higher level of risk than other loan types, although care is taken to minimize these risks. Numerous risk factors impact this portfolio, including industry specific risks such as the economy, new technology, labor rates and cyclical, as well as customer specific factors, such as cash flow, financial structure, operating controls and asset quality. C&I loans decreased \$3.9 million from December 31, 2017 to March 31, 2018.

Commercial real estate loans consist of commercial mortgages, which generally are secured by nonresidential and multi-family residential properties, including hotel/motel and apartment lending. Commercial real estate loans are to many of the same customers and carry similar industry risks as C&I loans. Commercial real estate loans increased \$18.7 million from December 31, 2017 to March 31, 2018. At March 31, 2018, \$30.9 million of the commercial real estate loans were for commercial properties under construction.

Consumer loans may be secured by automobiles, boats, recreational vehicles and other personal property. The Company monitors the risk associated with these types of loans by monitoring such factors as portfolio growth, lending policies and economic conditions. Underwriting standards are continually evaluated and modified based upon these factors. Consumer loans increased \$0.4 million during the first three months of 2018.

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### Allowance and Provision for Loan Losses

Management systematically monitors the loan portfolio and the appropriateness of the allowance for loan losses (“ALLL”) on a quarterly basis to provide for probable losses incurred in the portfolio. Management assesses the risk in each loan type based on historical delinquency and loss trends, the general economic environment of its local markets, individual loan performance, and other relevant factors. Individual credits in excess of \$1 million are selected at least annually for detailed loan reviews, which are utilized by management to assess the risk in the portfolio and the appropriateness of the allowance. Due to the nature of commercial lending, evaluation of the appropriateness of the allowance as it relates to these loan types is often based more upon specific credit review, with consideration given to the potential impairment of certain credits and historical loss rates, adjusted for general economic conditions and other inherent risk factors. Conversely, due to the homogeneous nature of the real estate and installment portfolios, the portions of the allowance allocated to those portfolios are primarily based on prior loss history of each portfolio, adjusted for general economic conditions and other inherent risk factors. Risk factors considered by the Company in completing this analysis include: (i) unemployment and economic trends in the Company’s markets; (ii) concentrations of credit, if any, among any industries; (iii) trends in loan growth, loan mix, delinquencies, losses or credit impairment; and (iv) adherence to lending policies and others. Each risk factor is designated as low, moderate/increasing, or high based on the Company’s assessment of the risk to loss associated with each factor. Each risk factor is then weighted to consider probability of occurrence.

The allowance not specifically allocated to individual credits is generally determined by analyzing potential exposure and other qualitative factors that could negatively impact the adequacy of the allowance. Loans not individually evaluated for impairment are grouped by pools with similar risk characteristics and the related historical loss rates are adjusted to reflect current inherent risk factors, such as unemployment, overall economic conditions, concentrations of credit, loan growth, classified and impaired loan trends, staffing, adherence to lending policies, and loss trends.

Determination of the ALLL is subjective in nature and requires management to periodically reassess the validity of its assumptions. Differences between actual losses and estimated losses are assessed such that management can timely modify its evaluation model to ensure that adequate provision has been made for risk in the total loan portfolio.

As a result of the Company’s quarterly analysis of the adequacy of the ALLL, the Company recorded a provision for loan losses of \$0.2 million in the first three months of 2018 as compared to \$0.7 million in the first three months of 2017. The provision for loan losses recorded in the first three months of 2018 reflects changes in the quality of the portfolio and general improvement in the Company’s historical loss rates used to compute the allowance not specifically allocated to individual credits. Changes in the amount of the provision and related allowance are based on the Company’s detailed systematic methodology and are directionally consistent with changes in the composition and quality of the Company’s loan portfolio. The Company believes its methodology for determining the adequacy of its ALLL adequately provides for probable losses inherent in the loan portfolio and produces a provision and allowance for loan losses that is directionally consistent with changes in asset quality and loss experience.

The Company had net charge-offs of \$0.6 million for the first three months of 2018 and \$1.2 million for the first three months of 2017. Net charge-offs in the first three months of 2018 consisted primarily of net charge-offs on commercial and industrial loans (\$0.3 million) and DDA overdrafts (\$0.2 million).

Based on the Company’s analysis of the adequacy of the allowance for loan losses and in consideration of the known factors utilized in computing the allowance, management believes that the allowance for loan losses as of March 31, 2018 is adequate to provide for probable losses inherent in the Company’s loan portfolio. Future provisions for loan losses will be dependent upon trends in loan balances including the composition of the loan portfolio, changes in loan quality and loss experience trends, and recoveries of previously charged-off loans, among other factors.

Table Five  
Analysis of the Allowance for Loan Losses

An analysis of changes in the Company's allowance for loan losses follows (dollars in thousands):

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|   | Three months ended |          | Year              |   |
|---|--------------------|----------|-------------------|---|
|   | March 31,          |          | ended             |   |
|   | 2018               | 2017     | December 31, 2017 |   |
| Balance at beginning of period                | \$18,836           | \$19,730 | \$19,730          |   |
| Charge-offs:                                  |                    |          |                   |   |
| Commercial and industrial                     | (339 )             | (53 )    | (400 )            |   |
| Commercial real estate                        | (157 )             | (180 )   | (720 )            |   |
| Residential real estate                       | (131 )             | (626 )   | (1,637 )          |   |
| Home equity                                   | (71 )              | (121 )   | (403 )            |   |
| Consumer                                      | (99 )              | (6 )     | (60 )             |   |
| DDA overdrafts                                | (636 )             | (636 )   | (2,714 )          |   |
| Total charge-offs                             | (1,433 )           | (1,622 ) | (5,934 )          |   |
| Recoveries:                                   |                    |          |                   |   |
| Commercial and industrial                     | 2                  | 2        | 58                |   |
| Commercial real estate                        | 223                | 11       | 112               |   |
| Residential real estate                       | 106                | 25       | 294               |   |
| Home equity                                   | —                  | —        | 45                |   |
| Consumer                                      | 46                 | 11       | 63                |   |
| DDA overdrafts                                | 420                | 371      | 1,462             |   |
| Total recoveries                              | 797                | 420      | 2,034             |   |
| Net charge-offs                               | (636 )             | (1,202 ) | (3,900 )          |   |
| Provision for purchased credit impaired loans | —                  | (19 )    | 2,845             |   |
| Provision for loan losses                     | 181                | 700      | 161               |   |
| Balance at end of period                      | \$18,381           | \$19,209 | \$18,836          |   |
| As a Percent of Average Total Loans:          |                    |          |                   |   |
| Net charge-offs (annualized)                  | 0.08               | %0.16    | %0.13             | % |
| Provision for loan losses (annualized)        | 0.02               | %0.09    | %0.10             | % |
| As a Percent of Non-Performing Loans:         |                    |          |                   |   |
| Allowance for loan losses                     | 189.87             | %167.70  | %178.39           | % |
| As a Percent of Total Loans:                  |                    |          |                   |   |
| Allowance for loan losses                     | 0.59               | %0.62    | %0.60             | % |

Table Six

## Allocation of the Allowance for Loan Losses

The allocation of the allowance for loan losses is shown in the table below (in thousands). The allocation of a portion of the allowance in one portfolio loan classification does not preclude its availability to absorb losses in other portfolio segments.

|                           | As of           |              |          |
|---------------------------|-----------------|--------------|----------|
|                           | As of March 31, | December 31, |          |
|                           | 2018            | 2017         | 2017     |
| Commercial and industrial | \$4,763         | \$4,283      | \$ 4,571 |
| Commercial real estate    | 5,769           | 6,004        | 6,183    |
| Residential real estate   | 4,943           | 6,723        | 5,212    |
| Home equity               | 1,200           | 1,299        | 1,138    |

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|                           |          |          |           |
|---------------------------|----------|----------|-----------|
| Consumer                  | 212      | 64       | 62        |
| DDA overdrafts            | 1,494    | 836      | 1,670     |
| Allowance for Loan Losses | \$18,381 | \$19,209 | \$ 18,836 |

The ALLL decreased from \$18.8 million at December 31, 2017 to \$18.4 million at March 31, 2018. Below is a summary of the changes in the components of the ALLL from December 31, 2017 to March 31, 2018.



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The allowance related to the commercial and industrial loan portfolio increased from \$4.6 million at December 31, 2017 to \$4.8 million at March 31, 2018.

The allowance allocated to the commercial real estate portfolio decreased \$0.4 million from \$6.2 million at December 31, 2017 to \$5.8 million at March 31, 2018, primarily due to a decrease in risk-rated loans which was partially offset by growth in the loan portfolio.

The allowance allocated to the residential real estate portfolio decreased from \$5.2 million at December 31, 2017 to \$4.9 million at March 31, 2018, primarily due to an improvement in historical loss rates, partially offset by growth in the loan portfolio.

The allowance allocated to the home equity loan portfolio increased slightly from \$1.1 million at December 31, 2017 to \$1.2 million at March 31, 2018.

The allowance allocated to the consumer loan portfolio increased slightly from \$0.1 million at December 31, 2017 to \$0.2 million at March 31, 2018.

The allowance allocated to overdraft deposit accounts decreased slightly from \$1.7 million at December 31, 2017 to \$1.5 million at March 31, 2018.

## Table Seven

## Non-Accrual and Past-Due Loans

The Company's nonperforming assets and past-due loans are shown below (dollars in thousands):

|   | As of March 31, |          | December |
|---|-----------------|----------|----------|
|   | 2018            | 2017     | 31,      |
|   |                 |          | 2017     |
| Non-accrual loans                       | \$9,590         | \$11,418 | \$10,297 |
| Accruing loans past due 90 days or more | 91              | 35       | 262      |
| Total non-performing loans              | 9,681           | 11,453   | 10,559   |
| Other real estate owned ("OREO")        | 3,912           | 4,405    | 3,585    |
| Total non-performing assets             | \$13,593        | \$15,858 | \$14,144 |

## As a Percent of Loans and Other Real Estate Owned:

|                      |      |       |       |   |
|----------------------|------|-------|-------|---|
| Non-performing loans | 0.43 | %0.52 | %0.45 | % |
|----------------------|------|-------|-------|---|

|                |         |         |          |
|----------------|---------|---------|----------|
| Past-due loans | \$8,291 | \$6,170 | \$10,964 |
|----------------|---------|---------|----------|

## As a Percentage of Total Loans

|                |      |       |       |   |
|----------------|------|-------|-------|---|
| Past-due loans | 0.26 | %0.20 | %0.35 | % |
|----------------|------|-------|-------|---|

The Company's ratio of non-performing assets to total loans and other real estate owned improved from 0.45% at December 31, 2017 to 0.43% at March 31, 2018. Excluded from this ratio are purchased credit-impaired loans in which the Company estimated cash flows and estimated a credit mark. These loans are considered performing loans provided that the loan is performing in accordance with the estimated expectations. Such loans would be considered non-performing loans if the loan's performance deteriorates below the initial expectations. Total past due loans decreased from \$11.0 million, or 0.35% of total loans outstanding, at December 31, 2016 to \$8.3 million, or 0.26% of total loans outstanding, at March 31, 2018.

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. The accrual of interest income is generally discontinued when a loan becomes 90 days past due as to principal or interest, unless the loan is well collateralized and in the process of collection. When interest accruals are discontinued, interest credited to income in the current year that is unpaid and deemed uncollectible is charged to operations. Prior-year interest accruals that are unpaid and deemed uncollectible are charged to the allowance for loan losses, provided that such amounts were specifically reserved.

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Impaired Loans

Information pertaining to the Company's impaired loans is included in the following table (in thousands):

|   | As of March<br>31, |          | As of<br>December<br>31, |
|---|--------------------|----------|--------------------------|
|   | 2018               | 2017     | 2017                     |
| Impaired loans with a valuation allowance             | \$2,975            | \$2,832  | \$ 5,782                 |
| Impaired loans with no valuation allowance            | 6,631              | 7,405    | 3,885                    |
| Total impaired loans                                  | \$9,606            | \$10,237 | \$ 9,667                 |
| Allowance for loan losses allocated to impaired loans | \$172              | \$636    | \$ 647                   |

The average recorded investment in impaired loans during the three months ended March 31, 2018 and March 31, 2017 was \$9.5 million and \$7.3 million, respectively. There were no commitments to provide additional funds on non-accrual, impaired, or other potential problem loans at March 31, 2018.

The Company recognized less than \$0.2 million, respectively, of interest income received in cash on non-accrual and impaired loans for both the three months ended March 31, 2018 and March 31, 2017. Less than \$0.1 million and \$0.2 million of interest income, respectively, would have been recognized during the three months ended March 31, 2018 and March 31, 2017, if such loans had been current in accordance with their original terms.

Table Nine  
Troubled Debt Restructurings ("TDRs")

The following table sets forth the Company's troubled debt restructurings ("TDRs") (in thousands):

|                           | As of March 31, |          | December<br>31, |
|---------------------------|-----------------|----------|-----------------|
|                           | 2018            | 2017     | 2017            |
| Accruing:                 |                 |          |                 |
| Residential real estate   | \$20,786        | \$20,294 | \$21,005        |
| Home equity               | 3,015           | 3,104    | 3,047           |
| Commercial and industrial | 125             | 38       | 135             |
| Commercial real estate    | 8,324           | 8,513    | 8,381           |
| Total accruing TDRs       | 32,250          | 31,949   | 32,568          |
| Non-Accruing:             |                 |          |                 |
| Residential real estate   | 256             | 100      | 84              |
| Home equity               | 40              | 30       | 50              |
| Total non-accruing TDRs   | 296             | 130      | 134             |
| Total TDRs                | \$32,546        | \$32,079 | \$32,702        |

Regulatory guidance requires that loans be accounted for as collateral-dependent loans when borrowers have filed Chapter 7 bankruptcy, the debt has been discharged by the bankruptcy court and the borrower has not reaffirmed the debt. The filing of bankruptcy is deemed to be evidence that the borrower is in financial difficulty and the discharge of debt by the bankruptcy court is deemed to be a concession granted to the borrower.

The Company's troubled debt restructurings ("TDRs") related to its borrowers who had filed for Chapter 7 bankruptcy protection make up 72% of the Company's total TDRs as of March 31, 2018. The average age of these TDRs was 12.1 years; the average current balance as a percentage of the original balance was 68.2%; and the average loan-to-value ratio was 65.4% as of March 31, 2018. Of the total 461 Chapter 7 related TDRs, 31 had an estimated loss exposure based on the current balance and appraised value at March 31, 2018.

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## Non-Interest Income and Non-Interest Expense

Three months ended March 31, 2018 vs. 2017  
(in millions)

|   | Three<br>months<br>ended<br>March<br>31,<br>2018 | \$        | %        | Change | %      |
|---|--|-----------|----------|--------|--------|
|   | 2017   |           |          | Change | Change |
| Gains on sale of investment securities      | \$ 4.3   | \$ (4.3 ) | (100.0)% |        |        |
| Non-interest income (excluding above gains) | 14.2   | 0.3       | 2.1      |        | %      |
| Non-interest expense                        | 24.6   | 0.3       | 1.2      |        | %      |

**Non-Interest Income:** Non-interest income was \$14.5 million for the first quarter of 2018 as compared to \$18.5 million for the first quarter of 2017. During the first quarter of 2017 the Company realized \$4.3 million of investment gains that represented partial recoveries of impairment charges previously recognized on pooled trust preferred securities. Exclusive of this gain, non-interest income increased from \$14.2 million for the first quarter of 2017 to \$14.5 million for the first quarter of 2018. This increase was attributable to an increase of \$0.2 million, or 4.7%, in bankcard revenues; an increase of \$0.2 million, or 13.1%, in trust and wealth management fee income; an increase of \$0.2 million in other income; and an increase of \$0.1 million, or 2.0%, in service charges. These increases were partially offset by a decrease of \$0.4 million in bank owned life insurance revenues due to death benefit proceeds received in the first quarter of 2017.

**Non-Interest Expense:** Non-interest expenses increased \$0.3 million, from \$24.6 million in the first quarter of 2017 to \$24.9 million in the first quarter of 2018. This increase was primarily due to an increase in salaries and employee benefits of \$0.2 million due largely to salary increases.

**Income Tax Expense:** The Company's effective income tax rate for the first quarter of 2018 was 20.0% compared to 40.2% for the year ended December 31, 2017, and 32.3% for the quarter ended March 31, 2017. On December 22, 2017, the President signed the Tax Cut and Jobs Act ("TCJA") into law. Among other things, the TCJA reduced the corporate income tax rate from 35% to 21%, effective January 1, 2018. As a result of this decrease in corporate income tax rate, the Company reassessed its deferred tax assets and liabilities, which resulted in a charge to earnings in the fourth quarter of 2017 of \$7.1 million. Exclusive of this item, the Company's tax rate from operations was 32.7% for the year ended December 31, 2017.

## Risk Management

Market risk is the risk of loss due to adverse changes in current and future cash flows, fair values, earnings or capital due to adverse movements in interest rates and other factors, including foreign exchange rates, underlying credit risk and commodity prices. Because the Company has no significant foreign exchange activities and holds no commodities, interest rate risk represents the primary risk factor affecting the Company's balance sheet and net interest margin. Significant changes in interest rates by the Federal Reserve could result in similar changes in LIBOR interest rates, prime rates, and other benchmark interest rates that could affect the estimated fair value of the Company's investment securities portfolio, interest paid on the Company's short-term and long-term borrowings, interest earned

on the Company's loan portfolio and interest paid on its deposit accounts.

The Company's Asset and Liability Committee ("ALCO") has been delegated the responsibility of managing the Company's interest-sensitive balance sheet accounts to maximize earnings while managing interest rate risk. ALCO, comprised of various members of executive and senior management, is also responsible for establishing policies to monitor and limit the Company's exposure to interest rate risk and to manage the Company's liquidity position. ALCO satisfies its responsibilities through quarterly meetings during which product pricing issues, liquidity measures, and interest sensitivity positions are monitored.

In order to measure and manage its interest rate risk, the Company uses an asset/liability management and simulation software model to periodically update the interest sensitivity position of the Company's balance sheet. The model is also used to perform analyses that measure the impact on net interest income and capital as a result of various changes in the interest rate environment. Such analyses quantify the effects of various interest rate scenarios on projected net interest income.

The Company's policy objective is to avoid negative fluctuations in net income or the economic value of equity of more than 15% within a 12-month period, assuming an immediate parallel increase or decrease of 400 basis points. The Company

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measures the long-term risk associated with sustained increases and decreases in rates through analysis of the impact to changes in rates on the economic value of equity.

The following table summarizes the sensitivity of the Company's net income to various interest rate scenarios. The results of the sensitivity analyses presented below differ from the results used internally by ALCO in that, in the analyses below, interest rates are assumed to have an immediate and sustained parallel shock. The Company recognizes that rates are volatile, but rarely move with immediate and parallel effects. Internally, the Company considers a variety of interest rate scenarios that are deemed to be possible while considering the level of risk it is willing to assume in "worst-case" scenarios such as shown by the following:

| Immediate<br>Basis<br>Point<br>Change<br>in<br>Interest<br>Rates | Implied<br>Federal<br>Funds Rate<br>Associated<br>with<br>Change in<br>Interest<br>Rates | Estimated<br>Increase<br>(Decrease)<br>in Net<br>Income<br>Over 12<br>Months |
|--|--|--|
|--|--|--|

March

|             |        |        |
|-------------|--------|--------|
| 31,<br>2018 |        |        |
| +400        | 5.75 % | +4.8 % |
| +300        | 4.75   | +5.6   |
| +200        | 3.75   | +5.5   |
| +100        | 2.75   | +3.8   |
| -50         | 1.25   | -6.1   |
| -100        | 0.75   | -14.4  |

December

|             |        |        |
|-------------|--------|--------|
| 31,<br>2017 |        |        |
| +400        | 5.50 % | +4.0 % |
| +300        | 4.50   | +5.9   |
| +200        | 3.50   | +6.2   |
| +100        | 2.50   | +4.7   |
| -50         | 1.00   | -6.0   |
| -100        | 0.50   | -12.3  |

These estimates are highly dependent upon assumptions made by management, including, but not limited to, assumptions regarding the manner in which interest-bearing demand deposit and saving deposit accounts reprice in different interest rate scenarios, changes in the composition of deposit balances, pricing behavior of competitors, prepayments of loans and deposits under alternative rate environments, and new business volumes and pricing. As a result, there can be no assurance that the estimates above will be achieved in the event that interest rates increase during 2018 and beyond. The estimates above do not necessarily imply that the Company will experience increases in net income if market interest rates rise. The table above indicates how the Company's net income behaves relative to an increase or decrease in rates compared to what would otherwise occur if rates remain stable.

Based upon the estimates above, the Company believes that its net income is positively correlated with increasing rates as compared to the level of net income the Company would expect if interest rates remain flat.

## Liquidity

The Company evaluates the adequacy of liquidity at both the City Holding Company ("City Holding") level and at the banking subsidiary level. At the City Holding level, the principal source of cash is dividends from its banking subsidiary, City National Bank ("City National"). Dividends paid by City National to City Holding are subject to certain legal and regulatory limitations. Generally, any dividends in amounts that exceed the earnings retained by City National in the current year plus retained net profits for the preceding two years must be approved by regulatory authorities. At March 31, 2018, City National could pay dividends up to \$86.4 million plus net profits for the remainder of 2018, as defined by statute, up to the dividend declaration date without prior regulatory permission.

On December 19, 2016, the Company announced that it had filed a prospectus supplement to its existing shelf registration statement on Form S-3 for the sale of its common stock having an aggregate value of up to \$55 million through an "at-the-market" equity offering program. Through the year ended December 31, 2017, the Company sold approximately 548,000 common shares at a weighted average price of \$64.82, net of broker fees. The Company has sold no shares since the first quarter of 2017. To



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date, the Company has received \$36.4 million in gross proceeds. Under the program, the Company has the ability to receive an additional \$18.6 million in gross proceeds from the sale of common shares.

Over the next 12 months, City Holding has an obligation to remit interest payments approximating \$0.8 million on the debentures held by City Holding Capital Trust III. Interest payments on the debentures can be deferred for up to five years under certain circumstances and dividends to shareholders can, if necessary, be suspended. City Holding anticipates continuing the payment of dividends on its common stock, which are expected to approximate \$28.4 million on an annualized basis over the next 12 months based on common shareholders outstanding at March 31, 2018. In addition to these anticipated cash needs, City Holding has operating expenses and other contractual obligations, which are estimated to require \$1.6 million of additional cash over the next 12 months. As of March 31, 2018, City Holding reported a cash balance of \$39.0 million and management believes that City Holding's available cash balance, together with cash dividends from City National, will be adequate to satisfy its funding and cash needs over the next 12 months.

Excluding the interest and dividend payments discussed above, City Holding has no significant commitments or obligations in years after 2018 other than the repayment of its \$16.5 million obligation under the debentures held by City Holding Capital Trust III. However, this obligation does not mature until June 2038, or earlier at the option of City Holding. It is expected that City Holding will be able to obtain the necessary cash, either through dividends obtained from City National or the issuance of other debt, to fully repay the debentures at their maturity.

City National manages its liquidity position in an effort to effectively and economically satisfy the funding needs of its customers and to accommodate the scheduled repayment of borrowings. Funds are available to City National from a number of sources, including depository relationships, sales and maturities within the investment securities portfolio, and borrowings from the Federal Home Loan Bank ("FHLB") and other financial institutions. As of March 31, 2018, City National's assets are significantly funded by deposits and capital. Additionally, City National maintains borrowing facilities with the FHLB and other financial institutions that are accessed as necessary to fund operations and to provide contingency funding mechanisms. As of March 31, 2018, City National has the capacity to borrow an additional \$1.7 billion from the FHLB and other financial institutions under existing borrowing facilities. City National maintains a contingency funding plan, incorporating these borrowing facilities, to address liquidity needs in the event of an institution-specific or systemic financial industry crisis. Also, although it has no current intention to do so, City National could liquidate its unpledged securities, if necessary, to provide an additional funding source. City National also segregates certain mortgage loans, mortgage-backed securities, and other investment securities in a separate subsidiary so that it can separately monitor the asset quality of these primarily mortgage-related assets, which could be used to raise cash through securitization transactions or obtain additional equity or debt financing if necessary.

The Company manages its asset and liability mix to balance its desire to maximize net interest income against its desire to minimize risks associated with capitalization, interest rate volatility, and liquidity. With respect to liquidity, the Company has chosen a conservative posture and believes that its liquidity position is strong. The Company's net loan to asset ratio is 74.3% as of March 31, 2018 and deposit balances fund 82.1% of total assets. The Company has obligations to extend credit, but these obligations are primarily associated with existing home equity loans that have predictable borrowing patterns across the portfolio. The Company has investment security balances with carrying values that totaled \$630.1 million at March 31, 2018, and that greatly exceeded the Company's non-deposit sources of borrowing, which totaled \$211.9 million. Further, the Company's deposit mix has a very high proportion of transaction and savings accounts that fund 55.6% of the Company's total assets.

As illustrated in the Consolidated Statements of Cash Flows, the Company generated \$12.4 million of cash from operating activities during the first three months of 2018, primarily from interest income received on loans and investments, net of interest expense paid on deposits and borrowings. The Company used \$24.7 million of cash in

investing activities during the first three months of 2018, primarily due to net purchases of investment securities of \$35.7 million and an increase in loans of \$10.8 million. These increases were partially offset by a decrease in maturities and calls of securities available-for-sale of \$21.2 million. The Company generated \$53.6 million of cash in financing activities during the first three months of 2018, principally as a result of an increase in interest-bearing deposits of \$94.8 million and an increase in non-interest-bearing deposits of \$36.6 million. These increases were partially offset by a decrease in short-term borrowings of \$56.8 million, purchases of treasury stock of \$14.0 million, and dividends paid of \$7.2 million to the Company's common stockholders.

#### Capital Resources

Shareholders' equity decreased \$10.6 million, or 2.1%, due to the repurchase of 204,000 common shares at a weighted average price of \$68.50 per share (\$14.0 million) as part of a one million share repurchase plan authorized by the Board of Directors in September 2014, an increase in other comprehensive loss of \$8.2 million due to a decrease in the fair value of available for sale

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securities, and cash dividends declared of \$7.1 million. These decreases in shareholders equity were partially offset by net income of \$17.6 million and an increase in stock based compensation of \$1.1 million.

In July 2013, the Federal Reserve published the final rules that established a new comprehensive capital framework for banking organizations, commonly referred to as Basel III. These final rules substantially revised the risk-based capital requirements applicable to bank holding companies and depository institutions. The final rule became effective January 1, 2015 for smaller, non-complex banking organizations, with full implementation by January 1, 2019.

Regulatory guidelines require the Company to maintain a minimum common equity tier I ("CET1") capital ratio of 6.375% and a total capital to risk-adjusted assets ratio of 9.875%, with at least one-half of capital consisting of tangible common stockholders' equity and a minimum Tier I leverage ratio of 7.875%. Similarly, City National is also required to maintain minimum capital levels as set forth by various regulatory agencies. Under capital adequacy guidelines, City National is required to maintain minimum CET1, total capital, Tier I capital, and leverage ratios of 6.375%, 9.875%, 7.875%, and 4.0%, respectively. To be classified as "well capitalized," City National must maintain CET1, total capital, Tier I capital, and leverage ratios of 6.5%, 10.0%, 8.0%, and 5.0%, respectively.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require City Holding and City National to maintain (i) a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average assets (as compared to a current minimum leverage ratio of 3.0% for banking organizations that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk).

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to City Holding Company or City National Bank.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 capital to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The Company's regulatory capital ratios for both City Holding and City National are illustrated in the following tables (dollars in thousands):

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| March 31, 2018               | Actual         |       | Minimum Required - Basel III Phase-In Schedule |        | Minimum Required - Basel III Fully Phased-In (*) |       | Required to be Considered Well Capitalized |       |
|------------------------------|----------------|-------|--|--------|--|-------|--|-------|
|                              | Capital Amount | Ratio | Capital Amount                                 | Ratio  | Capital Amount                                   | Ratio | Capital Amount                             | Ratio |
| <b>CET I Capital</b>         |                |       |  |        |  |       |  |       |
| City Holding Company         | \$430,044      | 15.1% | \$181,765                                      | 6.375% | \$199,585  | 7.0%  | \$185,329                                  | 6.5%  |
| City National Bank           | 355,791        | 12.6  | 180,218  | 6.375  | 197,887  | 7.0   | 183,752                                    | 6.5   |
| <b>Tier I Capital</b>        |                |       |  |        |  |       |  |       |
| City Holding Company         | 446,044        | 15.6  | 224,533  | 7.875  | 242,354  | 8.5   | 228,097                                    | 8.0   |
| City National Bank           | 355,791        | 12.6  | 222,622  | 7.875  | 240,291  | 8.5   | 226,156                                    | 8.0   |
| <b>Total Capital</b>         |                |       |  |        |  |       |  |       |
| City Holding Company         | 464,936        | 16.3  | 281,558  | 9.875  | 299,378  | 10.5  | 285,122                                    | 10.0  |
| City National Bank           | 374,682        | 13.3  | 279,161  | 9.875  | 296,830  | 10.5  | 282,695                                    | 10.0  |
| <b>Tier I Leverage Ratio</b> |                |       |  |        |  |       |  |       |
| City Holding Company         | 446,044        | 10.9  | 163,651  | 4.000  | 163,651  | 4.0   | 204,564                                    | 5.0   |
| City National Bank           | 355,791        | 8.8   | 161,470  | 4.000  | 161,470  | 4.0   | 201,837                                    | 5.0   |

(\*) Represents the minimum required capital levels as of January 1, 2019 when Basel III Capital Rules have been fully phased in.

| December 31, 2017            | Actual         |       | Minimum Required - Basel III Phase-In Schedule |        | Minimum Required - Basel III Fully Phased-In (*) |       | Required to be Considered Well Capitalized |       |
|------------------------------|----------------|-------|--|--------|--|-------|--|-------|
|                              | Capital Amount | Ratio | Capital Amount                                 | Ratio  | Capital Amount                                   | Ratio | Capital Amount                             | Ratio |
| <b>CET I Capital</b>         |                |       |  |        |  |       |  |       |
| City Holding Company         | \$430,154      | 15.1% | \$163,441                                      | 5.750% | \$198,972  | 7.0%  | \$184,760                                  | 6.5%  |
| City National Bank           | 338,105        | 12.0  | 162,164  | 5.750  | 197,418  | 7.0   | 183,316                                    | 6.5   |
| <b>Tier I Capital</b>        |                |       |  |        |  |       |  |       |
| City Holding Company         | 446,154        | 15.7  | 206,078  | 7.250  | 241,609  | 8.5   | 227,397                                    | 8.0   |
| City National Bank           | 338,105        | 12.0  | 204,468  | 7.250  | 239,721  | 8.5   | 225,620                                    | 8.0   |
| <b>Total Capital</b>         |                |       |  |        |  |       |  |       |
| City Holding Company         | 465,292        | 16.4  | 262,927  | 9.250  | 298,458  | 10.5  | 284,246                                    | 10.0  |
| City National Bank           | 357,243        | 12.7  | 260,873  | 9.250  | 296,126  | 10.5  | 282,025                                    | 10.0  |
| <b>Tier I Leverage Ratio</b> |                |       |  |        |  |       |  |       |
| City Holding Company         | 446,154        | 11.0  | 161,834  | 4.000  | 161,834  | 4.0   | 202,293                                    | 5.0   |
| City National Bank           | 338,105        | 8.5   | 159,625  | 4.000  | 159,625  | 4.0   | 199,531                                    | 5.0   |

(\*) Represents the minimum required capital levels as of January 1, 2019 when Basel III Capital Rules have been fully phased in.

As of March 31, 2018, management believes that City Holding Company and its banking subsidiary, City National, were “well capitalized.” City Holding is subject to regulatory capital requirements administered by the Federal Reserve, while City National is subject to regulatory capital requirements administered by the Office of the Comptroller of the

Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”). Regulatory agencies can initiate certain mandatory actions if either City Holding or City National fails to meet the minimum capital requirements, as shown above. As of March 31, 2018, management believes that City Holding and City National have met all capital adequacy requirements.

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Item 3 - Quantitative and Qualitative Disclosures About Market Risk

The information called for by this item is provided under the caption “Risk Management” under Item 2 - Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Item 4 - Controls and Procedures

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, the Company carried out an evaluation, with the participation of the Company’s management, including the Company’s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company’s disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company’s periodic SEC filings. There has been no change in the Company’s internal control over financial reporting during the quarter ended March 31, 2018 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company is engaged in various legal actions that it deems to be in the ordinary course of business. As these legal actions are resolved, the Company could realize positive and/or negative impact to its financial performance in the period in which these legal actions are ultimately resolved. There can be no assurance that current actions will have immaterial results, either positive or negative, or that no material actions may be presented in the future.

Item 1A. Risk Factors

There have been no material changes to the factors disclosed in Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2017.

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

On September 24, 2014, the Company announced that the Board of Directors authorized the Company to buy back up to 1,000,000 shares of its common shares (approximately 7% of the outstanding shares at that time) in open market transactions

at prices that are accretive to the earnings per share of continuing shareholders. No time limit was placed on the duration of the share repurchase program. The following table sets forth information regarding the Company's common stock repurchases transacted during the quarter ended March 31, 2018:

| Total<br>Number<br>of Shares<br>Purchased | Maximum<br>Number<br>of Shares<br>that May |
|---|--|
|---|--|

| Period                         | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | as Part of         |   |
|--------------------------------|---|---------------------------------------|--------------------|---|
|                                |   |                                       | Announced<br>Plans | Yet Be<br>Purchased<br>Under the<br>Plans |
| January 1 - January 31, 2018   | —   | \$ —                                  | —                  | 402,248                                   |
| February 1 - February 28, 2018 | 140,629                                   | \$ 68.39                              | 140,629            | 261,619                                   |
| March 1 - March 31, 2018       | 63,698                                    | \$ 68.76                              | 63,698             | 197,921                                   |

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

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Item 6. Exhibits

The exhibits required to be filed or furnished with this Form 10-Q are attached hereto or incorporated herein by reference. For a list of such exhibits, see "Exhibit Index."

Exhibit Index

The following exhibits are filed herewith or are incorporated herein by reference.

- Agreement and Plan of Merger, dated November 14, 2011, by and among Virginia Savings Bancorp, Inc., Virginia Savings Bank, F.S.B., City Holding Company and City National Bank of West Virginia (attached to, and incorporated by reference from, City Holding Company's Form 8-K dated November 14, 2011, and filed with the Securities and Exchange Commission on November 14, 2011).
- 2(a) Agreement and Plan of Merger, dated August 2, 2012, by and among Community Financial Corporation, Community Bank, City Holding Company and City National Bank of West Virginia (attached to, and incorporated by reference from, City Holding Company's Form 8-K dated August 7, 2012, and filed with the Securities and Exchange Commission on August 7, 2012).
- 2(b) Articles of Incorporation of City Holding Company (attached to, and incorporated by reference from, Amendment No. 1 to City Holding Company's Registration Statement on Form S-4, Registration No. 2-86250, filed November 4, 1983 with the Securities and Exchange Commission).
- 3(a) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated March 6, 1984 (attached to, and incorporated by reference from, City Holding Company's Form 8-K Report dated March 7, 1984, and filed with the Securities and Exchange Commission on March 22, 1984).
- 3(b) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated March 4, 1986 (attached to, and incorporated by reference from, City Holding Company's Form 10-K Annual Report for the year ended December 31, 1986, filed March 31, 1987 with the Securities and Exchange Commission).
- 3(c) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated September 29, 1987 (attached to and incorporated by reference from, City Holding Company's Registration Statement on Form S-4, Registration No. 33-23295, filed with the Securities and Exchange Commission on August 3, 1988).
- 3(d) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated May 6, 1991 (attached to, and incorporated by reference from, City Holding Company's Form 10-K Annual Report for the year ended December 31, 1991, filed March 17, 1992 with the Securities and Exchange Commission).
- 3(e) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated May 7, 1991 (attached to, and incorporated by reference from, City Holding Company's Form 10-K Annual Report for the year ended December 31, 1991, filed March 17, 1992 with the Securities and Exchange Commission).
- 3(f) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated August 1, 1994 (attached to, and incorporated by reference from, City Holding Company's Form 10-Q Quarterly Report for the quarter ended September 30, 1994, filed November 14, 1994 with the Securities and Exchange Commission).
- 3(g) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated December 9, 1998 (attached to, and incorporated by reference from, City Holding Company's Form 10-K Annual Report for the year ended December 31, 1998, filed March 31, 1999 with the Securities and Exchange Commission).
- 3(h) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated June 13, 2001 (attached to, and incorporated by reference from, City Holding Company's Registration Statement on Form 8-A, filed June 22, 2001 with the Securities and Exchange Commission).
- 3(i) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated May 10, 2006 (attached to, and incorporated by reference from, City Holding Company's Form 10-Q, Quarterly Report for the quarter ended June 30, 2006, filed August 9, 2006 with the Securities and Exchange Commission).
- 3(j) Articles of Amendment to the Articles of Incorporation of City Holding Company, dated April 19, 2017 (attached to, and incorporated by reference from, City Holding Company's Form 10-Q Quarterly Report for the



quarter ended March 31, 2017, filed May 5, 2017 with the Securities and Exchange Commission).

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- 3(l) Amended and Restated Bylaws of City Holding Company, revised February 24, 2010 (attached to, and incorporated by reference from, City Holding Company's Current Report on Form 8-K filed March 1, 2010 with the Securities and Exchange Commission).
- 4(a) Rights Agreement dated as of June 13, 2001 (attached to, and incorporated by reference from, City Holding Company's Form 8-A, filed June 22, 2001, with the Securities and Exchange Commission).
- 4(b) Amendment No. 1 to the Rights Agreement dated as of November 30, 2005 (attached to, and incorporated by reference from, City Holding Company's Amendment No. 1 on Form 8-A, filed December 21, 2005, with the Securities and Exchange Commission).
- 31(a) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for Charles R. Hageboeck
- 31(b) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for David L. Bumgarner
- 32(a) Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for Charles R. Hageboeck
- 32(b) Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 for David L. Bumgarner
- 101.INS XBRL Instance Document\*
- 101.SCH XBRL Taxonomy Extension Schema\*
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase\*
- 101.DEF XBRL Taxonomy Extension Definition Linkbase\*
- 101.LAB XBRL Taxonomy Extension Label Linkbase\*
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase\*

\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

SIGNATURES

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

City Holding Company  
(Registrant)

/s/ Charles R. Hageboeck  
Charles R. Hageboeck  
President and Chief  
Executive Officer  
(Principal Executive  
Officer)

/s/ David L. Bumgarner  
David L. Bumgarner  
Senior Vice President,  
Chief Financial Officer  
and Principal Accounting  
Officer  
(Principal Financial  
Officer)

Date: May 3, 2018

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