

MACATAWA BANK CORP
Form 10-Q
July 26, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission file number: 000-25927

MACATAWA BANK CORPORATION
(Exact name of registrant as specified in its charter)

Michigan 38-3391345
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

10753 Macatawa Drive, Holland, Michigan 49424
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444

Indicate by checkmark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

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Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging Growth Company

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

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:
34,014,319 shares of the Company's Common Stock (no par value) were outstanding as of July 26, 2018.

Forward-Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and Macatawa Bank Corporation. Forward-looking statements are identifiable by words or phrases such as "outlook", "plan" or "strategy"; that an event or trend "could", "may", "should", "will", "is likely", or is "possible" or "probable" to occur or "continue", has "begun", "is scheduled" or "on track" or that the Company or its management "anticipates", "believes", "estimates", "plans", "forecasts", "predicts", "projects", or "expects" a particular result, or is "committed", "confident", "optimistic" or has an "opinion" that an event will occur, or other words or phrases such as "ongoing", "future", "signs", "efforts", "tend", "exploring", "appearing", "until", "term", "concern", "going forward", "focus", "starting", "initiative," "trend" and variations of such words and similar expressions. Such statements are based upon current beliefs and expectations and involve substantial risks and uncertainties which could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These statements include, among others, those related to future levels of earning assets, future composition of our loan portfolio, future impact of tax reform on our earnings, trends in credit quality metrics, future capital levels and capital needs, including the impact of Basel III, real estate valuation, future levels of repossessed and foreclosed properties and nonperforming assets, future levels of losses and costs associated with the administration and disposition of repossessed and foreclosed properties and nonperforming assets, future levels of loan charge-offs, future levels of other real estate owned, future levels of provisions for loan losses and reserve recoveries, the rate of asset dispositions, future dividends, future growth and funding sources, future cost of funds, future liquidity levels, future profitability levels, future interest rate levels, future net interest margin levels, the effects on earnings of changes in interest rates, future economic conditions, future effects of new or changed accounting standards, future loss recoveries, loan demand and loan growth and the future level of other revenue sources. Management's determination of the provision and allowance for loan losses, the appropriate carrying value of intangible assets (including deferred tax assets) and other real estate owned, and the fair value of investment securities (including whether any impairment on any investment security is temporary or other-than-temporary and the amount of any impairment) involves judgments that are inherently forward-looking. All statements with references to future time periods are forward-looking. All of the information concerning interest rate sensitivity is forward-looking. Our ability to sell other real estate owned at its carrying value or at all, successfully implement new programs and initiatives, increase efficiencies, maintain our current levels of deposits and other sources of funding, maintain liquidity, respond to declines in collateral values and credit quality, increase loan volume, originate high quality loans, maintain or improve mortgage banking income, realize the benefit of our deferred tax assets, continue payment of dividends and improve profitability is not entirely within our control and is not assured. The future effect of changes in the real estate, financial and credit markets and the national and regional economy on the banking industry, generally, and Macatawa Bank Corporation, specifically, are also inherently uncertain. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. Macatawa Bank Corporation does not undertake to update forward-looking statements to reflect the impact of circumstances or events that may arise after the date of the forward-looking statements.

Risk factors include, but are not limited to, the risk factors described in "Item 1A - Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2017. These and other factors are representative of the risk factors that may emerge and could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

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Part I Financial Information

Item 1.

MACATAWA BANK CORPORATION
CONSOLIDATED BALANCE SHEETS

As of June 30, 2018 (unaudited) and December 31, 2017

(Dollars in thousands, except per share data)

| | June 30, 2018 | December 31, 2017 |
|---|------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$37,105 | \$ 34,945 |
| Federal funds sold and other short-term investments | 107,416 | 126,522 |
| Cash and cash equivalents | 144,521 | 161,467 |
| Debt securities available for sale, at fair value | 218,770 | 220,720 |
| Debt securities held to maturity (fair value 2018 - \$80,536 and 2017 - \$86,452) | 79,569 | 85,827 |
| Federal Home Loan Bank (FHLB) stock | 11,558 | 11,558 |
| Loans held for sale, at fair value | 61 | 1,208 |
| Total loans | 1,327,686 | 1,320,309 |
| Allowance for loan losses | (16,695) | (16,600) |
| Net loans | 1,310,991 | 1,303,709 |
| Premises and equipment – net | 45,907 | 46,629 |
| Accrued interest receivable | 5,078 | 4,680 |
| Bank-owned life insurance | 40,744 | 40,243 |
| Other real estate owned - net | 3,872 | 5,767 |
| Net deferred tax asset | 3,960 | 3,785 |
| Other assets | 7,510 | 4,639 |
| Total assets | \$1,872,541 | \$ 1,890,232 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing | \$496,605 | \$ 490,583 |
| Interest-bearing | 1,083,856 | 1,088,427 |
| Total deposits | 1,580,461 | 1,579,010 |
| Other borrowed funds | 65,667 | 92,118 |
| Long-term debt | 41,238 | 41,238 |
| Accrued expenses and other liabilities | 5,461 | 4,880 |
| Total liabilities | 1,692,827 | 1,717,246 |
| Commitments and contingent liabilities | --- | --- |
| Shareholders' equity | | |
| Common stock, no par value, 200,000,000 shares authorized; 34,014,319 and 33,972,977 shares issued and outstanding at June 30, 2018 and December 31, 2017 | 217,675 | 217,081 |
| Retained deficit | (34,149) | (42,526) |
| Accumulated other comprehensive income (loss) | (3,812) | (1,569) |
| Total shareholders' equity | 179,714 | 172,986 |
| Total liabilities and shareholders' equity | \$1,872,541 | \$ 1,890,232 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

Three and Six Month Periods Ended June 30, 2018 and 2017

(unaudited)

(Dollars in thousands, except per share data)

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|---|---|
| Interest income | | | | |
| Loans, including fees | \$ 14,406 | \$ 12,540 | \$ 28,116 | \$ 24,996 |
| Securities | | | | |
| Taxable | 917 | 646 | 1,785 | 1,285 |
| Tax-exempt | 905 | 546 | 1,780 | 1,084 |
| FHLB Stock | 121 | 121 | 318 | 244 |
| Federal funds sold and other short-term investments | 487 | 189 | 856 | 281 |
| Total interest income | 16,836 | 14,042 | 32,855 | 27,890 |
| Interest expense | | | | |
| Deposits | 1,319 | 557 | 2,312 | 1,038 |
| Other borrowings | 322 | 358 | 692 | 740 |
| Long-term debt | 542 | 422 | 1,015 | 824 |
| Total interest expense | 2,183 | 1,337 | 4,019 | 2,602 |
| Net interest income | 14,653 | 12,705 | 28,836 | 25,288 |
| Provision for loan losses | (300) | (500) | (400) | (1,000) |
| Net interest income after provision for loan losses | 14,953 | 13,205 | 29,236 | 26,288 |
| Noninterest income | | | | |
| Service charges and fees | 1,060 | 1,110 | 2,110 | 2,170 |
| Net gains on mortgage loans | 222 | 476 | 363 | 904 |
| Trust fees | 945 | 833 | 1,870 | 1,611 |
| ATM and debit card fees | 1,414 | 1,338 | 2,692 | 2,539 |
| Gain on sales of securities | --- | --- | --- | 3 |
| Bank owned life insurance ("BOLI") income | 237 | 243 | 475 | 481 |
| Other | 590 | 478 | 1,089 | 1,001 |
| Total noninterest income | 4,468 | 4,478 | 8,599 | 8,709 |
| Noninterest expense | | | | |
| Salaries and benefits | 6,389 | 6,153 | 12,583 | 12,152 |
| Occupancy of premises | 973 | 991 | 2,045 | 2,017 |
| Furniture and equipment | 773 | 750 | 1,578 | 1,482 |
| Legal and professional | 215 | 197 | 417 | 422 |
| Marketing and promotion | 229 | 225 | 457 | 453 |
| Data processing | 797 | 731 | 1,493 | 1,413 |
| FDIC assessment | 132 | 134 | 264 | 270 |
| Interchange and other card expense | 359 | 324 | 691 | 637 |
| Bond and D&O Insurance | 110 | 118 | 219 | 234 |
| Net (gains) losses on repossessed and foreclosed properties | 17 | (300) | 423 | (385) |
| Administration and disposition of problem assets | 66 | 142 | 121 | 322 |
| Other | 1,199 | 1,327 | 2,402 | 2,662 |

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| | | | | |
|-----------------------------------|----------|----------|-----------|----------|
| Total noninterest expenses | 11,259 | 10,792 | 22,693 | 21,679 |
| Income before income tax | 8,162 | 6,891 | 15,142 | 13,318 |
| Income tax expense | 1,434 | 2,129 | 2,659 | 4,095 |
| Net income | \$ 6,728 | \$ 4,762 | \$ 12,483 | \$ 9,223 |
| Basic earnings per common share | \$ 0.20 | \$ 0.14 | \$ 0.37 | \$ 0.27 |
| Diluted earnings per common share | \$ 0.20 | \$ 0.14 | \$ 0.37 | \$ 0.27 |
| Cash dividends per common share | \$ 0.06 | \$ 0.04 | \$ 0.12 | \$ 0.08 |

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Three and Six Month Periods Ended June 30, 2018 and 2017

(unaudited)

(Dollars in thousands)

| | Three Ended June 30, 2018 | Three Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|------------------------------------|------------------------------------|--|--|
| Net income | \$ 6,728 | \$ 4,762 | \$ 12,483 | \$ 9,223 |
| Other comprehensive income: | | | | |
| Unrealized gains (losses): | | | | |
| Net change in unrealized gains (losses) on debt securities available for sale, net of tax sale available for sale | (571) | 772 | (2,869) | 1,835 |
| Tax effect | 120 | (270) | 602 | (642) |
| Net change in unrealized gains (losses) on debt securities available for sale, net of tax | (451) | 502 | (2,267) | 1,193 |
| Less: reclassification adjustments: | | | | |
| Reclassification for gains included in net income | --- | --- | --- | 3 |
| Tax effect | --- | --- | --- | (1) |
| Reclassification for gains included in net income, net of tax | --- | --- | --- | 2 |
| Other comprehensive income (loss), net of tax | (451) | 502 | (2,267) | 1,191 |
| Comprehensive income | \$ 6,277 | \$ 5,264 | \$ 10,216 | \$ 10,414 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Six Month Periods Ended June 30, 2018 and 2017

(unaudited)

(Dollars in thousands, except per share data)

| | Common Stock | Retained Deficit | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|--|-----------------|---------------------|--|----------------------------------|
| Balance, January 1, 2017 | \$216,731 | \$(53,008) | \$ (1,484) | \$ 162,239 |
| Net income for the six months ended June 30, 2017 | --- | 9,223 | --- | 9,223 |
| Cash dividends at \$.08 per share | --- | (2,706) | --- | (2,706) |
| Net change in unrealized loss on securities available for sale, net of tax | --- | --- | 1,191 | 1,191 |
| Stock compensation expense | 228 | --- | --- | 228 |
| Balance, June 30, 2017 | \$216,959 | \$(46,491) | \$ (293) | \$ 170,175 |
| Balance, January 1, 2018, as reported | \$217,081 | \$(42,804) | \$ (1,291) | \$ 172,986 |
| Cumulative effect adjustment upon adoption of ASU 2018-02 | --- | 278 | (278) | --- |
| Balance, January 1, 2018, adjusted | \$217,081 | \$(42,526) | \$ (1,569) | \$ 172,986 |
| Reclassification for equity securities upon adoption of ASU 2016-01 | --- | (24) | 24 | --- |
| Net income for the six months ended June 30, 2018 | --- | 12,483 | --- | 12,483 |
| Cash dividends at \$.12 per share | --- | (4,082) | --- | (4,082) |
| Repurchase of 452 shares for taxes withheld on vested restricted stock | (5) | --- | --- | (5) |
| Issuance of 45,000 shares for stock option exercise | 386 | --- | --- | 386 |
| Net change in unrealized loss on debt securities available for sale, net of tax | --- | --- | (2,267) | (2,267) |
| Stock compensation expense | 213 | --- | --- | 213 |
| Balance, June 30, 2018 | \$217,675 | \$(34,149) | \$ (3,812) | \$ 179,714 |

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

Six Month Periods Ended June 30, 2018 and 2017

(unaudited)

(Dollars in thousands)

| | Six Months Ended June 30, 2018 | | Six Months Ended June 30, 2017 | |
|--|---|--|---|--|
| Cash flows from operating activities | | | | |
| Net income | \$ 12,483 | | \$ 9,223 | |
| Adjustments to reconcile net income to net cash from operating activities: | | | | |
| Depreciation and amortization | 1,257 | | 973 | |
| Stock compensation expense | 213 | | 228 | |
| Provision for loan losses | (400) | | (1,000) | |
| Origination of loans for sale | (13,531) | | (33,707) | |
| Proceeds from sales of loans originated for sale | 15,041 | | 33,608 | |
| Net gains on mortgage loans | (363) | | (904) | |
| Gain on sales of securities | --- | | (3) | |
| Write-down of other real estate | 291 | | 85 | |
| Net (gain) loss on sales of other real estate | 132 | | (470) | |
| Net loss on sale of premises and equipment | --- | | 69 | |
| Deferred income tax expense | 427 | | 2,353 | |
| Change in accrued interest receivable and other assets | (1,799) | | 63 | |
| Earnings in bank-owned life insurance | (475) | | (481) | |
| | 581 | | 236 | |

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| | | |
|--|-----------|-----------|
| Change in accrued expenses and other liabilities | | |
| Net cash from operating activities | 13,857 | 10,273 |
| Cash flows from investing activities | | |
| Loan originations and payments, net | (7,175) | 30,005 |
| Purchases of securities available for sale | (19,096) | (14,683) |
| Purchases of securities held to maturity | (5,515) | (3,000) |
| Proceeds from: | | |
| Maturities and calls of securities | 24,465 | 10,872 |
| Sales of securities available for sale | --- | 5,807 |
| Principal paydowns on securities | 4,018 | 3,381 |
| Sales of other real estate | 1,765 | 5,601 |
| Sales of premises and equipment | --- | 590 |
| Additions to premises and equipment | (564) | (568) |
| Net cash from investing activities | (2,102) | 38,005 |
| Cash flows from financing activities | | |
| Change in deposits | 1,451 | 11,266 |
| Repayments and maturities of other borrowed funds | (31,451) | (21,388) |
| Proceeds from other borrowed funds | 5,000 | 20,000 |
| Proceeds from exercise of stock options | 386 | --- |
| Repurchase of shares for taxes withheld on vested restricted stock | (5) | --- |
| Cash dividends paid | (4,082) | (2,706) |
| Net cash from financing activities | (28,701) | 7,172 |

| | | |
|--|------------|------------|
| Net change in cash and cash equivalents | (16,946) | 55,450 |
| Cash and cash equivalents at beginning of period | 161,467 | 89,819 |
| Cash and cash equivalents at end of period | \$ 144,521 | \$ 145,269 |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

Six Month Periods Ended June 30, 2018 and 2017

(unaudited)

(Dollars in thousands)

| | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|
| Supplemental cash flow information | | |
| Interest paid | \$ 3,920 | \$ 2,600 |
| Income taxes paid | 1,100 | 825 |
| Supplemental noncash disclosures: | | |
| Transfers from loans to other real estate | 293 | 60 |
| Security settlement | --- | --- |
| Reclassification for equity securities upon adoption of ASU 2016-01 | 1,470 | --- |

See accompanying notes to consolidated financial statements.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of Macatawa Bank Corporation ("the Company", "our", "we") and its wholly-owned subsidiary, Macatawa Bank ("the Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The Bank operates 26 full service branch offices providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan.

The Company owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company under accounting principles generally accepted in the United States of America.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) believed necessary for a fair presentation have been included.

Operating results for the three and six month periods ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, valuation of deferred tax assets, loss contingencies, fair value of other real estate owned and fair values of financial instruments are particularly subject to change.

Allowance for Loan Losses: The allowance for loan losses (allowance) is a valuation allowance for probable incurred credit losses inherent in our loan portfolio, increased by the provision for loan losses and recoveries, and decreased by charge-offs of loans. Management believes the allowance for loan losses balance to be adequate based on known and inherent risks in the portfolio, past loan loss experience, information about specific borrower situations and estimated collateral values, economic conditions and other relevant factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Management continues its collection efforts on previously charged-off balances and applies recoveries as additions to the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current qualitative factors. The Company maintains a loss migration analysis that tracks loan

losses and recoveries based on loan class and the loan risk grade assignment for commercial loans. At June 30, 2018, an 18 month annualized historical loss experience was used for commercial loans and a 12 month historical loss experience period was applied to residential mortgage loans and consumer loans. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, external factors and other considerations.

A loan is impaired when, based on current information and events, it is believed to be probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans for which the terms have been modified and a concession has been made, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Commercial and commercial real estate loans with relationship balances exceeding \$500,000 and an internal risk grading of 6 or worse are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated and the loan is reported at the present value of estimated future cash flows using the loan's existing interest rate or at the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment and they are not separately identified for impairment disclosures.

Troubled debt restructurings are also considered impaired with impairment generally measured at the present value of estimated future cash flows using the loan's effective rate at inception or using the fair value of collateral, less estimated costs to sell, if repayment is expected solely from the collateral.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed unless they add value to the property.

Income Taxes: Income tax expense is the sum of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

The Company recognizes a tax position as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company recognizes interest and penalties related to income tax matters in income tax expense.

During the first quarter of 2018, the Company adopted ASU 2018-02, allowing for the reclassification of the income tax effects of the revaluation the deferred tax impact on accumulated other comprehensive income ("AOCI") due to the enactment of tax reform at the end of 2017. The Company's only component of AOCI is the fair value adjustment for securities available for sale. Upon adoption of this ASU, a transfer was made from AOCI to retained earnings in the amount of \$278,000.

Revenue Recognition: The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The Company's primary source of revenue is interest income from the Bank's loans and investment securities. The Company also earns noninterest revenue from various banking services offered by the Bank.

Interest Income: The Company's largest source of revenue is interest income which is primarily recognized on an accrual basis based on contractual terms written into loans and investment contracts.

Noninterest Revenue: The Company derives the majority of its noninterest revenue from: (1) service charges for deposit related services, (2) gains related to mortgage loan sales, (3) trust fees and (4) debit and credit card

interchange income. Most of these services are transaction based and revenue is recognized as the related service is provided.

Derivatives: Certain of the Bank's commercial loan customers have entered into interest rate swap agreements directly with the Bank. At the same time the Bank enters into a swap agreement with its customer, the Bank enters into a corresponding interest rate swap agreement with a correspondent bank at terms mirroring the Bank's interest rate swap with its commercial loan customer. This is known as a back-to-back swap agreement. Under this arrangement the Bank has seven freestanding interest rate swaps, each of which is carried at fair value. As the terms mirror each other, there is no income statement impact to the Bank. At June 30, 2018 and December 31, 2017, the total notional amount of such agreements was \$61.5 million and \$42.3 million and resulted in a derivative asset with a fair value of \$404,000 and \$197,000, respectively, which were included in other assets and a derivative liability of \$404,000 and \$197,000, respectively, which were included in other liabilities.

Reclassifications: Some items in the prior period financial statements were reclassified to conform to the current presentation.

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MACATAWA BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Adoption of New Accounting Standards: FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new standard requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The ASU also requires public business entities to use exit price notation when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The new standard was effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The impact of adoption of this ASU by the Company was not material, but did result in a reclassification of an equity investment from securities available for sale to other assets with its related market value changes reflected in earnings for the six months ended June 30, 2018. In addition, the fair value disclosures for financial instruments in Note 5 are computed using an exit price notion as required by the ASU.

FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this Update create a new topic in the Codification, Topic 606. In addition to superseding and replacing nearly all existing U.S. GAAP revenue recognition guidance, including industry-specific guidance, ASC 606 establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, ASU 2014-09 adds a new Subtopic to the Codification, ASC 340-40, Other Assets and Deferred Costs: Contracts with Customers, to provide guidance on costs related to obtaining a contract with a customer and costs incurred in fulfilling a contract with a customer that are not in the scope of another ASC Topic. The new guidance does not apply to certain contracts within the scope of other ASC Topics, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product or service warranties, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers. The amendments are effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. Adoption of this ASU effective January 1, 2018 did not materially affect the financial results of the Company. Additional disclosure has been added to Note 1 disclosing the composition of the Company's noninterest revenue.

FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force). This ASU addresses concerns regarding diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. In particular, this ASU addresses eight specific cash flow issues in an effort to reduce this diversity in practice: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon bonds; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. The amendments are effective for annual periods beginning after December 15, 2017, and for interim periods within those annual periods. The impact of adoption of this ASU by the Company on January 1, 2018 was not material.

FASB issued ASU No. 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This ASU allows a company to make a one-time reclassification from accumulated other comprehensive income to retained earnings for the stranded tax effects resulting from the Tax Cuts and Jobs Act, which was enacted

at the end of 2017. ASU 2018-02 is effective for all entities with periods beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period for which financial statements have not yet been issued. The amendments in ASU 2018-02 are to be applied either in the period of adoption, or retrospectively to each period in which the effect of the change in the US federal corporate income tax rate is recognized. The ASU requires a disclosure of the accounting policy for releasing income tax effects from accumulated other comprehensive income. The Company early adopted this ASU in the first quarter of 2018 and has recorded a reclassification adjustment of \$278,000 decreasing accumulated other comprehensive income and increasing retained earnings, effective December 31, 2017, and has included discussion as part of the Income Taxes accounting policy disclosure.

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MACATAWA BANK CORPORATION
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NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Newly Issued Not Yet Effective Standards: FASB issued ASU 2016-02, Leases. The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. As the Company owns most of its branch locations, this ASU will apply primarily to operating leases and the impact of adoption of this ASU by the Company is not expected to be material.

FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU provides financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing 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 new guidance eliminates the probable initial recognition threshold and, instead, reflects an entity's current estimate of all expected credit losses. The new guidance broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually to include forecasted information, as well as past events and current conditions. There is no specified method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Although an entity may still use its current systems and methods for recording the allowance for credit losses, under the new rules, the inputs used to record the allowance for credit losses generally will need to change to appropriately reflect an estimate of all expected credit losses and the use of reasonable and supportable forecasts. Additionally, credit losses on available-for-sale debt securities will now have to be presented as an allowance rather than as a write-down. This ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within those years. The Company has selected a software vendor for applying this new ASU, began implementation of the software in the second quarter of 2018 and is currently evaluating the impact of this new ASU on its consolidated financial statements.

FASB issued ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities. This ASU simplifies and expands the eligible hedging strategies for financial and nonfinancial risks by more closely aligning hedge accounting with a company's risk management activities, and also simplifies the application of Topic 815, Derivatives and Hedging, through targeted improvements in key practice areas. This includes expanding the list of items eligible to be hedged and amending the methods used to measure the effectiveness of hedging relationships. In addition, the ASU prescribes how hedging results should be presented and requires incremental disclosures. These changes are intended to allow preparers more flexibility and to enhance the transparency of how hedging results are presented and disclosed. Further, the ASU provides partial relief on the timing of certain aspects of hedge documentation and eliminates the requirement to recognize hedge ineffectiveness separately in earnings in the current period. The ASU is effective for years beginning after December 15, 2018, and interim periods within those years. The Company does not expect the impact of adoption of this ASU to be material.

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NOTE 2 – SECURITIES

The amortized cost and fair value of securities at period-end were as follows (dollars in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| <u>June 30, 2018</u> | | | | |
| <u>Available for Sale:</u> | | | | |
| U.S. Treasury and federal agency securities | \$ 96,201 | \$ --- | \$ (2,499) | \$ 93,702 |
| U.S. Agency MBS and CMOs | 29,509 | 4 | (860) | 28,653 |
| Tax-exempt state and municipal bonds | 44,089 | 204 | (535) | 43,758 |
| Taxable state and municipal bonds | 45,371 | 5 | (1,053) | 44,323 |
| Corporate bonds and other debt securities | 8,425 | --- | (91) | 8,334 |
| | \$ 223,595 | \$ 213 | \$ (5,038) | \$ 218,770 |
| <u>Held to Maturity</u> | | | | |
| Tax-exempt state and municipal bonds | \$ 79,569 | \$ 1,375 | \$ (408) | \$ 80,536 |
| | | | | |
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| <u>December 31, 2017</u> | | | | |
| <u>Available for Sale:</u> | | | | |
| U.S. Treasury and federal agency securities | \$ 103,309 | \$ --- | \$ (1,345) | \$ 101,964 |
| U.S. Agency MBS and CMOs | 23,797 | 7 | (419) | 23,385 |
| Tax-exempt state and municipal bonds | 41,684 | 519 | (146) | 42,057 |
| Taxable state and municipal bonds | 44,267 | 10 | (542) | 43,735 |
| Corporate bonds and other debt securities | 8,149 | 1 | (41) | 8,109 |
| Other equity securities | 1,500 | --- | (30) | 1,470 |
| | \$ 222,706 | \$ 537 | \$ (2,523) | \$ 220,720 |
| <u>Held to Maturity</u> | | | | |
| Tax-exempt state and municipal bonds | \$ 85,827 | \$ 806 | \$ (181) | \$ 86,452 |

There were no sales of securities in the three and six month periods ended June 30, 2018. Proceeds from the sale of securities available for sale were \$2.4 million in the three month period ended June 30, 2017 and \$5.8 million in the six month period ended June 30, 2017 resulting in no gains or losses on sale for the three month period ended June 30, 2017 and net gains of \$3,000 for the six month period ended June 30, 2017, as reported in the Consolidated Statements of Income. This resulted in reclassifications of \$3,000 (\$2,000 net of tax) from accumulated comprehensive income to gain on sale of securities in the Consolidated Statements of Income in the six month period ended June 30, 2017.

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MACATAWA BANK CORPORATION
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NOTE 2 – SECURITIES (Continued)

Contractual maturities of debt securities at June 30, 2018 were as follows (dollars in thousands):

| | Held-to-Maturity Securities | | Available-for-Sale Securities | |
|----------------------------|-----------------------------|------------|-------------------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | \$ 14,095 | \$ 14,126 | \$ 14,875 | \$ 14,820 |
| Due from one to five years | 26,634 | 26,962 | 127,872 | 124,892 |
| Due from five to ten years | 14,457 | 14,753 | 51,872 | 50,915 |
| Due after ten years | 24,383 | 24,695 | 28,976 | 28,143 |
| | \$ 79,569 | \$ 80,536 | \$ 223,595 | \$ 218,770 |

Securities with unrealized losses at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (dollars in thousands):

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| <u>June 30, 2018</u> | | | | | | |
| U.S. Treasury and federal agency securities | \$45,027 | \$ (990) | \$43,172 | \$ (1,422) | \$88,199 | \$ (2,412) |
| U.S. Agency MBS and CMOs | 21,112 | (603) | 5,526 | (257) | 26,638 | (860) |
| Tax-exempt state and municipal bonds | 32,386 | (752) | 4,079 | (191) | 36,465 | (943) |
| Taxable state and municipal bonds | 31,882 | (633) | 11,065 | (420) | 42,947 | (1,053) |
| Corporate bonds and other debt securities | 9,605 | (138) | 2,231 | (40) | 11,836 | (178) |
| Total temporarily impaired | \$140,012 | \$ (3,116) | \$66,073 | \$ (2,330) | \$206,085 | \$ (5,446) |

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| <u>December 31, 2017</u> | | | | | | |
| U.S. Treasury and federal agency securities | \$50,614 | \$ (439) | \$43,787 | \$ (876) | \$94,401 | \$ (1,315) |
| U.S. Agency MBS and CMOs | 16,719 | (249) | 6,228 | (170) | 22,947 | (419) |
| Tax-exempt state and municipal bonds | 20,124 | (243) | 4,208 | (82) | 24,332 | (325) |
| Taxable state and municipal bonds | 30,331 | (279) | 9,781 | (265) | 40,112 | (544) |
| Corporate bonds and other debt securities | 8,021 | (42) | 2,250 | (29) | 10,271 | (71) |
| Other equity securities | --- | --- | 1,470 | (30) | 1,470 | (30) |
| Total temporarily impaired | \$125,809 | \$ (1,252) | \$67,724 | \$ (1,452) | \$193,533 | \$ (2,704) |

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MACATAWA BANK CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

NOTE 2 – SECURITIES (Continued)

Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Management determined that the unrealized losses for each period were attributable to changes in interest rates and not due to credit quality. As such, no OTTI charges were necessary during the three and six month periods ended June 30, 2018 and 2017.

Securities with a carrying value of approximately \$2.0 million were pledged as security for public deposits, letters of credit and for other purposes required or permitted by law at June 30, 2018 and December 31, 2017.

NOTE 3 – LOANS

Portfolio loans were as follows (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|-------------------------------------|------------------|----------------------|
| Commercial and industrial | \$458,468 | \$ 465,208 |
| Commercial real estate: | | |
| Residential developed | 13,901 | 11,888 |
| Unsecured to residential developers | 2,517 | 2,332 |
| Vacant and unimproved | 36,268 | 39,752 |
| Commercial development | 738 | 1,103 |
| Residential improved | 83,223 | 90,467 |
| Commercial improved | 299,766 | 298,714 |
| Manufacturing and industrial | 110,588 | 97,679 |
| Total commercial real estate | 547,001 | 541,935 |
| Consumer | | |
| Residential mortgage | 238,419 | 224,452 |
| Unsecured | 190 | 226 |
| Home equity | 76,787 | 82,234 |
| Other secured | 6,821 | 6,254 |
| Total consumer | 322,217 | 313,166 |
| Total loans | 1,327,686 | 1,320,309 |
| Allowance for loan losses | (16,695) | (16,600) |
| | \$1,310,991 | \$ 1,303,709 |

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NOTE 3 – LOANS (Continued)

Activity in the allowance for loan losses by portfolio segment was as follows (dollars in thousands):

| | Commercial and | | Commercial | | |
|---|-------------------|-------------|------------|-------------|----------|
| <u>Three months ended June 30, 2018</u> | Industrial | Real Estate | Consumer | Unallocated | Total |
| Beginning balance | \$ 6,506 | \$ 6,532 | \$ 3,603 | \$ 34 | \$16,675 |
| Charge-offs | --- | --- | (30) | --- | (30) |
| Recoveries | 55 | 257 | 38 | --- | 350 |
| Provision for loan losses | (412) | 87 | 40 | (15) | (300) |
| Ending Balance | \$ 6,149 | \$ 6,876 | \$ 3,651 | \$ 19 | \$16,695 |

| | Commercial and | | Commercial | | |
|---|-------------------|-------------|------------|-------------|----------|
| <u>Three months ended June 30, 2017</u> | Industrial | Real Estate | Consumer | Unallocated | Total |
| Beginning balance | \$ 6,469 | \$ 6,598 | \$ 3,591 | \$ 38 | \$16,696 |
| Charge-offs | (108) | --- | (31) | --- | (139) |
| Recoveries | 41 | 456 | 16 | --- | 513 |
| Provision for loan losses | (66) | (471) | 45 | (8) | (500) |
| Ending Balance | \$ 6,336 | \$ 6,583 | \$ 3,621 | \$ 30 | \$16,570 |

| | Commercial and | | Commercial | | |
|---------------------------------------|-------------------|-------------|------------|-------------|----------|
| <u>Six months ended June 30, 2018</u> | Industrial | Real Estate | Consumer | Unallocated | Total |
| Beginning balance | \$ 6,478 | \$ 6,590 | \$ 3,494 | \$ 38 | \$16,600 |
| Charge-offs | (66) | --- | (60) | --- | (126) |
| Recoveries | 89 | 460 | 72 | --- | 621 |
| Provision for loan losses | (352) | (174) | 145 | (19) | (400) |
| Ending Balance | \$ 6,149 | \$ 6,876 | \$ 3,651 | \$ 19 | \$16,695 |

| | Commercial and | | Commercial | | |
|---------------------------------------|-------------------|-------------|------------|-------------|----------|
| <u>Six months ended June 30, 2017</u> | Industrial | Real Estate | Consumer | Unallocated | Total |
| Beginning balance | \$ 6,345 | \$ 6,703 | \$ 3,871 | \$ 43 | \$16,962 |
| Charge-offs | (108) | --- | (57) | --- | (165) |
| Recoveries | 64 | 618 | 91 | --- | 773 |
| Provision for loan losses | 35 | (738) | (284) | (13) | (1,000) |
| Ending Balance | \$ 6,336 | \$ 6,583 | \$ 3,621 | \$ 30 | \$16,570 |

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MACATAWA BANK CORPORATION
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NOTE 3 – LOANS (Continued)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method (dollars in thousands):

| | Commercial and Industrial | Commercial Real Estate | Consumer | Unallocated | Total |
|---|---------------------------------|---------------------------|------------|-------------|--------------|
| <u>June 30, 2018</u> | | | | | |
| Allowance for loan losses: | | | | | |
| Ending allowance attributable to loans: | | | | | |
| Individually reviewed for impairment | \$ 306 | \$ 325 | \$ 524 | \$ --- | \$ 1,155 |
| Collectively evaluated for impairment | 5,843 | 6,551 | 3,127 | 19 | 15,540 |
| Total ending allowance balance | \$ 6,149 | \$ 6,876 | \$ 3,651 | \$ 19 | \$ 16,695 |
| Loans: | | | | | |
| Individually reviewed for impairment | \$ 2,558 | \$ 5,235 | \$ 7,025 | \$ --- | \$ 14,818 |
| Collectively evaluated for impairment | 458,910 | 541,766 | 315,192 | --- | 1,312,868 |
| Total ending loans balance | \$ 458,468 | \$ 547,001 | \$ 322,217 | \$ --- | \$ 1,327,686 |
| | | | | | |
| | Commercial and Industrial | Commercial Real Estate | Consumer | Unallocated | Total |
| <u>December 31, 2017</u> | | | | | |
| Allowance for loan losses: | | | | | |
| Ending allowance attributable to loans: | | | | | |
| Individually reviewed for impairment | \$ 497 | \$ 197 | \$ 514 | \$ --- | \$ 1,208 |
| Collectively evaluated for impairment | 5,981 | 6,393 | 2,980 | 38 | 15,392 |
| Total ending allowance balance | \$ 6,478 | \$ 6,590 | \$ 3,494 | \$ 38 | \$ 16,600 |
| Loans: | | | | | |
| Individually reviewed for impairment | \$ 6,402 | \$ 7,332 | \$ 8,345 | \$ --- | \$ 22,079 |
| Collectively evaluated for impairment | 458,806 | 534,603 | 304,821 | --- | 1,298,230 |
| Total ending loans balance | \$ 465,208 | \$ 541,935 | \$ 313,166 | \$ --- | \$ 1,320,309 |

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MACATAWA BANK CORPORATION
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 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of June 30, 2018 (dollars in thousands):

| <u>June 30, 2018</u> | Unpaid Principal Balance | Recorded Investment | Allowance Allocated |
|--|--------------------------------|------------------------|------------------------|
| With no related allowance recorded: | | | |
| Commercial and industrial | \$ 954 | \$ 954 | \$ --- |
| Commercial real estate: | | | |
| Residential developed | --- | --- | --- |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 136 | 136 | --- |
| Commercial development | --- | --- | --- |
| Residential improved | 894 | 894 | --- |
| Commercial improved | 1,730 | 1,730 | --- |
| Manufacturing and industrial | --- | --- | --- |
| | 2,760 | 2,760 | --- |
| Consumer: | | | |
| Residential mortgage | --- | --- | --- |
| Unsecured | --- | --- | --- |
| Home equity | --- | --- | --- |
| Other secured | --- | --- | --- |
| | --- | --- | --- |
| Total with no related allowance recorded | \$ 3,714 | \$ 3,714 | \$ --- |
| With an allowance recorded: | | | |
| Commercial and industrial | \$ 1,604 | \$ 1,604 | \$ 306 |
| Commercial real estate: | | | |
| Residential developed | 175 | 175 | 2 |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 116 | 116 | 3 |
| Commercial development | --- | --- | --- |
| Residential improved | 208 | 208 | 14 |
| Commercial improved | 1,580 | 1,580 | 296 |
| Manufacturing and industrial | 396 | 396 | 10 |
| | 2,475 | 2,475 | 325 |
| Consumer: | | | |
| Residential mortgage | 5,753 | 5,753 | 429 |
| Unsecured | --- | --- | --- |
| Home equity | 1,272 | 1,272 | 95 |
| Other secured | --- | --- | --- |

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| | | | |
|----------------------------------|-----------|-----------|----------|
| | 7,025 | 7,025 | 524 |
| Total with an allowance recorded | \$ 11,104 | \$ 11,104 | \$ 1,155 |
| Total | \$ 14,818 | \$ 14,818 | \$ 1,155 |

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NOTE 3 – LOANS (Continued)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2017 (dollars in thousands):

| <u>December 31, 2017</u> | Unpaid Principal Balance | Recorded Investment | Allowance Allocated |
|--|--------------------------------|------------------------|------------------------|
| With no related allowance recorded: | | | |
| Commercial and industrial | \$ 3,438 | \$ 3,438 | \$ --- |
| Commercial real estate: | | | |
| Residential developed | --- | --- | --- |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | --- | --- | --- |
| Commercial development | 190 | 190 | --- |
| Residential improved | 15 | 15 | --- |
| Commercial improved | --- | --- | --- |
| Manufacturing and industrial | --- | --- | --- |
| | 205 | 205 | --- |
| Consumer: | | | |
| Residential mortgage | --- | --- | --- |
| Unsecured | --- | --- | --- |
| Home equity | --- | --- | --- |
| Other secured | --- | --- | --- |
| | --- | --- | --- |
| Total with no related allowance recorded | \$ 3,643 | \$ 3,643 | \$ --- |
| With an allowance recorded: | | | |
| Commercial and industrial | \$ 2,964 | \$ 2,964 | \$ 497 |
| Commercial real estate: | | | |
| Residential developed | 179 | 179 | 4 |
| Unsecured to residential developers | --- | --- | --- |
| Vacant and unimproved | 126 | 126 | 3 |
| Commercial development | --- | --- | --- |
| Residential improved | 1,715 | 1,715 | 69 |
| Commercial improved | 4,928 | 4,928 | 119 |
| Manufacturing and industrial | 179 | 179 | 2 |
| | 7,127 | 7,127 | 197 |
| Consumer: | | | |
| Residential mortgage | 6,638 | 6,638 | 409 |
| Unsecured | --- | --- | --- |
| Home equity | 1,707 | 1,707 | 105 |
| Other secured | --- | --- | --- |

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| | | | |
|----------------------------------|-----------|-----------|----------|
| | 8,345 | 8,345 | 514 |
| Total with an allowance recorded | \$ 18,436 | \$ 18,436 | \$ 1,208 |
| Total | \$ 22,079 | \$ 22,079 | \$ 1,208 |

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MACATAWA BANK CORPORATION
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 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents information regarding average balances of impaired loans and interest recognized on impaired loans for the three and six month periods ended June 30, 2018 and 2017 (dollars in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|--|--|--|--|
| Average of impaired loans during the period: | | | | |
| Commercial and industrial | \$ 3,959 | \$ 5,342 | \$ 5,872 | \$ 6,093 |
| Commercial real estate: | | | | |
| Residential developed | 176 | 183 | 177 | 184 |
| Unsecured to residential developers | --- | --- | --- | --- |
| Vacant and unimproved | 254 | 262 | 211 | 320 |
| Commercial development | --- | 189 | 63 | 189 |
| Residential improved | 1,175 | 2,665 | 1,315 | 3,376 |
| Commercial improved | 3,327 | 5,995 | 3,529 | 6,077 |
| Manufacturing and industrial | 399 | 327 | 326 | 276 |
| Consumer | 7,487 | 10,812 | 7,777 | 11,153 |
| Interest income recognized during impairment: | | | | |
| Commercial and industrial | 215 | 239 | 517 | 517 |
| Commercial real estate | 61 | 125 | 135 | 252 |
| Consumer | 70 | 118 | 155 | 226 |
| Cash-basis interest income recognized | | | | |
| Commercial and industrial | 230 | 266 | 524 | 531 |
| Commercial real estate | 50 | 126 | 129 | 249 |
| Consumer | 65 | 120 | 152 | 227 |

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NOTE 3 – LOANS (Continued)

Nonaccrual loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans. The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of June 30, 2018 and December 31, 2017 (dollars in thousands):

| <u>June 30, 2018</u> | Nonaccrual | Over 90 days Accruing |
|-------------------------------------|------------|-----------------------------|
| Commercial and industrial | \$ 2 | \$ --- |
| Commercial real estate: | | |
| Residential developed | --- | --- |
| Unsecured to residential developers | --- | --- |
| Vacant and unimproved | --- | --- |
| Commercial development | --- | --- |
| Residential improved | 15 | --- |
| Commercial improved | 106 | --- |
| Manufacturing and industrial | --- | --- |
| | 121 | --- |
| Consumer: | | |
| Residential mortgage | 2 | --- |
| Unsecured | --- | --- |
| Home equity | --- | --- |
| Other secured | --- | --- |
| | 2 | --- |
| Total | \$ 125 | \$ --- |

| <u>December 31, 2017</u> | Nonaccrual | Over 90 days Accruing |
|-------------------------------------|------------|-----------------------------|
| Commercial and industrial | \$ 4 | \$ --- |
| Commercial real estate: | | |
| Residential developed | --- | --- |
| Unsecured to residential developers | --- | --- |
| Vacant and unimproved | --- | --- |
| Commercial development | 190 | --- |
| Residential improved | 89 | --- |
| Commercial improved | 106 | --- |
| Manufacturing and industrial | --- | --- |
| | 385 | --- |

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| | | |
|----------------------|--------|--------|
| Consumer: | | |
| Residential mortgage | 2 | --- |
| Unsecured | 4 | --- |
| Home equity | --- | --- |
| Other secured | --- | --- |
| | 6 | --- |
| Total | \$ 395 | \$ --- |

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MACATAWA BANK CORPORATION
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 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents the aging of the recorded investment in past due loans as of June 30, 2018 and December 31, 2017 by class of loans (dollars in thousands):

| | 30-90 Days | Greater Than 90 Days | Total Past Due | Loans Not Past Due | Total |
|-------------------------------------|---------------|-------------------------|-------------------|-----------------------|-------------|
| <u>June 30, 2018</u> | | | | | |
| Commercial and industrial | \$ 70 | \$ --- | \$ 70 | \$458,398 | \$458,468 |
| Commercial real estate: | | | | | |
| Residential developed | --- | --- | --- | 13,901 | 13,901 |
| Unsecured to residential developers | --- | --- | --- | 2,517 | 2,517 |
| Vacant and unimproved | --- | --- | --- | 36,268 | 36,268 |
| Commercial development | --- | --- | --- | 738 | 738 |
| Residential improved | --- | 15 | 15 | 83,208 | 83,223 |
| Commercial improved | 10 | 106 | 116 | 299,650 | 299,766 |
| Manufacturing and industrial | --- | --- | --- | 110,588 | 110,588 |
| | 10 | 121 | 131 | 546,870 | 547,001 |
| Consumer: | | | | | |
| Residential mortgage | 174 | --- | 174 | 238,245 | 238,419 |
| Unsecured | --- | --- | --- | 190 | 190 |
| Home equity | 150 | --- | 150 | 76,637 | 76,787 |
| Other secured | --- | --- | --- | 6,821 | 6,821 |
| | 324 | --- | 324 | 321,893 | 322,217 |
| Total | \$404 | \$ 121 | \$ 525 | \$1,327,161 | \$1,327,686 |
| | | | | | |
| <u>December 31, 2017</u> | | | | | |
| Commercial and industrial | \$ 290 | \$ --- | \$ 290 | \$464,918 | \$465,208 |
| Commercial real estate: | | | | | |
| Residential developed | --- | --- | --- | 11,888 | 11,888 |
| Unsecured to residential developers | --- | --- | --- | 2,332 | 2,332 |
| Vacant and unimproved | --- | --- | --- | 39,752 | 39,752 |
| Commercial development | --- | 190 | 190 | 913 | 1,103 |
| Residential improved | --- | 89 | 89 | 90,378 | 90,467 |
| Commercial improved | 125 | --- | 125 | 298,589 | 298,714 |
| Manufacturing and industrial | --- | --- | --- | 97,679 | 97,679 |
| | 125 | 279 | 404 | 541,531 | 541,935 |
| Consumer: | | | | | |
| Residential mortgage | 215 | --- | 215 | 224,237 | 224,452 |
| Unsecured | 10 | --- | 10 | 216 | 226 |
| Home equity | 76 | --- | 76 | 82,158 | 82,234 |
| Other secured | --- | --- | --- | 6,254 | 6,254 |
| | 301 | --- | 301 | 312,865 | 313,166 |

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| | | | | | |
|-------|--------|--------|--------|--------------|--------------|
| Total | \$ 716 | \$ 279 | \$ 995 | \$ 1,319,314 | \$ 1,320,309 |
|-------|--------|--------|--------|--------------|--------------|

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NOTE 3 – LOANS (Continued)

The Company had allocated \$1,155,000 and \$1,208,000 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of June 30, 2018 and December 31, 2017, respectively. These loans may have involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. The Company has been active at utilizing these programs and working with its customers to reduce the risk of foreclosure. For commercial loans, these modifications typically include an interest only period and, in some cases, a lowering of the interest rate on the loan. In some cases, the modification will include separating the note into two notes with the first note structured to be supported by current cash flows and collateral, and the second note made for the remaining unsecured debt. The second note is charged off immediately and collected only after the first note is paid in full. This modification type is commonly referred to as an A-B note structure. For consumer mortgage loans, the restructuring typically includes a lowering of the interest rate to provide payment and cash flow relief. For each restructuring, a comprehensive credit underwriting analysis of the borrower’s financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan’s actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status.

In situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired loan designations may be removed. In addition, the TDR designation may also be removed from loans modified under an A-B note structure. If the remaining “A” note is at a market rate at the time of restructuring (taking into account the borrower’s credit risk and prevailing market conditions), the loan can be removed from TDR designation in a subsequent calendar year after six months of performance in accordance with the new terms. The market rate relative to the borrower’s credit risk is determined through analysis of market pricing information gathered from peers and use of a loan pricing model. The general objective of the model is to achieve a consistent return on equity from one credit to the next, taking into consideration differences in credit risk. In the model, credits with higher risk receive a higher potential loss allocation, and therefore require a higher interest rate to achieve the target return on equity.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral, less estimated costs to sell. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

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The following table presents information regarding troubled debt restructurings as of June 30, 2018 and December 31, 2017 (dollars in thousands):

| | June 30, 2018 | | December 31, 2017 | |
|---------------------------|---------------|-------------|-------------------|-------------|
| | Number | Outstanding | Number | Outstanding |
| | of | Recorded | of | Recorded |
| | Loans | Balance | Loans | Balance |
| Commercial and industrial | 18 | \$ 2,559 | 19 | \$ 6,402 |
| Commercial real estate | 30 | 5,235 | 33 | 7,332 |
| Consumer | 88 | 7,024 | 99 | 8,345 |
| | 136 | \$ 14,818 | 151 | \$ 22,079 |

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 (Unaudited)

NOTE 3 – LOANS (Continued)

The following table presents information related to accruing troubled debt restructurings as of June 30, 2018 and December 31, 2017. The table presents the amount of accruing troubled debt restructurings that were on nonaccrual status prior to the restructuring, accruing at the time of restructuring and those that were upgraded to accruing status after receiving six consecutive monthly payments in accordance with the restructured terms as of each period reported (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|--|------------------|----------------------|
| Accruing TDR - nonaccrual at restructuring | \$--- | \$--- |
| Accruing TDR - accruing at restructuring | 13,434 | 16,809 |
| Accruing TDR - upgraded to accruing after six consecutive payments | 1,261 | 4,955 |
| | \$14,695 | \$ 21,764 |

The following tables present information regarding troubled debt restructurings executed during the three month periods ended June 30, 2018 and 2017 (dollars in thousands):

| | Three Months Ended June 30, 2018 | | | Three Months Ended June 30, 2017 | | |
|---------------------------|-------------------------------------|--------------------|--------------------------|-------------------------------------|--------------------|--------------------------|
| | # of Loans | Pre-TDR Balance | Writedown Upon TDR | # of Loans | Pre-TDR Balance | Writedown Upon TDR |
| Commercial and industrial | --- | \$ --- | \$ --- | --- | \$ --- | \$ --- |
| Commercial real estate | --- | --- | --- | 1 | 1,018 | --- |
| Consumer | 2 | 24 | --- | 2 | 174 | --- |
| | 2 | 24 | \$ --- | 3 | \$ 1,192 | \$ --- |

The following tables present information regarding troubled debt restructurings executed during the six month periods ended June 30, 2018 and 2017 (dollars in thousands):

| | Six Months Ended June 30, 2018 | | | Six Months Ended June 30, 2017 | | |
|---------------------------|-----------------------------------|--------------------|--------------------------|-----------------------------------|--------------------|--------------------------|
| | # of Loans | Pre-TDR Balance | Writedown Upon TDR | # of Loans | Pre-TDR Balance | Writedown Upon TDR |
| Commercial and industrial | --- | \$ --- | \$ --- | --- | \$ --- | \$ --- |
| Commercial real estate | 3 | 492 | --- | 1 | 1,018 | --- |
| Consumer | 4 | 92 | --- | 2 | 174 | --- |
| | 7 | 584 | \$ --- | 3 | \$ 1,192 | \$ --- |

According to the accounting standards, not all loan modifications are TDRs. TDRs are modifications or renewals where the Company has granted a concession to a borrower in financial distress. The Company reviews all modifications and renewals for determination of TDR status. In some situations a borrower may be experiencing financial distress, but the Company does not provide a concession. These modifications are not considered TDRs. In

other cases, the Company might provide a concession, such as a reduction in interest rate, but the borrower is not experiencing financial distress. This could be the case if the Company is matching a competitor's interest rate. These modifications would also not be considered TDRs. Finally, any renewals at existing terms for borrowers not experiencing financial distress would not be considered TDRs. As with other loans not considered TDR or impaired, allowance allocations are based on the historical based allocation for the applicable loan grade and loan class.

Payment defaults on TDRs have been minimal and during the three and six month periods ended June 30, 2018 and 2017, the balance of loans that became delinquent by more than 90 days past due or that were transferred to nonaccrual within 12 months of restructuring were not material.

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MACATAWA BANK CORPORATION
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NOTE 3 – LOANS (Continued)

Credit Quality Indicators: The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes commercial loans individually and classifies these relationships by credit risk grading. The Company uses an eight point grading system, with grades 5 through 8 being considered classified, or watch, credits. All commercial loans are assigned a grade at origination, at each renewal or any amendment. When a credit is first downgraded to a watch credit (either through renewal, amendment, loan officer identification or the loan review process), an Administrative Loan Review (“ALR”) is generated by the credit department and the loan officer. All watch credits have an ALR completed quarterly which analyzes the collateral position and cash flow of the borrower and its guarantors. Management meets quarterly with loan officers to discuss each of these credits in detail and to help formulate solutions where progress has stalled. When necessary, the loan officer proposes changes to the assigned loan grade as part of the ALR. Additionally, Loan Review reviews all loan grades upon origination, renewal or amendment and again as loans are selected through the loan review process. The credit will stay on the ALR until either its grade has improved to a 4 or the credit relationship is at a zero balance. The Company uses the following definitions for the risk grades:

1. Excellent - Loans supported by extremely strong financial condition or secured by the Bank’s own deposits. Minimal risk to the Bank and the probability of serious rapid financial deterioration is extremely small.

2. Above Average - Loans supported by sound financial statements that indicate the ability to repay or borrowings secured (and margined properly) with marketable securities. Nominal risk to the Bank and probability of serious financial deterioration is highly unlikely. The overall quality of these credits is very high.

3. Good Quality - Loans supported by satisfactory asset quality and liquidity, good debt capacity coverage, and good management in all critical positions. Loans are secured by acceptable collateral with adequate margins. There is a slight risk of deterioration if adverse market conditions prevail.

4. Acceptable Risk - Loans carrying an acceptable risk to the Bank, which may be slightly below average quality. The borrower has limited financial strength with considerable leverage. There is some probability of deterioration if adverse market conditions prevail. These credits should be monitored closely by the Relationship Manager.

5. Marginally Acceptable - Loans are of marginal quality with above normal risk to the Bank. The borrower shows acceptable asset quality but very little liquidity with high leverage. There is inconsistent earning performance without the ability to sustain adverse market conditions. The primary source of repayment is questionable, but the secondary source of repayment still remains an option. Very close attention by the Relationship Manager and management is needed.

6. Substandard - Loans are inadequately protected by the net worth and paying capacity of the borrower or the collateral pledged. The primary and secondary sources of repayment are questionable. Heavy debt condition may be evident and volume and earnings deterioration may be underway. It is possible that the Bank will sustain some loss if the deficiencies are not immediately addressed and corrected.

7. Doubtful - Loans supported by weak or no financial statements, as well as the ability to repay the entire loan, are questionable. Loans in this category are normally characterized less than adequate collateral, insolvent, or extremely weak financial condition. A loan classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses makes collection or liquidation in full highly questionable. The possibility of loss is extremely high, however, activity may be underway to minimize the loss or maximize the recovery.

8. Loss - Loans are considered uncollectible and of little or no value as a bank asset.

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NOTE 3 – LOANS (Continued)

As of June 30, 2018 and December 31, 2017, the risk grade category of commercial loans by class of loans were as follows (dollars in thousands):

| <u>June 30, 2018</u> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | Total |
|-------------------------------------|-------|----------|-----------|-----------|----------|---------|-------|-------|-------------|
| Commercial and industrial | \$--- | \$10,121 | \$147,480 | \$285,164 | \$14,328 | \$1,373 | \$2 | \$--- | \$458,468 |
| Commercial real estate: | | | | | | | | | |
| Residential developed | --- | --- | --- | 13,280 | 621 | --- | --- | --- | 13,901 |
| Unsecured to residential developers | --- | --- | --- | 2,517 | --- | --- | --- | --- | 2,517 |
| Vacant and unimproved | --- | --- | 9,192 | 24,060 | 3,016 | --- | --- | --- | 36,268 |
| Commercial development | --- | --- | 93 | 645 | --- | --- | --- | --- | 738 |
| Residential improved | --- | --- | 7,098 | 74,723 | 1,133 | 253 | 16 | --- | 83,223 |
| Commercial improved | --- | 2,698 | 72,439 | 220,695 | 2,800 | 1,029 | 105 | --- | 299,766 |
| Manufacturing & industrial | --- | 2,319 | 26,340 | 76,869 | 5,060 | --- | --- | --- | 110,588 |
| | \$--- | \$15,138 | \$262,642 | \$697,953 | \$26,958 | \$2,655 | \$123 | \$--- | \$1,005,469 |
| <u>December 31, 2017</u> | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | Total |
| Commercial and industrial | \$--- | \$15,002 | \$137,774 | \$291,373 | \$15,170 | \$5,885 | \$4 | \$--- | \$465,208 |
| Commercial real estate: | | | | | | | | | |
| Residential developed | --- | --- | 48 | 11,068 | 772 | --- | --- | --- | 11,888 |
| Unsecured to residential developers | --- | --- | --- | 2,332 | --- | --- | --- | --- | 2,332 |
| Vacant and unimproved | --- | --- | 19,244 | 17,332 | 3,176 | --- | --- | --- | 39,752 |
| Commercial development | --- | --- | 104 | 809 | --- | --- | 190 | --- | 1,103 |
| Residential improved | --- | --- | 7,275 | 80,818 | 1,533 | 752 | 89 | --- | 90,467 |
| Commercial improved | --- | 1,398 | 64,043 | 228,888 | 3,353 | 926 | 106 | --- | 298,714 |
| Manufacturing & industrial | --- | 927 | 44,714 | 49,238 | 2,311 | 489 | --- | --- | 97,679 |
| | \$--- | \$17,327 | \$273,202 | \$681,858 | \$26,315 | \$8,052 | \$389 | \$--- | \$1,007,143 |

Commercial loans rated a 6 or worse per the Company's internal risk rating system are considered substandard, doubtful or loss. Commercial loans classified as substandard or worse were as follows at period-end (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|--|------------------|----------------------|
| Not classified as impaired | \$442 | \$2,010 |
| Classified as impaired | 2,336 | 6,431 |
| Total commercial loans classified substandard or worse | \$2,778 | \$8,441 |

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NOTE 3 – LOANS (Continued)

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For consumer loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in consumer loans based on payment activity (dollars in thousands):

| | Residential | Consumer | Home | Consumer |
|----------------------|-------------|-----------|----------|----------|
| <u>June 30, 2018</u> | Mortgage | Unsecured | Equity | Other |
| Performing | \$ 238,419 | \$ 190 | \$76,787 | \$ 6,821 |
| Nonperforming | --- | --- | --- | --- |
| Total | \$ 238,419 | \$ 190 | \$76,787 | \$ 6,821 |

| | Residential | Consumer | Home | Consumer |
|--------------------------|-------------|-----------|----------|----------|
| <u>December 31, 2017</u> | Mortgage | Unsecured | Equity | Other |
| Performing | \$ 224,452 | \$ 226 | \$82,234 | \$ 6,254 |
| Nonperforming | --- | --- | --- | --- |
| Total | \$ 224,452 | \$ 226 | \$82,234 | \$ 6,254 |

NOTE 4 – OTHER REAL ESTATE OWNED

Other real estate owned was as follows (dollars in thousands):

| | Six | Year | Six |
|---|--------------|--------------|--------------|
| | Months Ended | Ended | Months Ended |
| | June 30, | December 31, | June 30, |
| | 2018 | 2017 | 2017 |
| Beginning balance | \$ 9,140 | \$ 22,864 | \$ 22,864 |
| Additions, transfers from loans | 293 | 120 | 60 |
| Proceeds from sales of other real estate owned | (1,765) | (7,034) | (5,601) |
| Valuation allowance reversal upon sale | (2,508) | (7,367) | (6,395) |
| Gain / (loss) on sales of other real estate owned | (132) | 557 | 470 |
| | 5,028 | 9,140 | 11,398 |
| Less: valuation allowance | (1,156) | (3,373) | (4,301) |
| Ending balance | \$ 3,872 | \$ 5,767 | \$ 7,097 |

Activity in the valuation allowance was as follows (dollars in thousands):

| | Six | Six |
|------------------------------|--------------|--------------|
| | Months Ended | Months Ended |
| | June 30, | June 30, |
| | 2018 | 2017 |
| Beginning balance | \$ 3,373 | \$ 10,611 |
| Additions charged to expense | 291 | 85 |

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| | | | | |
|---------------------|----------|---|----------|---|
| Reversals upon sale | (2,508 |) | (6,395 |) |
| Ending balance | \$ 1,156 | | \$ 4,301 | |

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NOTE 5 – FAIR VALUE

ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value include:

- Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant 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; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Investment Securities: The fair values of investment securities are determined by matrix pricing, which is a mathematical technique widely used 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 (Level 2 inputs). The fair values of certain securities held to maturity are determined by computing discounted cash flows using observable and unobservable market inputs (Level 3 inputs).

Loans Held for Sale: The fair value of loans held for sale is based upon binding quotes from third party investors (Level 2 inputs).

Impaired Loans: Loans identified as impaired are measured using one of three methods: the loan's observable market price, the fair value of collateral or the present value of expected future cash flows. For each period presented, no impaired loans were measured using the loan's observable market price. If an impaired loan has had a chargeoff or if the fair value of the collateral is less than the recorded investment in the loan, we establish a specific reserve and report the loan as nonrecurring Level 3. The fair value of collateral of impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: Other real estate owned (OREO) properties are initially recorded at fair value, less estimated costs to sell when acquired, establishing a new cost basis. Adjustments to OREO are measured at fair value, less costs to sell. Fair values are generally based on third party appraisals or realtor evaluations of the property. These appraisals and evaluations may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, an impairment loss is recognized through a valuation allowance, and the property is reported as nonrecurring Level 3.

Interest Rate Swaps: For interest rate swap agreements, we measure fair value utilizing pricing provided by a third-party pricing source that uses market observable inputs, such as forecasted yield curves, and other

unobservable inputs and accordingly, interest rate swap agreements are classified as Level 3.

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NOTE 5 – FAIR VALUE (Continued)

Assets measured at fair value on a recurring basis are summarized below (in thousands):

| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|------------|--|---|---|
| <u>June 30, 2018</u> | | | | |
| U.S. Treasury and federal agency securities | \$93,702 | \$ --- | \$ 93,702 | \$ --- |
| U.S. Agency MBS and CMOs | 28,653 | --- | 28,653 | --- |
| Tax-exempt state and municipal bonds | 43,758 | --- | 43,758 | --- |
| Taxable state and municipal bonds | 44,323 | --- | 44,323 | --- |
| Corporate bonds and other debt securities | 8,334 | --- | 8,334 | --- |
| Other equity securities | 1,435 | --- | 1,435 | --- |
| Loans held for sale | 61 | --- | 61 | --- |
| Interest rate swaps | 404 | --- | --- | 404 |
| Interest rate swaps | (404) | --- | --- | (404) |
| <u>December 31, 2017</u> | | | | |
| U.S. Treasury and federal agency securities | \$101,964 | \$ --- | \$ 101,964 | \$ --- |
| U.S. Agency MBS and CMOs | 23,385 | --- | 23,385 | --- |
| Tax-exempt state and municipal bonds | 42,057 | --- | 42,057 | --- |
| Taxable state and municipal bonds | 43,735 | --- | 43,735 | --- |
| Corporate bonds and other debt securities | 8,109 | --- | 8,109 | --- |
| Other equity securities | 1,470 | --- | 1,470 | --- |
| Loans held for sale | 1,208 | --- | 1,208 | --- |
| Interest rate swaps | 197 | --- | --- | 197 |
| Interest rate swaps | (197) | --- | --- | (197) |

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

| | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|--------------------------|------------|--|---|---|
| <u>June 30, 2018</u> | | | | |
| Impaired loans | \$2,483 | \$ --- | \$ --- | \$ 2,483 |
| Other real estate owned | 1,738 | --- | --- | 1,738 |
| <u>December 31, 2017</u> | | | | |
| Impaired loans | \$2,278 | \$ --- | \$ --- | \$ 2,278 |
| Other real estate owned | 3,658 | --- | --- | 3,658 |

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NOTE 5 – FAIR VALUE (Continued)

Quantitative information about Level 3 fair value measurements measured on a non-recurring basis was as follows at period end (dollars in thousands):

| | Asset Fair Value | Valuation Technique | Unobservable Inputs | Range (%) |
|----------------------------|------------------------|---------------------------|---|-----------------------|
| <u>June 30, 2018</u> | | | | |
| Impaired Loans | \$2,483 | Sales comparison approach | Adjustment for differences between comparable sales | 1.0 to 15.0 9.5 |
| | | Income approach | Capitalization rate | to 11.0 |
| Other real estate owned | 1,738 | Sales comparison approach | Adjustment for differences between comparable sales | 3.0 to 20.0 9.5 |
| | | Income approach | Capitalization rate | to 11.0 |
| | | | | |
| | Asset Fair Value | Valuation Technique | Unobservable Inputs | Range (%) |
| <u>December 31, 2017</u> | | | | |
| Impaired Loans | \$2,278 | Sales comparison approach | Adjustment for differences between comparable sales | 2.0 to 15.0 9.5 |
| | | Income approach | Capitalization rate | to 11.0 |
| Other real estate owned | 3,658 | Sales comparison approach | Adjustment for differences between comparable sales | 3.0 to 22.0 9.5 |
| | | Income approach | Capitalization rate | to 11.0 |

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NOTE 5 – FAIR VALUE (Continued)

The carrying amounts and estimated fair values of financial instruments, not previously presented, were as follows at June 30, 2018 and December 31, 2017 (dollars in thousands):

| | Level in Fair Value Hierarchy | June 30, 2018 | | December 31, 2017 | |
|--|-------------------------------------|--------------------|---------------|--------------------|---------------|
| | | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets | | | | | |
| Cash and due from banks | Level 1 | \$37,105 | \$37,105 | \$34,945 | \$34,945 |
| Cash equivalents | Level 2 | 107,416 | 107,416 | 126,522 | 126,522 |
| Securities held to maturity | Level 3 | 79,569 | 80,536 | 85,827 | 86,452 |
| FHLB stock | | 11,558 | NA | 11,558 | NA |
| Loans, net | Level 2 | 1,308,508 | 1,315,257 | 1,301,431 | 1,296,633 |
| Bank owned life insurance | Level 3 | 40,744 | 40,744 | 40,243 | 40,243 |
| Accrued interest receivable | Level 2 | 5,078 | 5,078 | 4,680 | 4,680 |
| Financial liabilities | | | | | |
| Deposits | Level 2 | (1,580,461) | (1,580,641) | (1,579,010) | (1,579,016) |
| Other borrowed funds | Level 2 | (65,667) | (64,570) | (92,118) | (91,313) |
| Long-term debt | Level 2 | (41,238) | (36,962) | (41,238) | (36,546) |
| Accrued interest payable | Level 2 | (704) | (704) | (604) | (604) |
| Off-balance sheet credit-related items | | | | | |
| Loan commitments | | --- | --- | --- | --- |

The methods and assumptions used to estimate fair value are described as follows.

Carrying amount is the estimated fair value for cash and cash equivalents, bank owned life insurance, accrued interest receivable and payable, demand deposits, short-term borrowings and variable rate loans or deposits that reprice frequently and fully. Security fair values are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities as discussed above. For fixed rate loans, interest-bearing time deposits in other financial institutions, or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet credit-related items is not significant.

The estimated fair values of financial instruments disclosed above as of June 30, 2018 follow the guidance in ASU 2016-01 which prescribes an “exit price” approach in estimating and disclosing fair value of financial instruments incorporating discounts for credit, liquidity and marketability factors. The fair values shown as of December 31, 2017 and prior use an “entry price” approach.

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NOTE 6 – DEPOSITS

Deposits are summarized as follows (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|-----------------------------------|------------------|----------------------|
| Noninterest-bearing demand | \$496,605 | \$ 490,583 |
| Interest bearing demand | 396,180 | 408,865 |
| Savings and money market accounts | 584,299 | 587,931 |
| Certificates of deposit | 103,377 | 91,631 |
| | \$1,580,461 | \$ 1,579,010 |

Time deposits that exceed the FDIC insurance limit of \$250,000 were approximately \$26.6 million at June 30, 2018 and \$25.0 million at December 31, 2017.

NOTE 7 - OTHER BORROWED FUNDS

Other borrowed funds include advances from the Federal Home Loan Bank and borrowings from the Federal Reserve Bank.

Federal Home Loan Bank Advances

At period-end, advances from the Federal Home Loan Bank were as follows (dollars in thousands):

| <u>Principal Terms</u> | Advance Amount | Range of Maturities | Weighted Average Interest Rate | |
|-------------------------------------|-------------------|-----------------------------|--------------------------------------|---|
| June 30, 2018 | | | | |
| Single maturity fixed rate advances | \$ 45,000 | September 2018 to May 2023 | 1.78 | % |
| Amortizable mortgage advances | 667 | July 2018 | 3.63 | % |
| Putable advances | 20,000 | November 2024 | 1.81 | % |
| | \$65,667 | | | |
| December 31, 2017 | | | | |
| Single maturity fixed rate advances | \$ 70,000 | February 2018 to April 2021 | 1.59 | % |
| Amortizable mortgage advances | 2,118 | March 2018 to July 2018 | 3.78 | % |
| Putable advances | 20,000 | November 2024 | 1.81 | % |
| | \$92,118 | | | |

Each advance is subject to a prepayment fee if paid prior to its maturity date. Fixed rate advances are payable at maturity. Amortizable mortgage advances are fixed rate advances with scheduled repayments based upon amortization to maturity. These advances were collateralized by residential and commercial real estate loans totaling

\$491.0 million and \$493.2 million under a blanket lien arrangement at June 30, 2018 and December 31, 2017, respectively.

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NOTE 7 - OTHER BORROWED FUNDS (Continued)

Scheduled repayments of FHLB advances as of June 30, 2018 were as follows (in thousands):

| | |
|------------|----------|
| 2018 | \$20,667 |
| 2019 | 10,000 |
| 2020 | --- |
| 2021 | 10,000 |
| 2022 | --- |
| Thereafter | 25,000 |
| | \$65,667 |

Federal Reserve Bank borrowings

The Company has a financing arrangement with the Federal Reserve Bank. There were no borrowings outstanding at June 30, 2018 and December 31, 2017, and the Company had approximately \$16.8 million and \$11.0 million in unused borrowing capacity based on commercial and mortgage loans pledged to the Federal Reserve Bank totaling \$18.5 million and \$13.2 million at June 30, 2018 and December 31, 2017, respectively.

NOTE 8 - EARNINGS PER COMMON SHARE

A reconciliation of the numerators and denominators of basic and diluted earnings per common share for the three and six month periods ended June 30, 2018 and 2017 are as follows (dollars in thousands, except per share data):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|---|---|
| Net income available to common shares | \$6,728 | \$4,762 | 12,483 | \$9,223 |
| Weighted average shares outstanding, including participating stock awards - Basic | 34,016,679 | 33,942,318 | 34,013,555 | 33,941,668 |
| Dilutive potential common shares: | | | | |
| Stock options | --- | 5,809 | 597 | 6,703 |
| Weighted average shares outstanding- Diluted | 34,016,679 | 33,948,127 | 34,014,152 | 33,948,371 |
| Basic earnings per common share | \$0.20 | \$0.14 | 0.37 | \$0.27 |
| Diluted earnings per common share | \$0.20 | \$0.14 | 0.37 | \$0.27 |

There were no antidilutive shares of common stock in the three and six month periods ended June 30, 2018 and 2017.

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NOTE 9 - FEDERAL INCOME TAXES

Income tax expense was as follows (dollars in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|----------|---|---|---|---|
| Current | \$ 1,294 | \$ (62) | \$ 2,232 | \$ 1,742 |
| Deferred | 140 | 2,191 | 427 | 2,353 |
| | \$ 1,434 | \$ 2,129 | \$ 2,659 | \$ 4,095 |

The difference between the financial statement tax expense and amount computed by applying the statutory federal tax rate to pretax income was reconciled as follows (dollars in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|---|---|
| Statutory rate | 21 % | 35 % | 21 % | 35 % |
| Statutory rate applied to income before taxes | \$ 1,714 | \$ 2,412 | \$ 3,180 | \$ 4,661 |
| Deduct | | | | |
| Tax-exempt interest income | (183) | (186) | (362) | (369) |
| Bank-owned life insurance | (50) | (85) | (100) | (168) |
| Other, net | (47) | (12) | (59) | (29) |
| | \$ 1,434 | \$ 2,129 | \$ 2,659 | \$ 4,095 |

The realization of deferred tax assets (net of a recorded valuation allowance) is largely dependent upon future taxable income, future reversals of existing taxable temporary differences and the ability to carryback losses to available tax years. In assessing the need for a valuation allowance, we consider positive and negative evidence, including taxable income in carry-back years, scheduled reversals of deferred tax liabilities, expected future taxable income and tax planning strategies. No valuation allowance was necessary at June 30, 2018 or December 31, 2017.

Legislation H.R. 1, formerly known as "Tax Cuts and Jobs Act" (the Tax Reform Act) was enacted on December 22, 2017. The Tax Reform Act reduced the corporate income tax rate to 21% effective January 1, 2018 and changed certain other provisions. Accounting guidance requires the Company to remeasure its deferred tax assets and deferred tax liabilities on the date of enactment using the new enacted tax rate of 21%. The Company recorded additional expense of \$2.5 million in the fourth quarter of 2017 to reflect changes that resulted from the enactment of the Tax Reform Act.

Concurrent with the enactment of the Tax Reform Act, the SEC staff issued SAB 118, which allows companies to recognize the cumulative impact of the income tax effects triggered by the enactment of the new law over a period of up to 12 months in the reporting period in which the adjustment is identified. The Company will apply SAB 118 and continue to refine the measurement of its net deferred tax balance on December 22, 2017 during the preparation of its 2017 tax return as additional guidance and information becomes available.

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NOTE 9 - FEDERAL INCOME TAXES (Continued)

The net deferred tax asset recorded included the following amounts of deferred tax assets and liabilities (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|--|------------------|----------------------|
| Deferred tax assets | | |
| Allowance for loan losses | \$ 3,506 | \$ 3,486 |
| Nonaccrual loan interest | 301 | 346 |
| Valuation allowance on other real estate owned | 243 | 708 |
| Unrealized loss on securities available for sale | 1,020 | 417 |
| Other | 271 | 229 |
| Gross deferred tax assets | 5,341 | 5,186 |
| Valuation allowance | --- | --- |
| Total net deferred tax assets | 5,341 | 5,186 |
| Deferred tax liabilities | | |
| Depreciation | (949) | (977) |
| Prepaid expenses | (183) | (183) |
| Other | (249) | (241) |
| Gross deferred tax liabilities | (1,381) | (1,401) |
| Net deferred tax asset | \$ 3,960 | \$ 3,785 |

There were no unrecognized tax benefits at June 30, 2018 or December 31, 2017 and the Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months. The Company is no longer subject to examination by the Internal Revenue Service for years before 2014.

NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK

Some financial instruments are used to meet customer financing needs and to reduce exposure to interest rate changes. These financial instruments include commitments to extend credit and standby letters of credit. These involve, to varying degrees, credit and interest rate risk in excess of the amount reported in the financial statements.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment, and generally have fixed expiration dates. Collateral or other security is normally not obtained for these financial instruments prior to their use and many of the commitments are expected to expire without being used. Standby letters of credit are conditional commitments to guarantee a customer's performance to a third party. Exposure to credit loss if the other party does not perform is represented by the contractual amount for commitments to extend credit and standby letters of credit.

A summary of the contractual amounts of financial instruments with off balance sheet risk was as follows at period-end (dollars in thousands):

June 30, December 31,

| | 2018 | 2017 |
|---------------------------|-----------|------------|
| Commitments to make loans | \$101,315 | \$ 111,681 |
| Letters of credit | 18,519 | 11,317 |
| Unused lines of credit | 496,157 | 457,485 |

The notional amount of commitments to fund mortgage loans to be sold into the secondary market was approximately \$10.0 million and \$5.8 million at June 30, 2018 and December 31, 2017, respectively.

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NOTE 10 – COMMITMENTS AND OFF BALANCE-SHEET RISK (Continued)

At June 30, 2018, approximately 45.7% of the Bank's commitments to make loans were at fixed rates, offered at current market rates. The remainder of the commitments to make loans were at variable rates tied to prime or one month LIBOR and generally expire within 30 days. The majority of the unused lines of credit were at variable rates tied to prime.

NOTE 11 – CONTINGENCIES

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business. As of June 30, 2018, there were no material pending legal proceedings to which the Company or any of its subsidiaries are a party or which any of its properties are the subject.

NOTE 12 – SHAREHOLDERS' EQUITY

Regulatory Capital

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), which effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures.

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NOTE 12 – SHAREHOLDERS' EQUITY (Continued)

At June 30, 2018 and December 31, 2017, actual capital levels and minimum required levels were (dollars in thousands):

| | Actual Amount | Ratio | Minimum Capital Adequacy Amount | Ratio | Minimum Capital Adequacy With Capital Buffer Amount | Ratio | To Be Well Capitalized Under Prompt Corrective Action Regulations Amount | Ratio |
|--|------------------|--------|--|-------|--|-------|---|-------|
| <u>June 30, 2018</u> | | | | | | | | |
| CET1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | \$183,526 | 11.8 % | \$69,797 | 4.5 % | \$98,879 | 6.4 % | N/A | N/A |
| Bank | 217,299 | 14.0 | 69,790 | 4.5 | 98,870 | 6.4 | \$100,808 | 6.5 % |
| Tier 1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 223,526 | 14.4 | 93,062 | 6.0 | 122,144 | 7.9 | N/A | N/A |
| Bank | 217,299 | 14.0 | 93,054 | 6.0 | 122,133 | 7.9 | 124,072 | 8.0 |
| Total capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 240,221 | 15.5 | 124,083 | 8.0 | 153,165 | 9.9 | N/A | N/A |
| Bank | 233,994 | 15.1 | 124,072 | 8.0 | 153,151 | 9.9 | 155,090 | 10.0 |
| Tier 1 capital (to average assets) | | | | | | | | |
| Consolidated | 223,526 | 11.9 | 75,094 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 217,299 | 11.6 | 75,031 | 4.0 | N/A | N/A | 93,789 | 5.0 |
| <u>December 31, 2017</u> | | | | | | | | |
| CET1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | \$174,258 | 11.3 % | \$69,326 | 4.5 % | \$88,583 | 5.8 % | N/A | N/A |
| Bank | 208,356 | 13.5 | 69,257 | 4.5 | 88,495 | 5.8 | \$100,038 | 6.5 % |
| Tier 1 capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 214,258 | 13.9 | 92,435 | 6.0 | 111,692 | 7.3 | N/A | N/A |
| Bank | 208,356 | 13.5 | 92,343 | 6.0 | 111,581 | 7.3 | 123,124 | 8.0 |
| Total capital (to risk weighted assets) | | | | | | | | |
| Consolidated | 230,858 | 15.0 | 123,246 | 8.0 | 142,504 | 9.3 | N/A | N/A |
| Bank | 224,956 | 14.6 | 123,124 | 8.0 | 142,362 | 9.3 | 153,905 | 10.0 |
| Tier 1 capital (to average assets) | | | | | | | | |
| Consolidated | 214,258 | 11.9 | 72,138 | 4.0 | N/A | N/A | N/A | N/A |
| Bank | 208,356 | 11.6 | 72,076 | 4.0 | N/A | N/A | 90,095 | 5.0 |

Approximately \$40.0 million of trust preferred securities outstanding at June 30, 2018 and December 31, 2017, respectively, qualified as Tier 1 capital. Refer to our 2017 Form 10-K for more information on the trust preferred securities.

The Bank was categorized as "well capitalized" at June 30, 2018 and December 31, 2017.

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

Macatawa Bank Corporation is a Michigan corporation and a registered bank holding company. It wholly-owns Macatawa Bank, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the FDIC. The Bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust services in Kent County, Ottawa County, and northern Allegan County, Michigan. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in our Consolidated Financial Statements. For further information regarding consolidation, see the Notes to Consolidated Financial Statements.

At June 30, 2018, we had total assets of \$1.87 billion, total loans of \$1.33 billion, total deposits of \$1.58 billion and shareholders' equity of \$179.7 million. For the second quarter of 2018, we recognized net income of \$6.7 million compared to \$4.8 million in the second quarter of 2017. For the six months ended June 30, 2018, we recognized net income of \$12.5 million compared to \$9.2 million for the same period in 2017. The Bank was categorized as "well capitalized" under regulatory capital standards at June 30, 2018.

We paid a dividend of \$0.04 per share in the first and second quarters of 2017 and \$0.05 per share in the third and fourth quarters of 2017. We increased the dividend to \$0.06 per share for the first and second quarters of 2018.

RESULTS OF OPERATIONS

Summary: Net income for the quarter ended June 30, 2018 was \$6.7 million compared to \$4.8 million in the second quarter of 2017. Net income per common share on a diluted basis was \$0.20 for the second quarter of 2018 and \$0.14 for the second quarter of 2017. Net income for the six months ended June 30, 2018 was \$12.5 million, compared to \$9.2 million for the same period in 2017. Net income per share on a diluted basis for the six months ended June 30, 2018 was \$0.37 compared to \$0.27 for the same period in 2017.

The increase in earnings in the three months ended June 30, 2018 compared to the same period in 2017 was due primarily to increased net interest income and lower income tax expense. Net interest income increased to \$14.7 million in the three months ended June 30, 2018 compared to \$12.7 million in the same period in 2017. Income tax expense was lower by \$695,000 in the second quarter of 2018 primarily due to the effects of tax reform signed at the end of 2017, reducing the corporate federal income tax rate from 35% to 21%.

The increase in earnings in the six months ended June 30, 2018 compared to the same periods in 2017 was also due primarily to increased net interest income and lower income tax expense. Net interest income increased to \$28.8 million in the six months ended June 30, 2018 compared to \$25.3 million in the same period in 2017. Income tax expense was lower by \$1.4 million in the six months ended June 30, 2018 primarily due to the effects of tax reform signed at the end of 2017.

Other items impacting earnings in the three and six month periods ended June 30, 2018 included nonperforming asset expenses (including administration costs and losses), which were \$83,000 for three months ended June 30, 2018 and \$544,000 for the six months ended June 30, 2018 compared to a negative \$158,000 and a negative \$63,000 for the same periods in 2017 as we experienced net gains on sales of other real estate owned in the 2017 periods. Also, the provision for loan losses was a negative \$300,000 for the three months ended June 30, 2018 and negative \$400,000 for the six months ended June 30, 2018 compared to a negative \$500,000 and a negative \$1.0 million for the same periods in 2017. We again were in a net loan recovery position for the three months ended June 30, 2018, with \$320,000 in net loan recoveries, compared to \$374,000 in net loan recoveries in the same period in 2017. We were also in a net loan recovery position for the year to date period, with \$495,000 in net loan recoveries in the six month period ended

June 30, 2018 compared to \$608,000 in the same period in 2017. Each of these items is discussed more fully below.

Net Interest Income: Net interest income totaled \$14.7 million for the three months ended June 30, 2018 compared to \$12.7 million for the same period in 2017.

Net interest income was positively impacted in three months ended June 30, 2018 by an increase in average earning assets of \$162.1 million compared to the same period in 2017. Also, our average yield on earning assets for the three months ended June 30, 2018 increased 28 basis points compared to the same period in 2017 from 3.58% to 3.86%.

Average interest earning assets totaled \$1.76 billion for three months ended June 30, 2018 compared to \$1.59 billion for the same period in 2017. An increase of \$59.0 million in average securities between periods and an increase of \$64.5 million in average loans were the primary drivers of the increase. The net interest margin was 3.37% for the three months ended June 30, 2018 compared to 3.24% for the same period in 2017. Yield on commercial loans increased from 4.02% for three months ended June 30, 2017 to 4.45% for the same period in 2018. Yield on residential mortgage loans increased from 3.47% for the three months ended June 30, 2017 to 3.55% for the same period in 2018, while yields on consumer loans increased from 4.17% for the second quarter of 2017 to 4.73% for the second quarter of 2018.

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Average interest earning assets totaled \$1.74 billion for six months ended June 30, 2018 compared to \$1.59 billion for the same period in 2017. An increase of \$55.6 million in average securities between periods and an increase of \$56.4 million in average loans were the primary drivers of the increase. The net interest margin was 3.35% for the six months ended June 30, 2018 compared to 3.25% for the same period in 2017. Yield on commercial loans increased from 4.03% for six months ended June 30, 2017 to 4.38% for the same period in 2018. Yield on residential mortgage loans increased from 3.47% for the six months ended June 30, 2017 to 3.52% for the same period in 2018, while yields on consumer loans increased from 4.08% for the first half of 2017 to 4.60% for the first half of 2018.

The Federal Reserve Board increased the target federal funds rate by 100 basis points between December 2016 and December 2017, by 25 basis points in March 2018 and by 25 basis points in June 2018. These increases have had a net positive impact on our net interest margin position in the three and six months periods ended June 30, 2018 as more loans repriced at the higher rate than our funding sources.

Also positively impacting net interest income and resulting yields in each period was the recognition of interest that had been deferred on nonaccrual commercial loans upon payoff of these loans. This interest totaled \$20,000 in the three months ended June 30, 2018 and \$52,000 in the three months ended June 30, 2017 and \$76,000 in the six months ended June 30, 2018 compared to \$318,000 in the same period in 2017.

The cost of funds increased to 0.70% in the second quarter of 2018 compared to 0.49% in the second quarter of 2017. For the first six months of 2018, the cost of funds increased to 0.66% compared to 0.48% for the same period in 2017. Increases in the rates paid on our savings and money market accounts in response to the federal funds rate increases over the past year caused the increase in our cost of funds.

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The following table shows an analysis of net interest margin for the three month periods ended June 30, 2018 and 2017 (dollars in thousands):

| | For the three months ended June 30, | | | | | |
|--|-------------------------------------|-------------------------------|-----------------------------|--------------------|-------------------------------|-----------------------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Earned or Paid | Average Yield or Cost | Average Balance | Interest Earned or Paid | Average Yield or Cost |
| <u>Assets</u> | | | | | | |
| Taxable securities | \$ 179,954 | \$917 | 2.04 % | \$ 145,596 | \$646 | 1.77 % |
| Tax-exempt securities (1) | 131,162 | 905 | 3.55 | 106,495 | 545 | 3.21 |
| Commercial loans (2) | 1,007,037 | 11,322 | 4.45 | 956,815 | 9,730 | 4.02 |
| Residential mortgage loans | 237,116 | 2,102 | 3.55 | 214,857 | 1,863 | 3.47 |
| Consumer loans | 83,181 | 982 | 4.73 | 91,157 | 948 | 4.17 |
| Federal Home Loan Bank stock | 11,558 | 121 | 4.15 | 11,558 | 121 | 4.15 |
| Federal funds sold and other short-term investments | 106,901 | 487 | 1.80 | 68,371 | 189 | 1.09 |
| Total interest earning assets (1) | 1,756,909 | 16,836 | 3.86 | 1,594,849 | 14,042 | 3.58 |
| Noninterest earning assets: | | | | | | |
| Cash and due from banks | 31,330 | | | 30,499 | | |
| Other | 84,320 | | | 98,227 | | |
| Total assets | \$ 1,872,559 | | | \$ 1,723,575 | | |
| <u>Liabilities</u> | | | | | | |
| Deposits: | | | | | | |
| Interest bearing demand | \$409,334 | \$253 | 0.24 % | \$325,429 | \$68 | 0.08 % |
| Savings and money market accounts | 606,231 | 769 | 0.51 | 557,075 | 350 | 0.25 |
| Time deposits | 105,389 | 297 | 1.14 | 79,085 | 139 | 0.70 |
| Borrowings: | | | | | | |
| Other borrowed funds | 73,414 | 322 | 1.74 | 87,894 | 358 | 1.61 |
| Long-term debt | 41,238 | 542 | 4.17 | 41,238 | 422 | 4.05 |
| Total interest bearing liabilities | 1,235,606 | 2,183 | 0.70 | 1,090,721 | 1,337 | 0.49 |
| Noninterest bearing liabilities: | | | | | | |
| Noninterest bearing demand accounts | 454,454 | | | 458,186 | | |
| Other noninterest bearing liabilities | 5,750 | | | 6,427 | | |
| Shareholders' equity | 176,749 | | | 168,241 | | |
| Total liabilities and shareholders' equity | \$ 1,872,559 | | | \$ 1,723,575 | | |
| Net interest income | | \$ 14,653 | | | \$ 12,705 | |
| Net interest spread (1) | | | 3.16 % | | | 3.09 % |
| Net interest margin (1) | | | 3.37 % | | | 3.24 % |
| Ratio of average interest earning assets to average interest bearing liabilities | 142.19 % | | | 146.22 % | | |

(1) Yields are presented on a tax equivalent basis using a 21% and a 35% tax rate at June 30, 2018 and 2017, respectively.

(2) Includes loan fees of \$171,000 and \$157,000 for the three months ended June 30, 2018 and 2017. Includes average nonaccrual loans of approximately \$125,000 and \$592,000 for the three months ended June 30, 2018 and 2017.

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The following table shows an analysis of net interest margin for the six month periods ended June 30, 2018 and 2017 (dollars in thousands):

| | For the six months ended June 30, | | | | | |
|--|-----------------------------------|-------------------------|-----------------------|-----------------|-------------------------|-----------------------|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Earned or Paid | Average Yield or Cost | Average Balance | Interest Earned or Paid | Average Yield or Cost |
| <u>Assets</u> | | | | | | |
| Taxable securities | \$ 179,540 | \$ 1,785 | 1.99 % | \$ 146,612 | \$ 1,285 | 1.75 % |
| Tax-exempt securities (1) | 130,195 | 1,781 | 3.52 | 107,546 | 1,084 | 3.18 |
| Commercial loans (2) | 1,003,350 | 22,082 | 4.38 | 956,484 | 19,387 | 4.03 |
| Residential mortgage loans | 232,925 | 4,096 | 3.52 | 216,050 | 3,743 | 3.47 |
| Consumer loans | 84,876 | 1,937 | 4.60 | 92,263 | 1,865 | 4.08 |
| Federal Home Loan Bank stock | 11,558 | 318 | 5.47 | 11,558 | 245 | 4.21 |
| Federal funds sold and other short-term investments | 101,371 | 856 | 1.68 | 56,832 | 281 | 0.98 |
| Total interest earning assets (1) | 1,743,815 | 32,855 | 3.81 | 1,587,345 | 27,890 | 3.58 |
| Noninterest earning assets: | | | | | | |
| Cash and due from banks | 29,975 | | | 28,387 | | |
| Other | 85,519 | | | 99,424 | | |
| Total assets | \$ 1,859,309 | | | \$ 1,715,156 | | |
| <u>Liabilities</u> | | | | | | |
| Deposits: | | | | | | |
| Interest bearing demand | \$ 394,798 | \$ 399 | 0.21 % | \$ 323,231 | \$ 138 | 0.08 % |
| Savings and money market accounts | 605,743 | 1,383 | 0.46 | 553,404 | 641 | 0.23 |
| Time deposits | 101,678 | 530 | 1.05 | 78,529 | 259 | 0.67 |
| Borrowings: | | | | | | |
| Other borrowed funds | 80,405 | 692 | 1.71 | 93,427 | 740 | 1.57 |
| Long-term debt | 41,238 | 1,015 | 4.90 | 41,238 | 824 | 3.98 |
| Total interest bearing liabilities | 1,223,862 | 4,019 | 0.66 | 1,089,829 | 2,602 | 0.48 |
| Noninterest bearing liabilities: | | | | | | |
| Noninterest bearing demand accounts | 454,278 | | | 453,583 | | |
| Other noninterest bearing liabilities | 5,829 | | | 5,454 | | |
| Shareholders' equity | 175,340 | | | 166,290 | | |
| Total liabilities and shareholders' equity | \$ 1,859,309 | | | \$ 1,715,156 | | |
| Net interest income | | \$ 28,836 | | | \$ 25,288 | |
| Net interest spread (1) | | | 3.15 % | | | 3.10 % |
| Net interest margin | | | 3.35 % | | | 3.25 % |
| Ratio of average interest earning assets to average interest bearing liabilities | 142.48 % | | | 145.65 % | | |

(1) Yields are presented on a tax equivalent basis using a 21% and a 35% tax rate at June 30, 2018 and 2017, respectively.

(2) Includes loan fees of \$297,000 and \$366,000 for the six months ended June 30, 2018 and 2017. Includes average nonaccrual loans of approximately \$311,000 and \$488,000 for the six months ended June 30, 2018 and 2017.

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The following table presents the dollar amount of changes in net interest income due to changes in volume and rate:

| | For the three months ended June 30, 2018 vs 2017 | | | For the six months ended June 30, 2018 vs 2017 | | |
|---|--|----------|----------|--|----------|----------|
| | Increase (Decrease) Due to Volume | Rate | Total | Increase (Decrease) Due to Volume | Rate | Total |
| (Dollars in thousands) | | | | | | |
| Interest income | | | | | | |
| Taxable securities | \$ 166 | \$ 105 | \$ 271 | \$ 313 | \$ 187 | \$ 500 |
| Tax-exempt securities | 245 | 115 | 360 | 449 | 248 | 697 |
| Commercial loans | 529 | 1,063 | 1,592 | 980 | 1,715 | 2,695 |
| Residential mortgage loans | 197 | 42 | 239 | 296 | 57 | 353 |
| Consumer loans | (395) | 429 | 34 | (344) | 416 | 72 |
| Federal Home Loan Bank stock | --- | --- | --- | --- | 73 | 73 |
| Federal funds sold and other short-term investments | 139 | 159 | 298 | 304 | 271 | 575 |
| Total interest income | 881 | 1,913 | 2,794 | 1,998 | 2,967 | 4,965 |
| Interest expense | | | | | | |
| Interest bearing demand | \$ 22 | \$ 163 | \$ 185 | \$ 36 | \$ 225 | \$ 261 |
| Savings and money market accounts | 33 | 386 | 419 | 66 | 676 | 742 |
| Time deposits | 56 | 102 | 158 | 91 | 180 | 271 |
| Other borrowed funds | (175) | 139 | (36) | (187) | 139 | (48) |
| Long-term debt | --- | 120 | 120 | --- | 191 | 191 |
| Total interest expense | (64) | 910 | 846 | 6 | 1,411 | 1,417 |
| Net interest income | \$ 945 | \$ 1,003 | \$ 1,948 | \$ 1,992 | \$ 1,556 | \$ 3,548 |

Provision for Loan Losses: The provision for loan losses for the three months ended June 30, 2018 was a negative \$300,000 compared to a negative \$500,000 for the same period in 2017. The negative provisions for loan losses for each period were the result of continued stabilization of real estate values on problem credits, continued improvement in asset quality metrics and net loan recoveries of \$320,000 in the three months ended June 30, 2018 and \$374,000 in the same period in 2017. At June 30, 2018, we had experienced net loan recoveries in each of the past fourteen quarters. The provision for loan losses for the first half of 2018 was a negative \$400,000 compared to a negative \$1.0 million for the same period in 2017.

Gross loan recoveries were \$350,000 for the three months ended June 30, 2018 and \$513,000 for the same period in 2017. In the three months ended June 30, 2018, we had \$30,000 in charge-offs, compared to \$139,000 in the same period in 2017. For the six months ended June 30, 2018, we experienced gross loan recoveries of \$621,000 compared to \$773,000 for the same period in 2017. Gross charge-offs for the six months ended June 30, 2018 were \$126,000 compared to \$165,000 for the same period in 2017. We continue to experience positive results from our collection efforts as evidenced by our net loan recoveries. While we expect our collection efforts to produce further recoveries, they will not continue at the same level we have experienced the past several quarters.

The amounts of loan loss provision in both the most recent quarter and comparable prior year period were the result of establishing our allowance for loan losses at levels believed necessary based upon our methodology for determining the adequacy of the allowance. The sustained level of quarterly net recoveries over the past several quarters had a significant effect on the historical loss component of our methodology. More information about our allowance for loan losses and our methodology for establishing its level may be found under the heading "Allowance for Loan Losses"

below.

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Noninterest Income: Noninterest income for the three and six month periods ended June 30, 2018 was \$4.5 million and \$8.6 million compared to \$4.5 million and \$8.7 million and for the same periods in 2017. The components of noninterest income are shown in the table below (in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|--|---|---|---|---|
| Service charges and fees on deposit accounts | \$ 1,060 | \$ 1,110 | 2,110 | \$ 2,170 |
| Net gains on mortgage loans | 222 | 476 | 363 | 904 |
| Trust fees | 945 | 833 | 1,870 | 1,611 |
| Gain as sales of securities | --- | --- | --- | 3 |
| ATM and debit card fees | 1,414 | 1,338 | 2,692 | 2,539 |
| Bank owned life insurance ("BOLI") income | 237 | 243 | 475 | 481 |
| Investment services fees | 271 | 250 | 495 | 466 |
| Other income | 319 | 228 | 594 | 535 |
| Total noninterest income | \$ 4,468 | \$ 4,478 | \$ 8,599 | \$ 8,709 |

Net gains on mortgage loans were down \$254,000 in the three months ended June 30, 2018 and down \$541,000 in the six months ended June 30, 2018 compared to same periods in 2017 as a result of an overall shift in the mix from loans originated for sale to loans originated for portfolio as well as lower overall origination volume. Mortgage loans originated for sale in the three months ended June 30, 2018 were \$8.4 million, compared to \$16.8 million in the same period in 2017. Mortgage loans originated for portfolio in three months ended June 30, 2018 were \$18.8 million, compared to \$12.2 million in the same period in 2017. For the first six months of 2018, mortgages originated for sale were \$13.5 million, compared to \$33.7 million for the same period in 2017. Mortgage loans originated for portfolio in the first half of 2018 were \$34.9 million, compared to \$21.3 million for the first half of 2017.

ATM and debit card fees were up in the three months ended June 30, 2018 due to higher volume of usage by our customers. Trust fees were up for the three and six months ended June 30, 2018 due to success in growing the number of trust customer relationships we have and favorable investment market value changes.

Noninterest Expense: Noninterest expense increased to \$11.3 million for the three month period ended June 30, 2018, from \$10.8 million for the same period in 2017. Noninterest expense increased to \$22.7 million for the six month period ended June 30, 2018 compared to \$21.7 million for the same period in 2017. The components of noninterest expense are shown in the table below (in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|------------------------------------|---|---|---|---|
| Salaries and benefits | \$ 6,389 | \$ 6,153 | \$ 12,583 | \$ 12,152 |
| Occupancy of premises | 973 | 991 | 2,045 | 2,017 |
| Furniture and equipment | 773 | 750 | 1,578 | 1,482 |
| Legal and professional | 215 | 197 | 417 | 422 |
| Marketing and promotion | 229 | 225 | 457 | 453 |
| Data processing | 797 | 731 | 1,493 | 1,413 |
| FDIC assessment | 132 | 134 | 264 | 270 |
| Interchange and other card expense | 359 | 324 | 691 | 637 |
| Bond and D&O insurance | 110 | 118 | 219 | 234 |
| | 17 | (300) | 423 | (385) |

Net (gains) losses on repossessed and foreclosed properties

| | | | | |
|--|-----------|-----------|-----------|-----------|
| Administration and disposition of problem assets | 66 | 142 | 121 | 322 |
| Outside services | 401 | 408 | 800 | 857 |
| Other noninterest expense | 798 | 919 | 1,602 | 1,805 |
| Total noninterest expense | \$ 11,259 | \$ 10,792 | \$ 22,693 | \$ 21,679 |

Most categories of noninterest expense were relatively flat or had reductions compared to the three months ended June 30, 2017 due to our ongoing efforts to manage expenses and scale our operations. Our largest component of noninterest expense, salaries and benefits, increased by \$236,000 in the three months ended June 30, 2018 from same period in 2017 and was up \$431,000 for the first six months of 2018. This increase is due to annual performance adjustments and inflationary increases in salaries as well as a higher level of costs associated with employee benefits. Variable based compensation was up \$16,000 compared to the three months ended June 30, 2017 and was down \$34,000 for the first six months of 2018 compared to the same period in 2017 due to mortgage production volumes.

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Data processing costs continue to increase as more customers choose to use electronic and mobile banking options. Data processing costs were up \$66,000 in the three months ended June 30, 2018 and were up \$80,000 for the first six months of 2018.

While costs associated with administration and disposition of problem assets have increased in 2018, they have decreased significantly over the past several years and have normalized. These expenses include legal costs, repossessed and foreclosed property administration expense and losses on repossessed and foreclosed properties. Repossessed and foreclosed property administration expense includes survey and appraisal, property maintenance and management and other disposition and carrying costs. Losses on repossessed and foreclosed properties include both net gains and losses on the sale of properties and unrealized losses from value declines for outstanding properties. The net expense increased from 2017 to 2018, primarily due to realizing net losses on sales in the first three and six months of 2018 compared to net gains on sales in same periods in 2017. Actual holding costs were down in 2018.

These costs are itemized in the following table (in thousands):

| | Three Months Ended June 30, 2018 | Three Months Ended June 30, 2017 | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|---|---|
| Legal and professional – nonperforming assets | \$ 9 | \$ 18 | \$ 22 | \$ 35 |
| Repossessed and foreclosed property administration | 57 | 124 | 99 | 287 |
| Net (gains) losses on repossessed and foreclosed properties | 17 | (300) | 423 | (385) |
| Total | \$ 83 | \$ (158) | \$ 544 | \$ (63) |

As the level of problem loans and assets have declined, the costs associated with these nonperforming assets have decreased significantly over the past several years. Other real estate owned decreased from \$7.1 million at June 30, 2017 to \$3.9 million at June 30, 2018. During the second quarter of 2017, we sold our largest individual other real estate owned property at that time (carry value of \$3.4 million) for a net gain of \$68,000. This property was responsible for a significant portion of our nonperforming asset expense, including maintenance, property taxes and utility costs.

Net gains/losses on repossessed assets and foreclosed properties for the three month period ended June 30, 2018 swung unfavorably by \$327,000 compared to the same period in 2017. For the first six months of 2018, net gains/losses swung unfavorably by \$602,000 compared to 2017. These changes were primarily due to net gains/losses on sales of other real estate properties in these periods. In the three month period ended June 30, 2018, net realized losses of \$6,000, compared to net realized gains of \$321,000 for the same period in 2017. For the six month period ended June 30, 2018, net realized losses totaled \$132,000, compared to net realized gains of \$470,000 for the same period in 2017.

Federal Income Tax Expense: We recorded \$1.4 million and \$2.7 million in federal income tax expense for the three and six month periods ended June 30, 2018 compared to \$2.1 million and \$4.1 million in the same periods in 2017. Our effective tax rate for the three and six month periods ended June 30, 2018 was 17.57% and 17.56%, compared to 30.90% and 30.75%, respectively, for the same periods in 2017. Federal income tax expense and related effective tax rates were lower in the 2018 periods due to the effect of tax reform legislation enacted at the end of 2017.

FINANCIAL CONDITION

Total assets were \$1.87 billion at June 30, 2018, a decrease of \$17.7 million from \$1.89 billion at December 31, 2017. This change reflected increases of \$7.4 million in our loan portfolio and \$2.9 million in other assets, offset by decreases of \$16.9 million in cash and cash equivalents, \$2.0 million in securities available for sale, \$1.1 million in

loans held for sale and \$1.9 in other real estate owned. Total deposits increased by \$1.5 million and other borrowed funds decreased by \$26.5 million at June 30, 2018 compared to December 31, 2017.

Cash and Cash Equivalents: Our cash and cash equivalents, which include federal funds sold and short-term investments, were \$144.5 million at June 30, 2018 compared to \$161.5 million at December 31, 2017. The decrease in these balances related primarily to the decrease in total deposits and other borrowed funds.

Securities: Debt securities available for sale were \$218.8 million at June 30, 2018 compared to \$220.7 million at December 31, 2017. The balance at June 30, 2018 primarily consisted of U.S. agency securities, agency mortgage backed securities and various municipal investments. Our held to maturity portfolio decreased from \$85.8 million at December 31, 2017 to \$79.6 million at June 30, 2018. Our held to maturity portfolio is comprised of state, municipal and privately placed commercial bonds.

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Portfolio Loans and Asset Quality: Total portfolio loans increased by \$7.4 million in the first six months of 2018 and were \$1.33 billion at June 30, 2018 compared to \$1.32 billion at December 31, 2017. During the first six months of 2018, our commercial portfolio decreased by \$1.7 million, while our consumer portfolio decreased by \$4.9 million and our residential mortgage portfolio increased by \$14.0 million.

Mortgage loans originated for portfolio are typically loans that conform to secondary market requirements and have a term of fifteen years or less. Mortgage loans originated for portfolio in the first six months of 2018 increased \$13.6 million compared to the same period in 2017, from \$21.3 million in the first six months of 2017 to \$34.9 million in the same period in 2018.

The volume of residential mortgage loans originated for sale in the first six months of 2018 decreased \$20.2 million compared to the same period in 2017 due to a higher interest rate environment. Residential mortgage loans originated for sale were \$13.5 million in the first six months of 2018 compared to \$33.7 million in the first six months of 2017.

The following table shows our loan origination activity for loans to be held in portfolio during the first six months of 2018 and 2017, broken out by loan type and also shows average originated loan size (dollars in thousands):

| | Six months ended June 30, 2018 | | | Six months ended June 30, 2017 | | |
|--|--------------------------------|-------------------------------------|----------------------|--------------------------------|-------------------------------------|----------------------|
| | Portfolio Originations | Percent of Total Originations | Average Loan Size | Portfolio Originations | Percent of Total Originations | Average Loan Size |
| Commercial real estate: | | | | | | |
| Residential developed | \$ 12,608 | 4.7 | % \$ 970 | \$ 1,798 | 0.9 | % \$ 360 |
| Unsecured to residential developers | --- | --- | --- | --- | --- | --- |
| Vacant and unimproved | 8,275 | 3.1 | 828 | 5,292 | 2.7 | 661 |
| Commercial development | 250 | 0.1 | 250 | 125 | 0.1 | 125 |
| Residential improved | 40,738 | 15.2 | 503 | 23,814 | 11.9 | 238 |
| Commercial improved | 17,608 | 6.5 | 550 | 35,523 | 17.8 | 866 |
| Manufacturing and industrial | 36,183 | 13.5 | 1,508 | 13,749 | 6.9 | 764 |
| Total commercial real estate | 115,662 | 43.1 | 718 | 80,301 | 40.3 | 464 |
| Commercial and industrial | 94,092 | 35.1 | 682 | 75,201 | 37.8 | 602 |
| Total commercial | 209,754 | 78.2 | 702 | 155,502 | 78.1 | 522 |
| Consumer | | | | | | |
| Residential mortgage | 34,878 | 13.0 | 226 | 21,274 | 10.7 | 239 |
| Unsecured | --- | --- | --- | --- | --- | --- |
| Home equity | 21,473 | 8.0 | 88 | 21,177 | 10.6 | 84 |
| Other secured | 2,059 | 0.8 | 27 | 1,235 | 0.6 | 16 |
| Total consumer | 58,410 | 21.8 | 123 | 43,686 | 21.9 | 104 |
| Total loans | \$ 268,164 | 100.0 | % 346 | \$ 199,188 | 100.0 | % 277 |

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The following table shows a breakout of our commercial loan activity during the first six months of 2018 and 2017 (dollars in thousands):

| | Six Months Ended June 30, 2018 | Six Months Ended June 30, 2017 |
|---|---|---|
| Commercial loans originated | \$ 209,754 | \$ 155,502 |
| Repayments of commercial loans | (176,238) | (150,401) |
| Change in undistributed - available credit | (35,190) | (22,666) |
| Net increase/(decrease) in total commercial loans | \$ (1,674) | \$ (17,565) |

Overall, the commercial loan portfolio decreased \$1.7 million in the first six months of 2018. Our commercial and industrial portfolio decreased by \$6.7 million and our commercial real estate loans increased by \$5.1 million. Our overall production of commercial loans increased by \$54.3 million from \$155.5 million in the first six months of 2017 compared to \$209.8 million in the same period of 2018. While production was significant, the ending portfolio balance changed only slightly from December 31, 2017 to June 30, 2018 due primarily to large repayments from a handful of commercial customers. Considering our pipeline of commercial credits at June 30, 2018, we expect to achieve measured, high quality loan portfolio growth throughout the remainder of 2018 consistent with growth experienced in the second half of the previous two years.

Commercial and commercial real estate loans remained our largest loan segment and accounted for approximately 75.7% and 76.3% of the total loan portfolio at June 30, 2018 and December 31, 2017. Residential mortgage and consumer loans comprised approximately 24.3% and 23.7% of total loans at June 30, 2018 and December 31, 2017.

A further breakdown of the composition of the loan portfolio is shown in the table below (in thousands):

| | June 30, 2018 | | December 31, 2017 | | |
|-------------------------------------|---------------|---------------------------|-------------------|---------------------------|---|
| | Balance | Percent of Total Loans | Balance | Percent of Total Loans | |
| Commercial real estate: (1) | | | | | |
| Residential developed | \$ 13,901 | 1.0 | % \$ 11,888 | 0.9 | % |
| Unsecured to residential developers | 2,517 | 0.2 | 2,332 | 0.2 | |
| Vacant and unimproved | 36,268 | 2.7 | 39,752 | 3.1 | |
| Commercial development | 738 | 0.1 | 1,103 | --- | |
| Residential improved | 83,223 | 6.3 | 90,467 | 6.9 | |
| Commercial improved | 299,766 | 22.6 | 298,714 | 22.6 | |
| Manufacturing and industrial | 110,588 | 8.3 | 97,679 | 7.4 | |
| Total commercial real estate | 547,001 | 41.2 | 541,935 | 41.1 | |
| Commercial and industrial | 458,468 | 34.5 | 465,208 | 35.2 | |
| Total commercial | 1,005,469 | 75.7 | 1,007,143 | 76.3 | |
| Consumer | | | | | |
| Residential mortgage | 238,419 | 18.0 | 224,452 | 17.0 | |
| Unsecured | 190 | --- | 226 | --- | |
| Home equity | 76,787 | 5.8 | 82,157 | 6.2 | |
| Other secured | 6,821 | 0.5 | 6,331 | 0.5 | |
| Total consumer | 322,217 | 24.3 | 313,166 | 23.7 | |
| Total loans | \$ 1,327,686 | 100.0 | % \$ 1,320,309 | 100.0 | % |

(1) Includes both owner occupied and non-owner occupied commercial real estate.

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Commercial real estate loans accounted for 41.2% and 41.1% of the total loan portfolio at June 30, 2018 and December 31, 2017 and consisted primarily of loans to business owners and developers of owner and non-owner occupied commercial properties and loans to developers of single and multi-family residential properties. In the table above, we show our commercial real estate portfolio by loans secured by residential and commercial real estate, and by stage of development. Improved loans are generally secured by properties that are under construction or completed and placed in use. Development loans are secured by properties that are in the process of development or fully developed. Vacant and unimproved loans are secured by raw land for which development has not yet begun and agricultural land.

Our consumer residential mortgage loan portfolio, which also includes residential construction loans made to individual homeowners, comprised 18.0% of portfolio loans at June 30, 2018 and 17.0% at December 31, 2017. We expect to continue to retain in our loan portfolio certain types of residential mortgage loans (primarily high quality, low loan-to-value loans) in an effort to continue to diversify our credit risk and deploy our excess liquidity. We typically hold for portfolio the originations of adjustable rate mortgages while selling into the secondary market the originations of fixed rate mortgages.

The volume of residential mortgage loans originated for sale during the first six months of 2018 decreased from the first six months of 2017 as a result of interest rate conditions. We are also experiencing a shift in production to financing home purchases versus refinancings. Volume has been negatively impacted by a shortage in the number of available residential properties for sale in our market areas.

Our portfolio of other consumer loans includes loans secured by personal property and home equity fixed term and line of credit loans. Consumer loans decreased by \$4.9 million to \$83.8 million at June 30, 2018 from \$88.7 million at December 31, 2017, due primarily to a decrease in home equity loans. Consumer loans comprised 6.3% of our portfolio loans at June 30, 2018 and 6.7% at December 31, 2017.

Our loan portfolio is reviewed regularly by our senior management, our loan officers, and an internal loan review team that is independent of our loan originators and credit administration. An administrative loan committee consisting of senior management and seasoned lending and collections personnel meets quarterly to manage our internal watch list and proactively manage high risk loans.

When reasonable doubt exists concerning collectability of interest or principal of one of our loans, the loan is placed in nonaccrual status. Any interest previously accrued but not collected is reversed and charged against current earnings.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. At June 30, 2018, nonperforming assets totaled \$4.0 million compared to \$6.2 million at December 31, 2017. Additions to other real estate owned in the first six months of 2018 were \$293,000, compared to \$60,000 in the first six months of 2017. At June 30, 2018, there were no loans in redemption, so we expect there to be few additions to other real estate owned in 2018. Proceeds from sales of foreclosed properties were \$1.8 million in the first six months of 2018, resulting in net realized loss on sales of \$132,000. Proceeds from sales of foreclosed properties were \$5.6 million in the first six months of 2017 resulting in net realized gains on sales of \$470,000. Based upon purchase agreements in place at June 30, 2018 and the sale of our largest individual property in the second quarter of 2017, we expect the level of sales of foreclosed properties to be lower in 2018 than experienced in 2017.

Nonperforming loans include loans on nonaccrual status and loans delinquent more than 90 days but still accruing. As of June 30, 2018, nonperforming loans were negligible and totaled \$125,000, or 0.01% of total portfolio loans, compared to \$395,000, or 0.03% of total portfolio loans, at December 31, 2017.

Nonperforming loans at June 30, 2018 consisted of \$121,000 of commercial real estate loans, \$2,000 of commercial and industrial loans, and \$2,000 of consumer and residential mortgage loans.

Foreclosed and repossessed assets include assets acquired in settlement of loans. Foreclosed assets totaled \$3.9 million at June 30, 2018 and \$5.8 million at December 31, 2017. Of this balance at June 30, 2018, there were 14 commercial real estate properties totaling approximately \$3.8 million. The remaining balance was comprised of 3 residential properties totaling approximately \$81,000. All properties acquired through or in lieu of foreclosure are initially transferred at their fair value less estimated costs to sell and then evaluated monthly for impairment after transfer using a lower of cost or market approach. Updated property valuations are obtained at least annually on all foreclosed assets.

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At June 30, 2018, our foreclosed asset portfolio had a weighted average age held in portfolio of 6.67 years. Below is a breakout of our foreclosed asset portfolio at June 30, 2018 and December 31, 2017 by property type and the percentages the property has been written down since taken into our possession and the combined writedown percentage, including losses taken when the property was loan collateral (dollars in thousands):

| <u>Foreclosed Asset Property Type</u> | June 30, 2018 | | | December 31, 2017 | | |
|---------------------------------------|----------------|----------------------------|--|-------------------|----------------------------|--|
| | Carrying Value | Foreclosed Asset Writedown | Combined Writedown (Loan and Foreclosed Asset) | Carrying Value | Foreclosed Asset Writedown | Combined Writedown (Loan and Foreclosed Asset) |
| Single Family | \$--- | --- | % --- | \$60 | --- | % 24.3 |
| Residential Lot | 81 | 39.2 | 75.8 | 109 | 46.9 | 73.1 |
| Multi-Family | --- | --- | --- | --- | --- | --- |
| Vacant Land | 800 | 35.1 | 49.2 | 1,345 | 56.1 | 60.5 |
| Residential Development | 831 | 41.5 | 83.6 | 2,167 | 30.0 | 71.8 |
| Commercial Office | --- | --- | --- | --- | --- | --- |
| Commercial Industrial | --- | --- | --- | --- | --- | --- |
| Commercial Improved | 2,160 | 6.9 | 8.1 | 2,086 | 6.7 | 8.0 |
| | \$3,872 | 24.2 | 58.5 | \$5,767 | 33.4 | 58.3 |

The following table shows the composition and amount of our nonperforming assets (dollars in thousands):

| | June 30, 2018 | December 31, 2017 |
|---|---------------|-------------------|
| Nonaccrual loans | \$ 125 | \$ 395 |
| Loans 90 days or more delinquent and still accruing | --- | --- |
| Total nonperforming loans (NPLs) | 125 | 395 |
| Foreclosed assets | 3,872 | 5,767 |
| Reposessed assets | --- | 11 |
| Total nonperforming assets (NPAs) | \$ 3,997 | \$ 6,173 |
| NPLs to total loans | 0.01 | % 0.03 |
| NPAs to total assets | 0.21 | % 0.33 |

The following table shows the composition and amount of our troubled debt restructurings (TDRs) at June 30, 2018 and December 31, 2017 (dollars in thousands):

| | June 30, 2018 | | | December 31, 2017 | | |
|------------------------|---------------|----------|----------|-------------------|----------|----------|
| | Commercial | Consumer | Total | Commercial | Consumer | Total |
| Performing TDRs | \$7,670 | \$ 7,024 | \$14,694 | \$13,420 | \$ 8,344 | \$21,764 |
| Nonperforming TDRs (1) | 124 | --- | 124 | 315 | 1 | 316 |
| Total TDRs | \$7,794 | \$ 7,024 | \$14,818 | \$13,735 | \$ 8,345 | \$22,080 |

(1) Included in nonperforming asset table above

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We had a total of \$14.8 million and \$22.1 million of loans whose terms have been modified in TDRs as of June 30, 2018 and December 31, 2017, respectively. These loans may have involved the restructuring of terms to allow customers to mitigate the risk of foreclosure by meeting a lower loan payment requirement based upon their current cash flow. These may also include loans that renewed at existing contractual rates, but below market rates for comparable credit. For each restructuring, a comprehensive credit underwriting analysis of the borrower's financial condition and prospects of repayment under the revised terms is performed to assess whether the structure can be successful and that cash flows will be sufficient to support the restructured debt. An analysis is also performed to determine whether the restructured loan should be on accrual status. Generally, if the loan is on accrual at the time of restructure, it will remain on accrual after the restructuring. In some cases, a nonaccrual loan may be placed on accrual at restructuring if the loan's actual payment history demonstrates it would have cash flowed under the restructured terms. After six consecutive payments under the restructured terms, a nonaccrual restructured loan is reviewed for possible upgrade to accruing status. In situations where there is a subsequent modification or renewal and the loan is brought to market terms, including a contractual interest rate not less than a market interest rate for new debt with similar credit risk characteristics, the TDR and impaired designations may be removed. Total TDRs decreased by \$7.3 million from December 31, 2017 to June 30, 2018. Of this decrease, \$3.7 million was due to a seasonal paydown on an commercial operating line of credit that was classified as a TDR. The remaining decrease was due to paydowns and payoffs of TDRs in the first six months of 2018. There were 136 loans identified as TDR at June 30, 2018 compared to 151 loans at December 31, 2017.

As with other impaired loans, an allowance for loan loss is estimated for each TDR based on the most likely source of repayment for each loan. For impaired commercial real estate loans that are collateral dependent, the allowance is computed based on the fair value of the underlying collateral, less estimated costs to sell. For impaired commercial loans where repayment is expected from cash flows from business operations, the allowance is computed based on a discounted cash flow computation. Certain groups of TDRs, such as residential mortgages, have common characteristics and for them the allowance is computed based on a discounted cash flow computation on the change in weighted rate for the pool. The allowance allocations for commercial TDRs where we have reduced the contractual interest rate are computed by measuring cash flows using the new payment terms discounted at the original contractual rate.

Allowance for loan losses: The allowance for loan losses at June 30, 2018 was \$16.7 million, an increase of \$95,000 from \$16.6 million at December 31, 2017. The balance of the allowance for loan losses represented 1.26% of total portfolio loans at June 30, 2018 and 1.26% at December 31, 2017. The allowance for loan losses to nonperforming loan coverage ratio increased from 4,203% at December 31, 2017 to 13,356% at June 30, 2018.

The table below shows the changes in certain credit metrics over the past five quarters (dollars in millions):

| | Quarter Ended June 30, 2018 | Quarter Ended March 31, 2018 | Quarter Ended December 31, 2017 | Quarter Ended September 30, 2017 | Quarter Ended June 30, 2017 |
|--|--------------------------------------|---------------------------------------|--|--|--------------------------------------|
| Commercial loans | \$ 1,005.5 | \$ 1,007.0 | \$ 1,007.1 | \$ 949.2 | \$ 949.8 |
| Nonperforming loans | 0.1 | 0.3 | 0.4 | 0.5 | 0.7 |
| Other real estate owned and repo assets | 3.9 | 5.2 | 5.8 | 6.7 | 7.1 |
| Total nonperforming assets | 4.0 | 5.5 | 6.2 | 7.2 | 7.8 |
| Net charge-offs (recoveries) | (0.3) | (0.2) | (0.2) | (0.2) | (0.4) |
| Total delinquencies | 0.5 | 1.6 | 1.0 | 0.8 | 0.8 |

As discussed earlier, we have had net loan recoveries in each of the last fourteen quarters. Our total delinquencies have continued to be negligible and were \$0.5 million at June 30, 2018 and \$1.0 million at December 31, 2017. Our delinquency percentage at June 30, 2018 was just 0.04%.

These factors all impact our necessary level of allowance for loan losses and our provision for loan losses. The allowance for loan losses increased \$95,000 in the first six months of 2018. We recorded a negative provision for loan losses of \$400,000 for the six months ended June 30, 2018 compared to a negative \$1.0 million for the same period of 2017. Net loan recoveries were \$495,000 for the six months ended June 30, 2018, compared to net recoveries of \$608,000 for the same period in 2017. The ratio of net recoveries to average loans was -0.07% on an annualized basis for the first six months of 2018, compared to -0.10% for the first six months of 2017.

We are encouraged by the reduced level of gross charge-offs over recent quarters. We do, however, recognize that future charge-offs and resulting provisions for loan losses are expected to be impacted by the timing and extent of changes in the overall economy and the real estate markets. We believe we have seen some stabilization in economic conditions and real estate markets. However, we expect it to take additional time for sustained improvement in the economy and real estate markets in order to further reduce our impaired loans.

Our allowance for loan losses is maintained at a level believed appropriate based upon our assessment of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance and related provision for loan losses relies on several key elements, which include specific allowances for loans considered impaired, general allowance for commercial loans not considered impaired based upon applying our loan rating system, and general allocations based on historical trends for homogeneous loan groups with similar risk characteristics.

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Overall, impaired loans declined by \$7.3 million to \$14.8 million at June 30, 2018 compared to \$22.1 million at December 31, 2017. The specific allowance for impaired loans decreased \$53,000 to \$1.2 million at June 30, 2018. The specific allowance for impaired loans represented 7.8% of total impaired loans at June 30, 2018 and 5.5% at December 31, 2017.

The general allowance allocated to commercial loans that were not considered to be impaired was based upon the internal risk grade of such loans. We use a loan rating method based upon an eight point system. Loans are stratified between real estate secured and non real estate secured. The real estate secured portfolio is further stratified by the type of real estate. Each stratified portfolio is assigned a loss allocation factor. A higher numerical grade assigned to a loan category generally results in a greater allocation percentage. Changes in risk grade of loans affect the amount of the allowance allocation.

The determination of our loss factors is based upon our actual loss history by loan grade and adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the analysis date. We use a rolling 18 month actual net chargeoff history as the base for our computation. Over the past few years, the 18 month period computations have reflected sizeable decreases in net chargeoff experience. We addressed this volatility in the qualitative factor considerations applied in our allowance for loan losses computation. Adjustments to the qualitative factors also involved consideration of different loss periods for the Bank, including 12, 24, 36, 48 and 60 month periods. We also considered the extended period of improved asset quality in assessing the overall qualitative component. Considering the change in our qualitative factors and our commercial loan portfolio balances, the general allowance allocated to commercial loans was \$12.4 million at June 30, 2018 and \$12.4 million at December 31, 2017. The qualitative component of our allowance allocated to commercial loans was \$12.3 million at June 30, 2018 down from \$12.6 million at December 31, 2017.

Groups of homogeneous loans, such as residential real estate and open- and closed-end consumer loans, receive allowance allocations based on loan type. A rolling 12 month (four quarter) historical loss experience period was applied to residential mortgage and consumer loan portfolios. As with commercial loans that are not considered impaired, the determination of the allowance allocation percentage is based principally on our historical loss experience. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans. The homogeneous loan allowance was \$3.1 million at June 30, 2018 and \$3.0 million at December 31, 2017.

The allowance allocations are not intended to imply limitations on usage of the allowance for loan losses. The entire allowance for loan losses is available for any loan losses without regard to loan type.

Premises and Equipment: Premises and equipment totaled \$45.9 million at June 30, 2018, down \$722,000 from \$46.6 million at December 31, 2017 as a result of depreciation expense exceeding acquisition cost during that period.

Deposits and Other Borrowings: Total deposits increased \$1.5 million to \$1.58 billion at June 30, 2018, as compared to \$1.58 billion at December 31, 2017. Non-interest checking account balances increased \$6.0 million during the first six months of 2018. Interest bearing demand account balances decreased \$12.7 million and savings and money market account balances decreased \$3.6 million in the first six months of 2018. Certificates of deposits increased by \$12.8 million in the first six months of 2018. We believe our success in maintaining the balances of personal and business checking and savings accounts was primarily attributable to our focus on quality customer service, the desire of customers to deal with a local bank, the convenience of our branch network and the breadth and depth of our sophisticated product line.

Noninterest bearing demand accounts comprised 31% of total deposits at June 30, 2018 and 31% at December 31, 2017. Because of the generally low rates paid on interest bearing account alternatives, many of our business customers have chosen to keep their balances in these more liquid noninterest bearing demand account types. Interest

bearing demand, including money market and savings accounts, comprised 62% of total deposits at June 30, 2018 and 63% at December 31, 2017. Time accounts as a percentage of total deposits were 7% at June 30, 2018 and 6% December 31, 2017. We are experiencing growth in time deposits after several years of decline due to the low interest rate environment. As deposit rates have begun to rise, customers are finding time deposits to be more attractive and this has resulted in some shift from non-maturing deposit types. Most of the growth is for maturity periods less than 18 months.

Borrowed funds totaled \$106.9 million at June 30, 2018, including \$65.7 million of Federal Home Loan Bank (“FHLB”) advances and \$41.2 million in long-term debt associated with trust preferred securities. Borrowed funds totaled \$133.4 million at December 31, 2017, including \$92.1 million of FHLB advances and \$41.2 million in long-term debt associated with trust preferred securities. Borrowed funds decreased by \$26.5 million in the first six months of 2018 primarily due to the scheduled maturities of \$31.5 million in FHLB advances during the first six months of 2018, partially offset by the addition of a \$5.0 million advance taken in May 2018.

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Total shareholders' equity of \$179.7 million at June 30, 2018 increased \$6.7 million from \$173.0 million at December 31, 2017. The increase was primarily a result of net income of \$12.5 million earned in the first six months of 2018 partially offset by a decrease of \$2.2 million in accumulated other comprehensive income and the payment of \$4.1 million in cash dividends to shareholders. The Bank was categorized as "well capitalized" at June 30, 2018.

In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures. We expect that the capital ratios for the Company and the Bank under Basel III will continue to exceed the well capitalized minimum capital requirements.

The following table shows our regulatory capital ratios (on a consolidated basis) for the past several quarters:

| <u>Macatawa Bank Corporation</u> | June 30, 2018 | | March 31, 2017 | | Dec 31, 2017 | | Sept 30, 2017 | | June 30, 2017 |
|--|------------------|---|-------------------|---|-----------------|---|------------------|---|------------------|
| Total capital to risk weighted assets | 15.5 | % | 15.4 | % | 15.0 | % | 15.5 | % | 15.5 |
| Common Equity Tier 1 to risk weighted assets | 11.8 | | 11.7 | | 11.3 | | 11.7 | | 11.6 |
| Tier 1 capital to risk weighted assets | 14.4 | | 14.3 | | 13.9 | | 14.4 | | 14.3 |
| Tier 1 capital to average assets | 11.9 | | 11.8 | | 11.9 | | 12.0 | | 12.2 |

Approximately \$40.0 million of trust preferred securities outstanding at June 30, 2018 qualified as Tier 1 capital.

LIQUIDITY

Liquidity of Macatawa Bank: The liquidity of a financial institution reflects its ability to manage a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the FRB's discount window, the Federal Home Loan Bank, federal funds purchased lines of credit and other secured borrowing sources with our correspondent banks, loan payments by our borrowers, maturity and sales of our securities available for sale, growth of our deposits, federal funds sold and other short-term investments, and the various capital resources discussed above.

Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. Our liquidity management involves periodic monitoring of our assets considered to be liquid and illiquid, and our funding sources considered to be core and non-core and short-term (less than 12 months) and long-term. We have established parameters that monitor, among other items, our level of liquid assets to short-term liabilities, our level of non-core funding reliance and our level of available borrowing capacity. We maintain a diversified wholesale funding structure and actively manage our maturing wholesale sources to reduce the risk to liquidity shortages. We have also developed a contingency funding

plan to stress test our liquidity requirements arising from certain events that may trigger liquidity shortages, such as rapid loan growth in excess of normal growth levels or the loss of deposits and other funding sources under extreme circumstances.

We have actively pursued initiatives to maintain a strong liquidity position. The Bank has reduced its reliance on non-core funding sources, including brokered deposits, and focused on achieving a non-core funding dependency ratio below its peer group average. We have had no brokered deposits on our balance sheet since December 2011. We continue to maintain significant on-balance sheet liquidity. At June 30, 2018, the Bank held \$107.4 million of federal funds sold and other short-term investments. In addition, the Bank had available borrowing capacity from correspondent banks of approximately \$334.0 million as of June 30, 2018.

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In the normal course of business, we enter into certain contractual obligations, including obligations which are considered in our overall liquidity management. The table below summarizes our significant contractual obligations at June 30, 2018 (dollars in thousands):

| | Maturing in | | | |
|-----------------------------|------------------|-----------|-----------|-------------------|
| | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Long term debt | \$--- | \$--- | \$--- | \$ 41,238 |
| Time deposit maturities | 65,614 | 35,561 | 2,174 | 28 |
| Other borrowed funds | 30,667 | 10,000 | 25,000 | --- |
| Operating lease obligations | 238 | 251 | --- | --- |
| Total | \$96,519 | \$ 45,812 | \$ 27,174 | \$ 41,266 |

In addition to normal loan funding, we also maintain liquidity to meet customer financing needs through unused lines of credit, unfunded loan commitments and standby letters of credit. The level and fluctuation of these commitments is also considered in our overall liquidity management. At June 30, 2018, we had a total of \$496.2 million in unused lines of credit, \$101.3 million in unfunded loan commitments and \$18.5 million in standby letters of credit.

Liquidity of Holding Company: The primary sources of liquidity for the Company are dividends from the Bank, existing cash resources and the capital markets if the need to raise additional capital arises. Banking regulations and the laws of the State of Michigan in which our Bank is chartered limit the amount of dividends the Bank may declare and pay to the Company in any calendar year. Under the state law limitations, the Bank is restricted from paying dividends to the Company in excess of retained earnings. In 2017, the Bank paid dividends to the Company totaling \$7.9 million. In the same period, the Company paid dividends to its shareholders totaling \$6.1 million. On February 27, 2018, the Bank paid a dividend totaling \$2.5 million to the Company in anticipation of the common share cash dividend of \$0.06 per share paid on February 28, 2018 to shareholders of record on February 13, 2018. The cash distributed for this cash dividend payment totaled \$2.0 million. On May 29, 2018, the Bank paid a dividend totaling \$2.6 million to the Company in anticipation of the common share cash dividend of \$0.06 per share paid on May 30, 2018 to shareholders of record on May 15, 2018. The cash distributed for this cash dividend payment totaled \$2.0 million. The Company retained the remaining balance in each period for general corporate purposes. At June 30, 2018, the Bank had a retained earnings balance of \$55.8 million.

During 2017, the Company received payments from the Bank totaling \$5.5 million, representing the Bank's intercompany tax liability for the 2017 tax year, in accordance with the Company's tax allocation agreement. In the same period, the Company made tax payments totaling \$4.7 million. In the first six months of 2018, the Company received tax payments from the Bank totaling \$2.7 million and made federal income tax payments totaling \$2.4 million.

The Company has the right to defer interest payments for 20 consecutive quarters on its trust preferred securities if necessary for liquidity purposes. During the deferral period, the Company may not declare or pay any dividends on its common stock or make any payment on any outstanding debt obligations that rank equally with or junior to the trust preferred securities.

The Company's cash balance at June 30, 2018 was \$6.4 million. The Company believes that it has sufficient liquidity to meet its cash flow obligations.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES:

To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and future results could differ. The allowance for loan losses, other real estate owned valuation, loss contingencies, revenue recognition and income taxes are deemed critical due to the required level of management judgment and the use of estimates, making them particularly subject to change.

Our methodology for determining the allowance for loan losses and the related provision for loan losses is described above in the "Allowance for Loan Losses" discussion. This area of accounting requires significant judgment due to the number of factors which can influence the collectability of a loan. Unanticipated changes in these factors could significantly change the level of the allowance for loan losses and the related provision for loan losses. Although, based upon our internal analysis, and in our judgment, we believe that we have provided an adequate allowance for loan losses, there can be no assurance that our analysis has properly identified all of the probable losses in our loan portfolio. As a result, we could record future provisions for loan losses that may be significantly different than the levels that we recorded in the first six months of 2018.

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Assets acquired through or instead of foreclosure, primarily other real estate owned, are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. New real estate appraisals are generally obtained at the time of foreclosure and are used to establish fair value. If fair value declines, a valuation allowance is recorded through expense. Estimating the initial and ongoing fair value of these properties involves a number of factors and judgments including holding time, costs to complete, holding costs, discount rate, absorption and other factors.

Loss contingencies are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. This, too, is an accounting area that involves significant judgment. Although, based upon our judgment, internal analysis, and consultations with legal counsel we believe that we have properly accounted for loss contingencies, future changes in the status of such contingencies could result in a significant change in the level of contingent liabilities and a related impact to operating earnings.

Noninterest revenue is recognized in accordance with contractual requirements and as we fulfill our obligations under contractual terms. Most of our noninterest revenue comes from services that are transaction based and such revenue is recognized as the related service is provided.

Our accounting for income taxes involves the valuation of deferred tax assets and liabilities primarily associated with differences in the timing of the recognition of revenues and expenses for financial reporting and tax purposes. At June 30, 2018, we had gross deferred tax assets of \$5.4 million, gross deferred tax liabilities of \$1.4 million resulting in a net deferred tax asset of \$4.0 million. Accounting standards require that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. Each reporting period we consider all reasonably available positive and negative evidence and determine whether it is "more likely than not" that we would be able to realize our deferred tax assets. With the positive results in the first six months of 2018, we concluded at June 30, 2018 that no valuation allowance on our net deferred tax asset was required. Changes in tax laws, changes in tax rates, changes in ownership and our future level of earnings can impact the ultimate realization of our net deferred tax asset.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity ("EVE") resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of June 30, 2018 (dollars in thousands):

| <u>Interest Rate Scenario</u> | Economic | | Net Interest | |
|--------------------------------------|-----------------|----------------|--------------|----------------|
| | Value of Equity | Percent Change | Income | Percent Change |
| Interest rates up 200 basis points | \$254,933 | (5.12)% | \$ 63,528 | 4.44 % |
| Interest rates up 100 basis points | 262,460 | (2.32) | 62,626 | 2.95 |
| No change | 268,690 | --- | 60,829 | --- |
| Interest rates down 100 basis points | 268,576 | (0.04) | 60,450 | (0.62) |
| Interest rates down 200 basis points | 251,460 | (6.41) | 58,008 | (4.64) |

If interest rates were to increase, this analysis suggests that we are positioned for an improvement in net interest income over the next twelve months.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; and client preferences.

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Item 4: CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), we conducted (a) an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e) as of June 30, 2018, the end of the period covered by this report.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as the Company's are designed to do, and management necessarily was required to apply its judgment in evaluating whether the benefits of the controls and procedures that the Company adopts outweigh their costs.

Our CEO and CFO, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report, have concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

Changes in Internal Controls. During the period covered by this report, there have been no changes in the (b) Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

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PART II – OTHER INFORMATION

Item 6. EXHIBITS.

- 3.1 Restated Articles of Incorporation. Previously filed with the Commission on October 27, 2016 in Macatawa Bank Corporation's Quarterly Report on Form 10-Q, Exhibit 3.1. Here incorporated by reference.
- 3.2 Bylaws. Previously filed with the Commission on February 19, 2015 in Macatawa Bank Corporation's Annual Report on Form 10-K for the year ended December 31, 2014, Exhibit 3.1. Here incorporated by reference.
- 4.1 Restated Articles of Incorporation. Exhibit 3.1 is here incorporated by reference.
- 4.2 Bylaws. Exhibit 3.2 is here incorporated by reference.
- 4.3 Long-Term Debt. The registrant has outstanding long-term debt which at the time of this report does not exceed 10% of the registrant's total consolidated assets. The registrant agrees to furnish copies of the agreements defining the rights of holders of such long-term debt to the SEC upon request.
- 31.1 Certification of Chief Executive Officer.
- 31.2 Certification of Chief Financial Officer.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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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.

MACATAWA BANK CORPORATION

/s/ Ronald L. Haan
Ronald L. Haan
Chief Executive Officer
(Principal Executive Officer)

/s/ Jon W. Swets
Jon W. Swets
Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

Dated: July 26, 2018