FARMERS & MERCHANTS BANCORP INC
Form 10-Q
October 25, 2017
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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 September 30, 2017

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from __________ to __________

Commission File Number 001-38084

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

OHIO	**34-1469491**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
307 North Defiance Street, Archbold, Ohio	**43502**
(Address of principal executive offices)	**(Zip Code)**

(419) 446-2501

Registrant s telephone number, including area code

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

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

Indicate by check mark whether the registrant has submitted electronically 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, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer , and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

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

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

Common Stock, No Par Value	9,266,676
Class	Outstanding as of October 25, 2017

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

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101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document [1]

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

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ITEM 1 FINANCIAL STATEMENTS
FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	Condensed Consolidated Balance Sheets (in thousands of dollars)	
	September 30, 2017 (Unaudited)	December 31, 2016
Assets		
Cash and due from banks	$ 48,313	$ 27,348
Federal funds sold	791	974
Total cash and cash equivalents	49,104	28,322
Interest-bearing time deposits	2,541	1,915
Securities - available-for-sale	192,811	218,527
Other securities, at cost	3,717	3,717
Loans held for sale	2,147	2,055
Loans, net	788,335	751,310
Premises and equipment	21,473	21,457
Goodwill	4,074	4,074
Mortgage servicing rights	2,264	2,192
Other real estate owned	615	774
Bank owned life insurance	14,446	14,376
Other assets	8,628	7,176
Total Assets	$ 1,090,155	$ 1,055,895
Liabilities and Stockholders Equity		
Liabilities		
Deposits		
Noninterest-bearing	$ 189,963	$ 186,390
Interest-bearing		
NOW accounts	294,911	230,446
Savings	224,911	226,537
Time	193,581	198,830
Total deposits	903,366	842,203
Federal Funds purchased and securities sold under agreements to repurchase	35,550	70,324
Federal Home Loan Bank (FHLB) advances	10,000	10,000
Dividend payable	1,193	1,053
Accrued expenses and other liabilities	7,157	6,738
Total liabilities	957,266	930,318

Commitments and Contingencies		
Stockholders Equity		
Common stock - No par value 20,000,000 shares authorized; issued and outstanding 10,400,000 shares 9/30/17 and 12/31/16 [1]	11,388	11,947
Treasury Stock - 1,133,324 shares 9/30/17, 1,158,250 shares 12/31/16 [1]	(12,126)	(12,267)
Retained earnings	134,320	127,869
Accumulated other comprehensive loss	(693)	(1,972)
Total stockholders equity	132,889	125,577
Total Liabilities and Stockholders Equity	$ 1,090,155	$ 1,055,895

(1) Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2016, Condensed Consolidated Balance Sheet has been derived from the audited Consolidated Balance Sheet as of that date.

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FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME & COMPREHENSIVE INCOME

(Unaudited)

(in thousands of dollars, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Interest Income				
Loans, including fees	$ 9,547	$ 8,629	$ 27,367	$ 24,997
Debt securities:				
U.S. Treasury and government agencies	605	559	1,870	1,734
Municipalities	290	344	905	1,093
Dividends	49	36	135	111
Federal funds sold	7	7	10	9
Other	37	15	93	37
Total interest income	10,535	9,590	30,380	27,981
Interest Expense				
Deposits	1,161	947	3,289	2,686
Federal funds purchased and securities sold under agreements to repurchase	135	115	366	346
Borrowed funds	37	37	110	110
Total interest expense	1,333	1,099	3,765	3,142
Net Interest Income - Before Provision for Loan Losses	9,202	8,491	26,615	24,839
Provision for Loan Losses	99	308	197	924
Net Interest Income After Provision For Loan Losses	9,103	8,183	26,418	23,915
Noninterest Income				
Customer service fees	1,320	1,711	4,131	4,497
Other service charges and fees	1,134	941	3,214	2,850
Net gain on sale of loans	181	216	600	619
Net gain on sale of available for sale securities		47	47	503
Total noninterest income	2,635	2,915	7,992	8,469
Noninterest Expense				
Salaries and Wages	3,236	2,981	9,374	8,661
Employee benefits	943	849	2,648	2,426
Net occupancy expense	434	359	1,221	1,083

Furniture and equipment	493	438	1,456	1,293
Data processing	300	360	919	1,132
Franchise taxes	226	219	676	658
Net (gain) loss on sale of other assets owned	13	(6)	27	39
FDIC Assessment	82	126	247	368
Mortgage servicing rights amortization	85	123	266	311
Other general and administrative	1,545	1,473	4,692	4,594
Total other operating expenses	7,357	6,922	21,526	20,565
Income Before Income Taxes	4,381	4,176	12,884	11,819
Income Taxes	1,159	1,161	3,600	3,349
Net Income	3,222	3,015	9,284	8,470
Other Comprehensive Income (Loss) (Net of Tax):				
Net unrealized gain (loss) on available for sale securities	(472)	58	1,984	2,652
Reclassification adjustment for gain on sale of available for sale securities		(47)	(47)	(503)
Net unrealized gain (loss) on available for sale securities	(472)	11	1,937	2,149
Tax expense (benefit)	(160)	4	659	731
Other comprehensive income (loss)	(312)	7	1,278	1,418
Comprehensive Income	$ 2,910	$ 3,022	$ 10,562	$ 9,888
Earnings Per Share - Basic and Diluted (1)	$ 0.35	$ 0.33	$ 1.00	$ 0.92
Dividends Declared (1)	$ 0.13	$ 0.12	$ 0.37	$ 0.34

(1) Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017

See Notes to Condensed Consolidated Unaudited Financial Statements

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FARMERS & MERCHANTS BANCORP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	(in thousands of dollars) Nine Months Ended	
	September 30, 2017	September 30, 2016
Cash Flows from Operating Activities		
Net income	$ 9,284	$ 8,470
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,426	1,112
Amortization on available for sale securities, net	843	833
Amortization of servicing rights	266	311
Amortization of core deposit intangible	203	242
Compensation expense related to stock awards	346	297
Provision for loan loss	197	924
Gain on sale of loans held for sale	(600)	(619)
Originations of loans held for sale	(42,601)	(44,296)
Proceeds from sale of loans held for sale	44,574	44,119
Loss on sale of other assets owned	27	39
Gain on sales of securities available for sale	(47)	(503)
Change in other assets and other liabilities, net	(1,667)	(1,300)
Net cash provided by operating activities	12,251	9,629
Cash Flows from Investing Activities		
Activity in available-for-sale securities:		
Maturities, prepayments and calls	16,682	22,910
Sales	13,562	45,418
Purchases	(3,387)	(55,863)
Change in interest-bearing time deposits	(626)	(1,915)
Proceeds from sales of other assets owned	17	20
Additions to premises and equipment	(1,459)	(1,901)
Loan originations and principal collections, net	(39,195)	(52,996)
Net cash used in investing activities	(14,406)	(44,327)
Cash Flows from Financing Activities		
Net change in deposits	61,163	66,762
Net change in federal funds purchased and securities sold under agreements to repurchase	(34,774)	(19,328)
Purchase of Treasury Stock	(202)	(194)
Cash dividends paid on common stock	(3,250)	(3,062)

Net cash provided by financing activities	22,937	44,178
Net Increase in Cash and Cash Equivalents	20,782	9,480
Cash and cash equivalents - Beginning of year	28,322	22,018
Cash and cash equivalents - End of period	$ 49,104	$ 31,498
Supplemental Information		
Cash paid during the year for:		
Interest	$ 3,735	$ 3,098
Income taxes	$ 3,802	$ 3,810
Noncash investing activities:		
Transfer of loans to other real estate owned	$	$ 376

See Notes to Condensed Consolidated Unaudited Financial Statements.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS
NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017. Operating results for the nine months ended September 30, 2017 are not necessarily indicative of the results that are expected for the year ended December 31, 2017. The condensed consolidated balance sheet of the Company as of December 31, 2016, has been derived from the audited consolidated balance sheet of the Company as of that date. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2016.

NOTE 2 ASSET PURCHASES

The Company recognized core deposit intangible assets of $1.09 million with the purchase of the Hicksville office on July 9, 2010. These were amortized over an estimated remaining economic useful life of the deposits of 7 years on a straight line basis.

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

The amortization expense for the year ended December 31, 2016 was $323 thousand. Of the $245 thousand to be expensed in 2017, $203 thousand has been expensed for the nine months ended September 30, 2017.

	(In Thousands)		
	Hicksville	Custar	Total
2017	$ 78	$ 167	$ 245
2018		167	167
2019		167	167
2020		161	161
	$ 78	$ 662	$ 740

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

NOTE 3 SECURITIES

The amortized cost and fair value of securities, with gross unrealized gains and losses at September 30, 2017 and December 31, 2016, follows:

	(In Thousands) September 30, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	$ 15,790	$	$ (114)	$ 15,676
U.S. Government agencies	79,224		(1,064)	78,160
Mortgage-backed securities	42,409	142	(561)	41,990
State and local governments	56,438	779	(232)	56,985
Total available-for-sale securities	$ 193,861	$ 921	$ (1,971)	$ 192,811

	(In Thousands) December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	$ 24,920	$ 1	$ (146)	$ 24,775
U.S. Government agencies	84,266	3	(1,795)	82,474
Mortgage-backed securities	49,155	185	(879)	48,461
State and local governments	63,173	634	(990)	62,817
Total available-for-sale securities	$ 221,514	$ 823	$ (3,810)	$ 218,527

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

1. The fair value of the security has significantly declined from book value.

2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB by Standard and Poors.)

3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.

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

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

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

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

NOTE 3 SECURITIES (Continued)

Information pertaining to securities with gross unrealized losses at September 30, 2017 and December 31, 2016, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

	(In Thousands) September 30, 2017			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (114)	$ 15,676	$	$
U.S. Government agencies	(554)	62,910	(510)	15,251
Mortgage-backed securities	(288)	22,344	(273)	10,360
State and local governments	(130)	8,776	(102)	6,032
Total available-for-sale securities	$ (1,086)	$ 109,706	$ (885)	$ 31,643

	(In Thousands) December 31, 2016			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	$ (146)	$ 15,745	$	$
U.S. Government agencies	(1,795)	77,471		
Mortgage-backed securities	(879)	36,474		
State and local governments	(983)	37,540	(7)	526
Total available-for-sale securities	$ (3,803)	$ 167,230	$ (7)	$ 526

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

Below are the gross realized gains and losses for the three and nine months ended September 30.

	Three Months (In Thousands)		Nine Months (In Thousands)	
	2017	2016	2017	2016
Gross realized gains	$	$ 47	$ 58	$ 514
Gross realized losses			(11)	(11)
Net realized gains	$	$ 47	$ 47	$ 503
Tax expense related to net realized gains	$	$ 16	$ 16	$ 171

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

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

NOTE 3 SECURITIES (Continued)

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

	(In Thousands)	
	Amortized Cost	Fair Value
One year or less	$ 9,014	$ 9,017
After one year through five years	88,228	88,088
After five years through ten years	50,404	49,979
After ten years	3,806	3,737
Total	$ 151,452	$ 150,821
Mortgage-backed securities	42,409	41,990
Total	$ 193,861	$ 192,811

Investments with a carrying value of $84.5 million and $129.4 million at September 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Farmer Mac stock as of September 30, 2017 and December 31, 2016.

NOTE 4 LOANS

Loan balances as of September 30, 2017 and December 31, 2016:

	(In Thousands)	
Loans:	September 30, 2017	December 31, 2016
Consumer Real Estate	$ 84,283	$ 86,234
Agricultural Real Estate	63,603	62,375
Agricultural	87,095	84,563
Commercial Real Estate	394,481	377,481
Commercial and Industrial	124,078	109,256
Consumer	35,843	33,179
Industrial Development Bonds	6,555	5,732

	795,938	758,820
Less: Net deferred loan fees and costs	(733)	(726)
	795,205	758,094
Less: Allowance for loan losses	(6,870)	(6,784)
Loans Net	$ 788,335	$ 751,310

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

NOTE 4 LOANS (Continued)

The following is a contractual maturity schedule by major category of loans as of September 30, 2017:

	(In Thousands)		
	Within One Year	After One Year Within Five Years	After Five Years
Consumer Real Estate	$ 2,153	$ 14,237	$ 67,893
Agricultural Real Estate	401	5,495	57,707
Agricultural	51,979	25,915	9,201
Commercial Real Estate	10,875	120,924	262,682
Commercial and Industrial	68,139	34,860	21,079
Consumer	5,077	23,025	7,741
Industrial Development Bonds	831	85	5,639

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of September 30, 2017:

	(In Thousands)	
	Fixed Rate	Variable Rate
Consumer Real Estate	$ 47,662	$ 36,621
Agricultural Real Estate	46,557	17,046
Agricultural	35,708	51,387
Commercial Real Estate	266,316	128,165
Commercial and Industrial	58,560	65,518
Consumer	31,554	4,289
Industrial Development Bonds	6,555	

As of September 30, 2017 and December 31, 2016 one to four family residential mortgage loans amounting to $17.7 and $17.9 million, respectively, have been pledged as security for future loans and existing loans the Bank has received from the Federal Home Loan Bank.

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

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

NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment (in thousands) in past due loans by portfolio classification of loans as of September 30, 2017 and December 31, 2016, net of deferred loan fees and costs:

September 30, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer Real Estate	$ 532	$ 0	$ 505	$ 1,037	$ 82,838	$ 83,875	$
Agricultural Real Estate	104		101	205	63,366	63,571	
Agricultural		2	124	126	87,113	87,239	
Commercial Real Estate			98	98	393,815	393,913	
Commercial and Industrial					130,720	130,720	
Consumer	37	8		45	35,842	35,887	
Total	$ 673	$ 10	$ 828	$ 1,511	$ 793,694	$ 795,205	$ 0

December 31, 2016	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
Consumer Real Estate	$ 882	$ 15	$ 507	$ 1,404	$ 84,469	$ 85,873	$
Agricultural Real Estate	12		132	144	62,192	62,336	
Agricultural	101			101	84,591	84,692	
Commercial Real Estate	60			60	376,827	376,887	
Commercial and Industrial					115,093	115,093	
Consumer	29	6		35	33,178	33,213	
Total	$ 1,084	$ 21	$ 639	$ 1,744	$ 756,350	$ 758,094	$ 0

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

NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of September 30, 2017 and December 31, 2016:

	(In Thousands)	
	September 30, 2017	December 31, 2016
Consumer Real Estate	$ 1,176	$ 1,091
Agricultural Real Estate	101	132
Agricultural	193	
Commercial Real Estate	98	
Commercial & Industrial	152	161
Consumer	9	
Total	$ 1,729	$ 1,384

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

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

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

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

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

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

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

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

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

NOTE 4 LOANS (Continued)

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

The risk ratings are described as follows.

1. Zero (0) Unclassified. Any loan which has not been assigned a classification.

2. One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank s loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

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

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

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

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

a.

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

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

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

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

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

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

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

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

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

NOTE 4 LOANS (Continued)

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

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

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

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

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

h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.

i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.

j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

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

a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.

b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.

c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

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

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

NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of September 30, 2017 and December 31, 2016:

	(In Thousands)				
	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
September 30, 2017					
1-2	$ 3,973	$ 5,316	$ 1,639	$ 10,166	$
3	14,762	31,796	26,253	15,037	3,568
4	43,491	49,712	349,120	96,923	2,987
5	1,124	254	10,686	1,379	
6	221	161	6,215	547	
7				113	
8					
Total	$ 63,571	$ 87,239	$ 393,913	$ 124,165	$ 6,555

	Agricultural Real Estate	Agricultural	Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
December 31, 2016					
1-2	$ 4,399	$ 7,334	$ 677	$ 10,060	$
3	16,660	31,397	27,858	14,064	2,640
4	39,808	44,560	333,523	83,100	3,092
5	1,209	1,234	8,321	1,379	
6	260	167	6,508	641	
7				117	
8					
Total	$ 62,336	$ 84,692	$ 376,887	$ 109,361	$ 5,732

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

NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, as was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of September 30, 2017 and December 31, 2016.

	(In Thousands) Consumer Real Estate September 30, 2017	Consumer Real Estate December 31, 2016
Grade		
Pass	$ 83,471	$ 85,322
Special Mention (5)		25
Substandard (6)	320	368
Doubtful (7)	84	158
Total	$ 83,875	$ 85,873

	(In Thousands) Consumer - Credit		Consumer - Other	
	September 30, 2017	December 31, 2016	September 30, 2017	December 31, 2016
Performing	$ 3,845	$ 4,061	$ 32,013	$ 29,120
Nonperforming	1		28	32
Total	$ 3,846	$ 4,061	$ 32,041	$ 29,152

Information about impaired loans as of September 30, 2017, December 31, 2016 and September 30, 2016 are as follows:

	(In Thousands) September 30, 2017	December 31, 2016	September 30, 2016
Impaired loans without a valuation allowance	$ 1,294	$ 1,141	$ 515
Impaired loans with a valuation allowance	685	711	891

Total impaired loans	$ 1,979	$ 1,852	$ 1,406
Valuation allowance related to impaired loans	$ 123	$ 135	$ 125
Total non-accrual loans	$ 1,729	$ 1,384	$ 1,132
Total loans past-due ninety days or more and still accruing	$	$	$
Quarter ended average investment in impaired loans	$ 1,804	$ 1,684	$ 1,499
Year to date average investment in impaired loans	$ 1,793	$ 1,802	$ 1,843

No additional funds are committed to be advanced in connection with impaired loans.

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

NOTE 4 LOANS (Continued)

The Bank had approximately $540 thousand of its impaired loans classified as troubled debt restructured (TDR) as of September 30, 2017, $557 thousand as of December 31, 2016 and $562 thousand as of September 30, 2016. During the year to date 2017, there were no new loans considered TDR.

The following table represents three and nine months ended September 30, 2017.

Three Months September 30, 2017 (in thousands) Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Nine Months September 30, 2017 (in thousands) Troubled Debt Restructurings	Number of Contracts Modified in the Last 9 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
None		$	$	None		$	$

The following table represents three and nine months ended September 30, 2016.

Three Months September 30, 2016 (in thousands) Troubled Debt Restructurings	Number of Contracts Modified in the Last 3 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Nine Months September 30, 2016 (in thousands) Troubled Debt Restructurings	Number of Contracts Modified in the Last 9 Months	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Consumer Real Estate		$	$	Consumer Real Estate	1	$ 138	$ 138

For the three and nine month period ended September 30, 2017 and 2016, there were no TDRs that subsequently defaulted after modification.

For the majority of the Bank s impaired loans, the Bank will apply the fair value of collateral or use a measurement incorporating the present value of expected future cash flows discounted at the loan s effective rate of interest. To determine fair value of collateral, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and ever