

SHORE BANCSHARES INC  
Form 10-Q  
November 08, 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  
X ACT OF 1934**

For the Quarterly Period Ended September 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 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

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Maryland 52-1974638  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

28969 Information Lane, Easton, Maryland 21601  
(Address of Principal Executive Offices) (Zip Code)

(410) 763-7800

Registrant's Telephone Number, Including Area Code

N/A

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer 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  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 Act). Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 12,749,497 shares of common stock outstanding as of October 30, 2018.

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**PART I – FINANCIAL INFORMATION**

## Item 1. Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)

|   | September 30,<br>2018<br>(Unaudited) | December 31,<br>2017 |
|---|--------------------------------------|----------------------|
| <b>ASSETS</b>   |                                      |                      |
| Cash and due from banks   | \$ 18,859                            | \$ 21,534            |
| Interest-bearing deposits with other banks  | 29,918                               | 10,286               |
| Cash and cash equivalents   | 48,777                               | 31,820               |
| Investment securities:  |                                      |                      |
| Available-for-sale, at fair value   | 167,675                              | 196,955              |
| Held to maturity, at amortized cost - fair value of \$5,983 (2018) and \$6,391 (2017) | 6,037                                | 6,247                |
| Equity securities, at fair value  | 649                                  | -                    |
| Loans   | 1,180,557                            | 1,093,514            |
| Less: allowance for credit losses   | (10,328 )                            | (9,781 )             |
| Loans, net  | 1,170,229                            | 1,083,733            |
| Premises and equipment, net   | 23,252                               | 23,054               |
| Goodwill  | 27,618                               | 27,618               |
| Other intangible assets, net  | 4,088                                | 4,719                |
| Other real estate owned, net  | 1,518                                | 1,794                |
| Other assets  | 23,700                               | 17,920               |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,473,543</b>                  | <b>\$ 1,393,860</b>  |
| <b>LIABILITIES</b>  |                                      |                      |
| Deposits:   |                                      |                      |
| Noninterest-bearing   | \$ 331,766                           | \$ 328,322           |
| Interest-bearing  | 850,070                              | 874,459              |
| Total deposits  | 1,181,836                            | 1,202,781            |
| Short-term borrowings   | 114,043                              | 21,734               |
| Other liabilities   | 6,245                                | 5,609                |
| <b>TOTAL LIABILITIES</b>  | <b>1,302,124</b>                     | <b>1,230,124</b>     |

## COMMITMENTS AND CONTINGENCIES

## STOCKHOLDERS' EQUITY

|  |              |              |
|--|--------------|--------------|
| Common stock, par value \$.01 per share; shares authorized -<br>35,000,000; shares issued and outstanding - 12,748,273 and 12,688,224<br>(including 15,913 unvested restricted stock) (2017) | 127          | 127          |
| Additional paid in capital   | 65,730       | 65,256       |
| Retained earnings  | 109,628      | 99,662       |
| Accumulated other comprehensive (loss)   | (4,066 )     | (1,309 )     |
| TOTAL STOCKHOLDERS' EQUITY   | 171,419      | 163,736      |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY   | \$ 1,473,543 | \$ 1,393,860 |

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Dollars in thousands, except per share amounts)

|  | For Three Months<br>Ended<br>September 30, |           | For Nine Months<br>Ended<br>September 30, |           |
|--|--|-----------|---|-----------|
|  | 2018                                       | 2017      | 2018                                      | 2017      |
| <b>INTEREST INCOME</b>                                       |  |           |   |           |
| Interest and fees on loans                                   | \$ 13,205                                  | \$ 11,771 | \$ 37,880                                 | \$ 31,762 |
| Interest and dividends on investment securities:             |  |           |   |           |
| Taxable  | 947  | 1,035     | 2,950                                     | 2,799     |
| Tax-exempt   | -  | -         | -   | 3         |
| Interest on deposits with other banks                        | 84   | 131       | 183                                       | 269       |
| Total interest income  | 14,236                                     | 12,937    | 41,013                                    | 34,833    |
| <b>INTEREST EXPENSE</b>                                      |  |           |   |           |
| Interest on deposits   | 826  | 607       | 1,954                                     | 1,656     |
| Interest on short-term borrowings                            | 463  | 4         | 1,150                                     | 18        |
| Total interest expense                                       | 1,289                                      | 611       | 3,104                                     | 1,674     |
| <b>NET INTEREST INCOME</b>                                   | 12,947                                     | 12,326    | 37,909                                    | 33,159    |
| Provision for credit losses                                  | 307  | 345       | 1,214                                     | 1,746     |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | 12,640                                     | 11,981    | 36,695                                    | 31,413    |
| <b>NONINTEREST INCOME</b>                                    |  |           |   |           |
| Service charges on deposit accounts                          | 982  | 945       | 2,834                                     | 2,657     |
| Trust and investment fee income                              | 383  | 389       | 1,197                                     | 1,122     |
| Gains on sales and calls of investment securities            | -  | 5         | -   | 5         |
| Insurance agency commissions                                 | 2,170                                      | 2,088     | 7,015                                     | 6,939     |
| Other noninterest income                                     | 1,175                                      | 998       | 3,133                                     | 2,688     |
| Total noninterest income                                     | 4,710                                      | 4,425     | 14,179                                    | 13,411    |
| <b>NONINTEREST EXPENSE</b>                                   |  |           |   |           |
| Salaries and wages   | 5,516                                      | 5,203     | 16,372                                    | 14,508    |
| Employee benefits  | 1,271                                      | 1,197     | 4,157                                     | 3,564     |
| Occupancy expense  | 767  | 696       | 2,303                                     | 1,950     |
| Furniture and equipment expense                              | 251  | 286       | 813                                       | 803       |
| Data processing  | 963  | 922       | 2,580                                     | 2,809     |
| Directors' fees  | 145  | 99        | 411                                       | 281       |



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|   |          |          |           |          |
|---|----------|----------|-----------|----------|
| Amortization of other intangible assets | 281      | 115      | 631       | 203      |
| FDIC insurance premium expense          | 193      | 189      | 612       | 398      |
| Other real estate owned expense, net    | 166      | 195      | 125       | 358      |
| Legal and professional                  | 463      | 493      | 1,432     | 1,855    |
| Other noninterest expenses              | 1,270    | 1,325    | 4,140     | 3,841    |
| Total noninterest expense               | 11,286   | 10,720   | 33,576    | 30,570   |
| <br>                                    |          |          |           |          |
| INCOME BEFORE INCOME TAXES              | 6,064    | 5,686    | 17,298    | 14,254   |
| Income tax expense                      | 1,610    | 2,274    | 4,395     | 5,690    |
| <br>                                    |          |          |           |          |
| NET INCOME                              | \$ 4,454 | \$ 3,412 | \$ 12,903 | \$ 8,564 |
| <br>                                    |          |          |           |          |
| Earnings per common share - Basic       | \$ 0.35  | \$ 0.27  | \$ 1.01   | \$ 0.68  |
| Earnings per common share - Diluted     | 0.35     | 0.27     | 1.01      | 0.67     |
| Dividends paid per common share         | 0.08     | 0.05     | 0.23      | 0.15     |

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(Dollars in thousands)

|  | For Three Months<br>Ended<br>September 30, |          | For Nine Months<br>Ended<br>September 30, |          |
|--|--|----------|---|----------|
|  | 2018                                       | 2017     | 2018                                      | 2017     |
| Net Income   | \$ 4,454                                   | \$ 3,412 | \$ 12,903                                 | \$ 8,564 |
| Other comprehensive (loss) income:   |  |          |   |          |
| Investment securities:   |  |          |   |          |
| Unrealized holding (losses) gains on available-for-sale-securities                                       | (420 )                                     | (385 )   | (3,836 )                                  | 1,555    |
| Tax effect   | 116  | 155      | 1,058                                     | (628 )   |
| Reclassification of (gains) recognized in net income   | -  | (5 )     | -   | (5 )     |
| Tax effect   | -  | 2        | -   | 2        |
| Amortization of unrealized loss on securities transferred from<br>available-for-sale to held-to-maturity | 7  | 8        | 22  | 23       |
| Tax effect   | (2 )                                       | (3 )     | (7 )                                      | (8 )     |
| Net of tax amount  | (299 )                                     | (228 )   | (2,763 )                                  | 939      |
| Total other comprehensive (loss) income  | (299 )                                     | (228 )   | (2,763 )                                  | 939      |
| Comprehensive income   | \$ 4,155                                   | \$ 3,184 | \$ 10,140                                 | \$ 9,503 |

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)

For the Nine Months Ended September 30, 2018 and 2017

(Dollars in thousands)

|  | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Stockholders'<br>Equity |
|--|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balances, January 1, 2018                  | \$ 127          | \$ 65,256                        | \$99,662             | \$ (1,309)   | ) \$ 163,736                     |
| Cumulative effect adjustment (ASU 2016-01) | -               | -                                | (6 )                 | 6  | -                                |
| Net Income                                 | -               | -                                | 12,903               | -  | 12,903                           |
| Other comprehensive (loss)                 | -               | -                                | -                    | (2,763 )   | (2,763 )                         |
| Stock-based compensation                   | -               | 474                              | -                    | -  | 474                              |
| Cash dividends declared                    | -               | -                                | (2,931 )             | -  | (2,931 )                         |
| Balances, September 30, 2018               | \$ 127          | \$ 65,730                        | \$109,628            | \$ (4,066)   | ) \$ 171,419                     |
| Balances, January 1, 2017                  | \$ 127          | \$ 64,201                        | \$90,964             | \$ (993)   | ) \$ 154,299                     |
| Net Income                                 | -               | -                                | 8,564                | -  | 8,564                            |
| Other comprehensive income                 | -               | -                                | -                    | 939  | 939                              |
| Stock-based compensation                   | -               | 748                              | -                    | -  | 748                              |
| Cash dividends declared                    | -               | -                                | (1,902 )             | -  | (1,902 )                         |
| Balances, September 30, 2017               | \$ 127          | \$ 64,949                        | \$97,626             | \$ (54)  | ) \$ 162,648                     |

See accompanying notes to Consolidated Financial Statements.

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(Dollars in thousands)

|   | For Nine Months Ended<br>September 30, |           |
|---|--|-----------|
|   | 2018                                   | 2017      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |  |           |
| Net Income  | \$ 12,903                              | \$ 8,564  |
| Adjustments to reconcile net income to net cash provided by operating activities:           |  |           |
| Net accretion of acquisition accounting estimates   | (517 )                                 | (347 )    |
| Provision for credit losses   | 1,214                                  | 1,746     |
| Depreciation and amortization   | 1,664                                  | 1,195     |
| Net amortization of securities  | 498                                    | 612       |
| Stock-based compensation expense  | 474                                    | 748       |
| Deferred income tax expense   | 566                                    | 3,075     |
| (Gains) on sales and calls of securities  | -                                      | (5 )      |
| Losses on disposals of premises and equipment   | -                                      | 2         |
| Losses on sales and valuation adjustments on other real estate owned                        | 73                                     | 293       |
| Fair value adjustment on equity securities  | 20                                     | -         |
| Net changes in:   |  |           |
| Accrued interest receivable   | (99 )                                  | (447 )    |
| Other assets  | (5,401 )                               | (2,236 )  |
| Accrued interest payable  | 331                                    | (15 )     |
| Other liabilities   | 305                                    | 543       |
| Net cash provided by operating activities   | 12,031                                 | 13,728    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |  |           |
| Proceeds from maturities and principal payments of investment securities available for sale | 24,292                                 | 35,957    |
| Purchases of investment securities available for sale                                       | -                                      | (84,495 ) |
| Purchases of equity securities  | (11 )                                  | -         |
| Proceeds from maturities and principal payments of investment securities held to maturity   | 228                                    | 479       |
| Net change in loans   | (87,470 )                              | (53,834 ) |
| Purchases of premises and equipment   | (1,026 )                               | (1,035 )  |
| Proceeds from sales of other real estate owned  | 280                                    | 470       |
| Cash received in branch acquisition (net of cash paid)                                      | -                                      | 64,045    |
| Net cash used in investing activities   | (63,707 )                              | (38,413 ) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |  |           |
| Net changes in:   |  |           |
| Noninterest-bearing deposits  | 3,444                                  | 29,883    |
| Interest-bearing deposits   | (24,189 )                              | (33,584 ) |
| Short-term borrowings   | 92,309                                 | (1,734 )  |

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|   |             |            |
|---|-------------|------------|
| Common stock dividends paid   | (2,931 )    | (1,902 )   |
| Net cash provided by (used in) financing activities   | 68,633      | (7,337 )   |
| Net increase (decrease) in cash and cash equivalents  | 16,957      | (32,022 )  |
| Cash and cash equivalents at beginning of period  | 31,820      | 75,938     |
| Cash and cash equivalents at end of period  | \$ 48,777   | \$ 43,916  |
| Supplemental cash flows information:  |             |            |
| Interest paid   | \$ 2,973    | \$ 1,738   |
| Income taxes paid   | \$ 4,025    | \$ 2,000   |
| Transfers from loans to other real estate owned   | \$ 77       | \$ 95      |
| Unrealized (loss) gain on securities available for sale   | \$ (3,836 ) | \$ 1,550   |
| Amortization of unrealized loss on securities transferred from available for sale to held to maturity | \$ 22       | \$ 23      |
| Branch purchase:  |             |            |
| Tangible assets acquired (net of cash received)   | \$ -        | \$ 129,188 |
| Identifiable intangible assets acquired   | \$ -        | \$ 3,954   |
| Liabilities assumed   | \$ -        | \$ 212,463 |

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.

Notes to Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2018 and 2017

(Unaudited)

### Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2018, the consolidated results of income and comprehensive income for the three and nine months ended September 30, 2018 and 2017, and changes in stockholders’ equity and cash flows for the nine months ended September 30, 2018 and 2017, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2017 were derived from the 2017 audited financial statements. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2017. For purposes of comparability, certain immaterial reclassifications have been made to amounts previously reported to conform with the current period presentation.

When used in these notes, the term “the Company” refers to Shore Bancshares, Inc. and, unless the context requires otherwise, its consolidated subsidiaries.

### Recent Accounting Standards

ASU No. 2016-02, “*Leases (Topic 842)*.” This ASU stipulates that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statement*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to

exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The amendments in this ASU are effective for fiscal years after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Leases and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU No. 2016-02 will have on its consolidated financial statements. The Company has put together an inventory of all leases and accumulated the lease data necessary to apply the amended guidance.

ASU No. 2016-13, *“Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.”* The amendments in this ASU will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. The amendments broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The use of forecasted information incorporates more timely information in the estimate of expected credit losses, which will be more decision useful to users of the financial statements. It is not expected that an entity will need to create an economic forecast over the entire contractual life of long-dated financial assets. Therefore, the amendments will allow an entity to revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts. The amendments retain many of the disclosure amendments in Accounting Standards Update No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. Credit losses on available-for-sale debt securities should be measured in a manner similar to current GAAP. However, the amendments require that credit losses be presented as an allowance rather than a write-down. For public entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All entities may adopt the amendments earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company believes this ASU will have a significant impact on our consolidated financial statements and the method in which we calculate our credit losses, primarily on loans and held to maturity securities. At this time, the Company has established a project management team which meets periodically to discuss and assign roles and responsibilities, key tasks to complete, and a general time line to be followed for implementation. The team has been working with an advisory consultant and has purchased a vendor model for implementation. Historical data has been collected and uploaded to the new model and the team is in the process of finalizing the methodologies that will be utilized. The team expects to be running a parallel simulation to its current incurred loss impairment model in the first quarter of 2019. The Company is continuing to evaluate the extent of the potential impact of this standard and continues to keep current on evolving interpretations and industry practices via webcasts, publications, conferences, and peer bank meetings.





ASU No. 2017-04 – In January 2017, FASB issued ASU No. 2017-04, “*Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.*” The ASU simplifies measurement of goodwill and eliminates Step 2 from the goodwill impairment test. The Company should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value. The impairment charge is limited to the amount of goodwill allocated to that reporting unit. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The guidance is not expected to have a significant impact on the Company’s financial positions, results of operations or disclosures.

ASU No. 2017-08 – In March 2017, the FASB issued ASU No. 2017-08, “*Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.*” Under current GAAP, entities normally amortize the premium as an adjustment of yield over the contractual life of the instrument. This guidance shortens the amortization period of certain callable debt securities held at a premium to the earliest call date. This update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company’s consolidated financial statements.

ASU No. 2017-09 – In May 2017, the FASB issued ASU No. 2017-09 “*Stock Compensation, Scope of Modification Accounting.*” This ASU clarifies when changes to the terms of conditions of a share-based payment award must be accounted for as modifications. Companies will apply the modification accounting guidance if the value, vesting conditions or classification of the award changes. The new guidance should reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications, as the guidance will allow companies to make certain non-substantive changes to awards without accounting for them as modifications. It does not change the accounting for modifications. ASU No. 2017-09 is effective for interim and annual reporting periods beginning after December 15, 2017; early adoption is permitted. ASU No. 2017-09 did not have a material impact on the Company’s consolidated financial statements.

ASU No. 2018-02 – In February 2018, the FASB issued ASU No. 2018-02 “*Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.*” The amendments provide financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company elected to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act in the financial statements for the period ending December 31, 2017. The amount of this reclassification in 2017 was \$226 thousand.

ASU No. 2018-03 - In February 2018, the FASB issued ASU 2018-03, “Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The amendments provide targeted improvements to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Specifically, the amendments include clarifications related to: measurement elections, transition requirements, and adjustments associated with equity securities without readily determinable fair values; fair value measurement requirements for forward contracts and purchased options on equity securities; presentation requirements for hybrid financial liabilities for which the fair value option has been elected; and measurement requirements for liabilities denominated in a foreign currency for which the fair value option has been elected. The amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Early adoption is permitted. The adoption of ASU No. 2018-03 did not have a material impact on the Company’s consolidated financial statements.

ASU No. 2018-11 – In July 2018, the FASB issued ASU 2018-11, “Leases - Targeted Improvements” to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company). The Company expects to elect both transition options. ASU 2018-11 is not expected to have a material impact on the Company’s Consolidated Financial Statements.

ASU No. 2018-13 – In August 2018, the FASB issued ASU 2018-13, “Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement.” This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. ASU No. 2018-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted. Entities are also allowed to elect early adoption the eliminated or modified disclosure requirements and delay adoption of the new disclosure requirements until their effective date. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company’s Consolidated Financial Statements.

## Note 2 – Business Combination

### ***Northwest Bank Branch Acquisition***

On May 19, 2017, the Bank purchased three branches from Northwest Bank (“NWBI”) located in Arbutus, Elkridge, and Owings Mills, Maryland. Pursuant to the transaction, the Bank acquired \$122.9 million in loans and \$212.5 million in deposits, as well as the branch premises and equipment. In connection with its purchase of the branches from NWBI, the Bank received a cash payment from NWBI of \$64.0 million, which was net of a premium paid on deposits of \$17.2 million. In addition to the premium paid on deposits, other costs associated with the acquisition totaled \$977 thousand. This acquisition provides the Bank with the opportunity to enhance its footprint in Maryland by extending its branch network across the Chesapeake Bay to the greater Baltimore area communities of Elkridge, Owings Mills and Arbutus.

The Company has accounted for the branch purchases under the acquisition method of accounting in accordance with FASB ASC topic 805, “Business Combinations,” whereby the acquired assets and liabilities were recorded by the Bank at their estimated fair values as of their acquisition date.

The acquired assets and assumed liabilities of the NWBI branches were measured at estimated fair value. Management made significant estimates and exercised significant judgement in accounting for the acquisition of the NWBI branches. Management evaluated expected cash flows, prepayment speeds and estimated loss factors to measure fair values for loans. Deposits were valued based upon interest rates, original and remaining terms and maturities, as well as current rates for similar funds in the same markets. Premises were based on recent appraised values, whereas equipment was acquired based on the remaining book value from NWBI, which approximated fair value. Management engaged independent outside experts to provide the fair value estimates. Subsequent to the purchase, management made a measurement period adjustment for deferred taxes related to intangible assets of \$291 thousand.

The following table provides the purchase price as of the acquisition date of May 19, 2017, the identifiable assets acquired and liabilities assumed at their estimated fair values, and the resulting goodwill of \$15.0 million recorded from the acquisition:

**(in thousands)**

Purchase Price Consideration:

|  |           |
|--|-----------|
| Cash consideration                               | \$ 17,186 |
| Total purchase price for NWBI branch acquisition | \$ 17,186 |

Assets acquired at fair value:

|                                     |            |
|-------------------------------------|------------|
| Cash and cash equivalents           | \$ 81,231  |
| Loans                               | 122,862    |
| Premises and equipment, net         | 6,326      |
| Core deposit intangible             | 3,954      |
| Deferred tax assets                 | 291        |
| Total fair value of assets acquired | \$ 214,664 |

Liabilities assumed at fair value:

|   |            |
|---|------------|
| Deposits                                | \$ 212,456 |
| Other liabilities                       | 7          |
| Total fair value of liabilities assumed | \$ 212,463 |

Net assets acquired at fair value: \$ 2,201

Amount of goodwill resulting from acquisition \$ 14,985

The total amount of goodwill arising from this transaction of \$15.0 million is expected to be deductible for tax purposes, pursuant to section 197 of the Internal Revenue Code.

**Acquired loans**

The following table outlines the contractually required payments receivable, cash flows we expect to receive, accretable yield and carrying value for all NWBI loans as of the acquisition date.

|                           | <b>Contractually<br/>Required<br/>Payments<br/>Receivable</b> | <b>Cash Flows<br/>Expected To Be<br/>Collected</b> | <b>Accretable FMV<br/>Adjustments</b> | <b>Carrying Value<br/>of Loans<br/>Receivable</b> |
|---------------------------|---|--|---------------------------------------|---|
| Performing loans acquired | \$ 125,131  | 125,131  | 2,269                                 | \$ 122,862  |

The Company recorded all loans acquired at the estimated fair value on the purchase date with no carryover of the related allowance for loan losses. The Company only acquired loans which were deemed to be performing loans with no signs of credit deterioration.

The Company determined the net discounted value of cash flows on approximately 864 performing loans totaling \$125.1 million. The valuation took into consideration the loans' underlying characteristics, including account types, remaining terms, annual interest rates, interest types, past delinquencies, timing of principal and interest payments, current market rates, loan-to-value ratios, loss exposures, and remaining balances. These performing loans were segregated into pools based on loan and payment type. The effect of this fair valuation process was a net accretable discount adjustment of \$2.3 million at acquisition.

**Note 3 – Earnings Per Share**

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share:

|  |   |
|--|---|
| For the Three Months<br>Ended<br>September 30, | For the Nine Months<br>Ended<br>September 30, |
|--|---|

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| (In thousands, except per share data)                              | 2018     | 2017     | 2018      | 2017     |
|--|----------|----------|-----------|----------|
| Net Income   | \$ 4,454 | \$ 3,412 | \$ 12,903 | \$ 8,564 |
| Weighted average shares outstanding - Basic                        | 12,748   | 12,687   | 12,736    | 12,679   |
| Dilutive effect of common stock equivalents-options                | 13       | 21       | 13        | 21       |
| Dilutive effect of common stock equivalents-restricted stock units | -        | 8        | -         | 6        |
| Weighted average shares outstanding - Diluted                      | 12,761   | 12,716   | 12,749    | 12,706   |
| Earnings per common share - Basic                                  | \$ 0.35  | \$ 0.27  | \$ 1.01   | \$ 0.68  |
| Earnings per common share - Diluted                                | \$ 0.35  | \$ 0.27  | \$ 1.01   | \$ 0.67  |

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2018 and 2017.

Note 4 – Investment Securities

The following table provides information on the amortized cost and estimated fair values of investment securities.

| (Dollars in thousands)         | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|--------------------------------|----------------|------------------------|-------------------------|----------------------|
| Available-for-sale securities: |                |                        |                         |                      |
| September 30, 2018             |                |                        |                         |                      |
| U.S. Government agencies       | \$42,411       | \$ 2                   | \$ 867                  | \$41,546             |
| Mortgage-backed                | 130,807        | 126                    | 4,804                   | 126,129              |
| Total                          | \$ 173,218     | \$ 128                 | \$ 5,671                | \$ 167,675           |
| December 31, 2017              |                |                        |                         |                      |
| U.S. Government agencies       | \$45,806       | \$ 23                  | \$ 497                  | \$45,332             |
| Mortgage-backed                | 152,198        | 157                    | 1,390                   | 150,965              |
| Equity                         | 666            | -                      | 8                       | 658                  |
| Total                          | \$ 198,670     | \$ 180                 | \$ 1,895                | \$ 196,955           |

The Company adopted ASU 2016-01 effective January 1, 2018 and equity securities with an aggregate fair value of \$649 thousand at September 30, 2018 are presented separately on the balance sheet. The fair value adjustment recorded through earnings totaled \$(20) thousand for the nine months ended September 30, 2018.

## Held-to-maturity securities:

September 30, 2018

|                                   |         |      |      |         |
|-----------------------------------|---------|------|------|---------|
| U.S. Government agencies          | \$1,635 | \$-  | \$50 | \$1,585 |
| States and political subdivisions | 1,402   | 17   | -    | 1,419   |
| Other Debt securities (1)         | 3,000   | -    | 21   | 2,979   |
| Total                             | \$6,037 | \$17 | \$71 | \$5,983 |

December 31, 2017

|                                   |         |       |     |         |
|-----------------------------------|---------|-------|-----|---------|
| U.S. Government agencies          | \$1,844 | \$21  | \$- | \$1,865 |
| States and political subdivisions | 1,403   | 47    | -   | 1,450   |
| Other Debt securities (1)         | 3,000   | 76    | -   | 3,076   |
| Total                             | \$6,247 | \$144 | \$- | \$6,391 |

(1) On December 15, 2016, the Company bought \$3.0 million in subordinated notes with a fixed to floating rate of 6.5% from a local regional bank which it intends to hold to maturity of December 30, 2026.





The following tables provide information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)         | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|                                | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| <b>September 30, 2018</b>      |                        |                      |                        |                      |               |                      |
| Available-for-sale securities: |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | \$ 4,209               | \$ 16                | \$ 37,151              | \$ 851               | \$ 41,360     | \$ 867               |
| Mortgage-backed                | 64,423                 | 2,247                | 54,037                 | 2,557                | 118,460       | 4,804                |
| Total                          | \$ 68,632              | \$ 2,263             | \$ 91,188              | \$ 3,408             | \$ 159,820    | \$ 5,671             |
| Held-to-maturity securities:   |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | -                      | -                    | 1,585                  | 50                   | 1,585         | 50                   |
| Other debt securities          | 2,979                  | 21                   | -                      | -                    | 2,979         | 21                   |
| Total                          | \$ 2,979               | \$ 21                | \$ 1,585               | \$ 50                | \$ 4,564      | \$ 71                |

| (Dollars in thousands)         | Less than<br>12 Months |                      | More than<br>12 Months |                      | Total         |                      |
|--------------------------------|------------------------|----------------------|------------------------|----------------------|---------------|----------------------|
|                                | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value          | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| December 31, 2017              |                        |                      |                        |                      |               |                      |
| Available-for-sale securities: |                        |                      |                        |                      |               |                      |
| U.S. Government agencies       | \$ 37,550              | \$ 453               | \$ 5,956               | \$ 44                | \$ 43,506     | \$ 497               |
| Mortgage-backed                | 96,622                 | 700                  | 28,215                 | 690                  | 124,837       | 1,390                |
| Equity securities              | -                      | -                    | 666                    | 8                    | 666           | 8                    |
| Total                          | \$ 134,172             | \$ 1,153             | \$ 34,837              | \$ 742               | \$ 169,009    | \$ 1,895             |

All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary. There were eighty-four available-for-sale securities and two held-to-maturity security in an unrealized loss position at September 30, 2018.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2018.

| <b>(Dollars in thousands)</b>          | <b>Available for sale</b> |                   | <b>Held to maturity</b> |                   |
|--|---------------------------|-------------------|-------------------------|-------------------|
|  | <b>Amortized</b>          |                   | <b>Amortized</b>        |                   |
|  | <b>Cost</b>               | <b>Fair Value</b> | <b>Cost</b>             | <b>Fair Value</b> |
| Due in one year or less                | \$8,000                   | \$ 7,985          | \$ -                    | \$ -              |
| Due after one year through five years  | 34,457                    | 33,577            | 901                     | 913               |
| Due after five years through ten years | 63,419                    | 61,099            | 3,501                   | 3,485             |
| Due after ten years                    | 67,342                    | 65,014            | 1,635                   | 1,585             |
| Total                                  | \$173,218                 | \$ 167,675        | \$ 6,037                | \$ 5,983          |

The maturity dates for debt securities are determined using contractual maturity dates.

Note 5 – Loans and Allowance for Credit Losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne’s County, Kent County, Caroline County, Dorchester County, Baltimore County and Howard County in Maryland, Kent County, Delaware and Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)      | September 30, 2018 | December 31, 2017 |
|-----------------------------|--------------------|-------------------|
| Construction                | \$ 126,313         | \$ 125,746        |
| Residential real estate     | 425,842            | 399,190           |
| Commercial real estate      | 513,169            | 464,887           |
| Commercial                  | 108,823            | 97,284            |
| Consumer                    | 6,410              | 6,407             |
| Total loans                 | 1,180,557          | 1,093,514         |
| Allowance for credit losses | (10,328 )          | (9,781 )          |
| Total loans, net            | \$ 1,170,229       | \$ 1,083,733      |

Loans are stated at their principal amount outstanding net of any purchase premiums, deferred fees and costs. Loans included deferred costs, net of deferred fees, of \$725 thousand and discounts on acquired loans of \$1.5 million at September 30, 2018. Loans included deferred costs, net of deferred fees, of \$609 thousand and discounts on acquired loans of \$1.8 million at December 31, 2017. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income.

Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan’s contractual terms. An impaired loan may show deficiencies in the borrower’s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan’s effective interest rate, or at the loan’s observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the

amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogenous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and are included in the formula portion of the allowance for credit losses. See additional discussion under the caption “Critical Accounting Policies” in Management’s Discussion and Analysis of Financial Condition and Results of Operations.

A loan is considered a troubled debt restructuring (“TDR”) if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company’s banking subsidiary, Shore United Bank (the “Bank”), the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower's financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made.

In the normal course of banking business, risks related to specific loan categories are as follows:

**Construction loans** – Construction loans are offered primarily to builders and individuals to finance the construction of single family dwellings. In addition, the Bank periodically finances the construction of commercial projects. Credit risk factors include the borrower's ability to successfully complete the construction on time and within budget, changing market conditions which could affect the value and marketability of projects, changes in the borrower's ability or willingness to repay the loan and potentially rising interest rates which can impact both the borrower's ability to repay and the collateral value.

**Residential real estate** – Residential real estate loans are typically made to consumers and are secured by residential real estate. Credit risk arises from the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Also impacting credit risk would be a shortfall in the value of the residential real estate in relation to the outstanding loan balance in the event of a default or subsequent liquidation of the real estate collateral.

**Commercial real estate** – Commercial real estate loans consist of both loans secured by owner occupied properties and non-owner occupied properties where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. These loans are subject to adverse changes in the local economy and commercial real estate markets. Credit risk associated with owner occupied properties arises from the borrower's financial stability and the ability of the borrower and the business to repay the loan. Non-owner occupied properties carry the risk of a tenant's deteriorating credit strength, lease expirations in soft markets and sustained vacancies which can adversely impact cash flow.

**Commercial** – Commercial loans are secured or unsecured loans for business purposes. Loans are typically secured by accounts receivable, inventory, equipment and/or other assets of the business. Credit risk arises from the successful operation of the business which may be affected by competition, rising interest rates, regulatory changes and adverse conditions in the local and regional economy.

Consumer – Consumer loans include home equity loans and lines, installment loans and personal lines of credit. Credit risk is similar to residential real estate loans above as it is subject to the borrower’s continuing financial stability and the value of the collateral securing the loan.

The following tables include impairment information relating to loans and the allowance for credit losses as of September 30, 2018 and December 31, 2017.

| (Dollars in thousands)                      | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total        |
|---|--------------|----------------------------|---------------------------|------------|----------|--------------|
| September 30, 2018                          |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 3,104     | \$ 6,931                   | \$ 5,936                  | \$ 324     | \$ -     | \$ 16,295    |
| Loans collectively evaluated for impairment | 123,209      | 418,911                    | 507,233                   | 108,499    | 6,410    | 1,164,262    |
| Total loans                                 | \$ 126,313   | \$ 425,842                 | \$ 513,169                | \$ 108,823 | \$ 6,410 | \$ 1,180,557 |
| Allowance for credit losses allocated to:   |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 375       | \$ 194                     | \$ 32                     | \$ 20      | \$ -     | \$ 621       |
| Loans collectively evaluated for impairment | 2,409        | 1,947                      | 2,905                     | 2,190      | 256      | 9,707        |
| Total allowance                             | \$ 2,784     | \$ 2,141                   | \$ 2,937                  | \$ 2,210   | \$ 256   | \$ 10,328    |

| (Dollars in thousands)                      | Construction | Residential<br>real estate | Commercial<br>real estate | Commercial | Consumer | Total        |
|---|--------------|----------------------------|---------------------------|------------|----------|--------------|
| December 31, 2017                           |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 6,975     | \$ 6,018                   | \$ 4,967                  | \$ 337     | \$ -     | \$ 18,297    |
| Loans collectively evaluated for impairment | 118,771      | 393,172                    | 459,920                   | 96,947     | 6,407    | 1,075,217    |
| Total loans                                 | \$ 125,746   | \$ 399,190                 | \$ 464,887                | \$ 97,284  | \$ 6,407 | \$ 1,093,514 |
| Allowance for credit losses allocated to:   |              |                            |                           |            |          |              |
| Loans individually evaluated for impairment | \$ 500       | \$ 239                     | \$ 33                     | \$ 33      | \$ -     | \$ 805       |
| Loans collectively evaluated for impairment | 1,960        | 2,045                      | 2,561                     | 2,208      | 202      | 8,976        |
| Total allowance                             | \$ 2,460     | \$ 2,284                   | \$ 2,594                  | \$ 2,241   | \$ 202   | \$ 9,781     |

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2018 and December 31, 2017. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken and interest paid on nonaccrual loans that has been applied to principal.

| (Dollars in thousands)     | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | September 30, 2018                          |  |
|----------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|---|--|
|                            |                          |                                       |                                       |                   | Quarter-to-date average recorded investment | Year-to-date average recorded investment |
| September 30, 2018         |                          |                                       |                                       |                   |   |  |
| Impaired nonaccrual loans: |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 3,409                 | \$ 284                                | \$ 2,748                              | \$ 356            | \$ 3,043                                    | \$ 3,006                                 |
| Residential real estate    | 2,399                    | 2,267                                 | -                                     | -                 | 1,710                                       | 1,573                                    |
| Commercial real estate     | 2,155                    | 1,739                                 | -                                     | -                 | 1,742                                       | 1,438                                    |
| Commercial                 | 425                      | -                                     | 324                                   | 20                | 327   | 338                                      |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | -  |
| Total                      | \$ 8,388                 | \$ 4,290                              | \$ 3,072                              | \$ 376            | \$ 6,822                                    | \$ 6,355                                 |
| Impaired accruing TDRs:    |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 72                    | \$ 53                                 | \$ 19                                 | \$ 19             | \$ 145                                      | \$ 1,138                                 |
| Residential real estate    | 4,664                    | 1,635                                 | 3,029                                 | 194               | 4,709                                       | 4,613                                    |
| Commercial real estate     | 4,197                    | 3,485                                 | 712                                   | 32                | 4,307                                       | 4,499                                    |
| Commercial                 | -                        | -                                     | -                                     | -                 | -   | -  |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | -  |
| Total                      | \$ 8,933                 | \$ 5,173                              | \$ 3,760                              | \$ 245            | \$ 9,161                                    | \$ 10,250                                |
| Total impaired loans:      |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 3,481                 | \$ 337                                | \$ 2,767                              | \$ 375            | \$ 3,188                                    | \$ 4,144                                 |
| Residential real estate    | 7,063                    | 3,902                                 | 3,029                                 | 194               | 6,419                                       | 6,186                                    |
| Commercial real estate     | 6,352                    | 5,224                                 | 712                                   | 32                | 6,049                                       | 5,937                                    |
| Commercial                 | 425                      | -                                     | 324                                   | 20                | 327   | 338                                      |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | -  |
| Total                      | \$ 17,321                | \$ 9,463                              | \$ 6,832                              | \$ 621            | \$ 15,983                                   | \$ 16,605                                |



| (Dollars in thousands)     | Unpaid principal balance | Recorded investment with no allowance | Recorded investment with an allowance | Related allowance | September 30, 2017                          |  |
|----------------------------|--------------------------|---------------------------------------|---------------------------------------|-------------------|---|--|
|                            |                          |                                       |                                       |                   | Quarter-to-date average recorded investment | Year-to-date average recorded investment |
| December 31, 2017          |                          |                                       |                                       |                   |   |  |
| Impaired nonaccrual loans: |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 3,100                 | \$ 182                                | \$ 2,821                              | \$ 459            | \$ 2,890                                    | \$ 3,253                                 |
| Residential real estate    | 1,620                    | 1,482                                 | -                                     | -                 | 2,840                                       | 3,573                                    |
| Commercial real estate     | 795                      | 149                                   | -                                     | -                 | 489   | 627                                      |
| Commercial                 | 425                      | -                                     | 337                                   | 33                | 344   | 153                                      |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | 55                                       |
| Total                      | \$ 5,940                 | \$ 1,813                              | \$ 3,158                              | \$ 492            | \$ 6,563                                    | \$ 7,661                                 |
| Impaired accruing TDRs:    |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 3,972                 | \$ 3,038                              | \$ 934                                | \$ 41             | \$ 4,034                                    | \$ 4,086                                 |
| Residential real estate    | 4,536                    | 2,042                                 | 2,494                                 | 239               | 3,691                                       | 3,620                                    |
| Commercial real estate     | 4,818                    | 4,084                                 | 734                                   | 33                | 4,841                                       | 4,872                                    |
| Commercial                 | -                        | -                                     | -                                     | -                 | -   | -  |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | -  |
| Total                      | \$ 13,326                | \$ 9,164                              | \$ 4,162                              | \$ 313            | \$ 12,566                                   | \$ 12,578                                |
| Total impaired loans:      |                          |                                       |                                       |                   |   |  |
| Construction               | \$ 7,072                 | \$ 3,220                              | \$ 3,755                              | \$ 500            | \$ 6,924                                    | \$ 7,339                                 |
| Residential real estate    | 6,156                    | 3,524                                 | 2,494                                 | 239               | 6,531                                       | 7,193                                    |
| Commercial real estate     | 5,613                    | 4,233                                 | 734                                   | 33                | 5,330                                       | 5,499                                    |
| Commercial                 | 425                      | -                                     | 337                                   | 33                | 344   | 153                                      |
| Consumer                   | -                        | -                                     | -                                     | -                 | -   | 55                                       |
| Total                      | \$ 19,266                | \$ 10,977                             | \$ 7,320                              | \$ 805            | \$ 19,129                                   | \$ 20,239                                |

The following tables provide a roll-forward for troubled debt restructurings as of September 30, 2018 and September 30, 2017.

| (Dollars in thousands)                   | 1/1/2018    |                   |             |             |                                     |            | 9/30/2018   |                   |
|--|-------------|-------------------|-------------|-------------|-------------------------------------|------------|-------------|-------------------|
|  | TDR Balance | New Disbursements | Charge-offs | Charge-offs | Reclassifications/Transfer In/(Out) | Payoffs    | TDR Balance | Related Allowance |
| For nine months ended September 30, 2018 |             |                   |             |             |                                     |            |             |                   |
| <u>Accruing TDRs</u>                     |             |                   |             |             |                                     |            |             |                   |
| Construction                             | \$3,972     | \$ -              | \$ (225 )   | \$ (379 )   | \$ (696 )                           | \$ (2,600) | \$72        | \$ 19             |
| Residential real estate                  | 4,536       | -                 | (63 )       | -           | 542                                 | (351 )     | 4,664       | 194               |
| Commercial real estate                   | 4,818       | -                 | (402 )      | -           | -                                   | (219 )     | 4,197       | 32                |
| Commercial                               | -           | -                 | -           | -           | -                                   | -          | -           | -                 |
| Consumer                                 | -           | -                 | -           | -           | -                                   | -          | -           | -                 |
| Total                                    | \$13,326    | \$ -              | \$ (690 )   | \$ (379 )   | \$ (154 )                           | \$ (3,170) | \$8,933     | \$ 245            |
| <u>Nonaccrual TDRs</u>                   |             |                   |             |             |                                     |            |             |                   |
| Construction                             | \$2,878     | \$ -              | \$ (73 )    | \$ -        | \$ 83                               | \$ -       | \$2,888     | \$ 356            |
| Residential real estate                  | -           | -                 | -           | (80 )       | 80                                  | -          | -           | -                 |
| Commercial real estate                   | 83          | -                 | -           | -           | (83 )                               | -          | -           | -                 |
| Commercial                               | 337         | -                 | (13 )       | -           | -                                   | -          | 324         | 20                |
| Consumer                                 | -           | -                 | -           | -           | -                                   | -          | -           | -                 |
| Total                                    | \$3,298     | \$ -              | \$ (86 )    | \$ (80 )    | \$ 80                               | \$ -       | \$3,212     | \$ 376            |
| Total                                    | \$16,624    | \$ -              | \$ (776 )   | \$ (459 )   | \$ (74 )                            | \$ (3,170) | \$12,145    | \$ 621            |

| (Dollars in thousands)                   | 1/1/2017    |                   |             |             |                                     |          | 9/30/2017   |                   |
|--|-------------|-------------------|-------------|-------------|-------------------------------------|----------|-------------|-------------------|
|  | TDR Balance | New Disbursements | Charge-offs | Charge-offs | Reclassifications/Transfer In/(Out) | Payoffs  | TDR Balance | Related Allowance |
| For nine months ended September 30, 2017 |             |                   |             |             |                                     |          |             |                   |
| <u>Accruing TDRs</u>                     |             |                   |             |             |                                     |          |             |                   |
| Construction                             | \$4,189     | \$ -              | \$ (22 )    | \$ -        | \$ -                                | \$ (134) | \$4,033     | \$ 41             |
| Residential real estate                  | 3,875       | -                 | (120 )      | (89 )       | 1,411                               | (452)    | 4,625       | 228               |
| Commercial real estate                   | 4,936       | -                 | (101 )      | -           | -                                   | -        | 4,835       | 35                |
| Commercial                               | -           | -                 | -           | -           | -                                   | -        | -           | -                 |
| Consumer                                 | -           | -                 | -           | -           | -                                   | -        | -           | -                 |
| Total                                    | \$13,000    | \$ -              | \$ (243 )   | \$ (89 )    | \$ 1,411                            | \$ (586) | \$13,493    | \$ 304            |
| <u>Nonaccrual TDRs</u>                   |             |                   |             |             |                                     |          |             |                   |
| Construction                             | \$3,818     | \$ -              | \$ (882 )   | \$ -        | \$ (108 )                           | \$ -     | \$2,828     | \$ 548            |
| Residential real estate                  | 1,603       | -                 | (66 )       | -           | (1,411 )                            | -        | 126         | 23                |
| Commercial real estate                   | 83          | -                 | -           | -           | -                                   | -        | 83          | -                 |
| Commercial                               | -           | 345               | (4 )        | -           | -                                   | -        | 341         | -                 |

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|          |          |       |           |          |           |           |          |       |
|----------|----------|-------|-----------|----------|-----------|-----------|----------|-------|
| Consumer | -        | -     | -         | -        | -         | -         | -        | -     |
| Total    | \$5,504  | \$345 | \$(952)   | ) \$-    | \$(1,519) | ) \$-     | \$3,378  | \$571 |
| Total    | \$18,504 | \$345 | \$(1,195) | ) \$(89) | \$(108)   | ) \$(586) | \$16,871 | \$875 |

The following tables provide information on loans that were modified and considered TDRs during the nine months ended September 30, 2018 and September 30, 2017.

| (Dollars in thousands)                          | Number of contracts | Premodification outstanding recorded investment | Postmodification outstanding recorded investment | Related allowance |
|---|---------------------|---|--|-------------------|
| <b>TDRs:</b>                                    |                     |   |  |                   |
| <b>For nine months ended September 30, 2018</b> |                     |   |  |                   |
| Construction                                    | -                   | \$ -  | \$ -   | \$ -              |
| Residential real estate                         | -                   | -   | -  | -                 |
| Commercial real estate                          | -                   | -   | -  | -                 |
| Commercial                                      | -                   | -   | -  | -                 |
| Consumer  | -                   | -   | -  | -                 |
| Total   | -                   | \$ -  | \$ -   | \$ -              |
| <b>For nine months ended September 30, 2017</b> |                     |   |  |                   |
| Construction                                    | -                   | \$ -  | \$ -   | \$ -              |
| Residential real estate                         | -                   | -   | -  | -                 |
| Commercial real estate                          | 1                   | 760   | 755  | -                 |
| Commercial                                      | 1                   | 462   | 345  | -                 |
| Consumer  | -                   | -   | -  | -                 |
| Total   | 2                   | \$ 1,222  | \$ 1,100   | \$ -              |

During the nine months ended September 30, 2018, there were no new TDR's or previously recorded TDR's which were modified.

The following tables provide information on TDRs that defaulted within twelve months of restructuring during the nine months ended September 30, 2018 and September 30, 2017. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is placed on nonaccrual, the loan is charged off, or there is a transfer to OREO or repossessed assets.

| (Dollars in thousands)                          | Number of contracts | Recorded investment | Related allowance |
|---|---------------------|---------------------|-------------------|
| <b>TDRs that subsequently defaulted:</b>        |                     |                     |                   |
| <b>For nine months ended September 30, 2018</b> |                     |                     |                   |
| Construction                                    | 1                   | \$ 379              | \$ -              |
| Residential real estate                         | 1                   | 154                 | -                 |

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|                        |          |               |             |
|------------------------|----------|---------------|-------------|
| Commercial real estate | -        | -             | -           |
| Commercial             | -        | -             | -           |
| Consumer               | -        | -             | -           |
| <b>Total</b>           | <b>2</b> | <b>\$ 533</b> | <b>\$ -</b> |

For nine months ended

September 30, 2017

|                         |          |              |             |
|-------------------------|----------|--------------|-------------|
| Construction            | -        | \$ -         | \$ -        |
| Residential real estate | 1        | 89           | -           |
| Commercial real estate  | -        | -            | -           |
| Commercial              | -        | -            | -           |
| Consumer                | -        | -            | -           |
| <b>Total</b>            | <b>1</b> | <b>\$ 89</b> | <b>\$ -</b> |

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. The Company added pass/watch credits to an existing pool that included loans that are risk rated as special mention and substandard to be collectively evaluated for impairment for both quantitative and qualitative factors at December 31, 2017. The Company believes that attributing additional reserves to this pool of loans better reflects the perceived risk for the total loan portfolio going forward, due to the significant organic loan growth over the past 24 months, the increase in pass/watch rated credits, and increasing balances/concentrations in certain segments of the loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. These loans and the pass/watch loans are assigned higher qualitative factors than favorably rated loans in the calculation of the formula portion of the allowance for credit losses. At September 30, 2018, there were no nonaccrual loans classified as special mention or doubtful and \$7.4 million of nonaccrual loans were identified as substandard. Similarly, at December 31, 2017, there were no nonaccrual loans classified as special mention or doubtful and \$5.0 million of nonaccrual loans were identified as substandard.

The following tables provide information on loan risk ratings as of September 30, 2018 and December 31, 2017.

| (Dollars in thousands)  | Pass/Performing | Pass/Watch | Special<br>Mention | Substandard | Doubtful | Total        |
|-------------------------|-----------------|------------|--------------------|-------------|----------|--------------|
| September 30, 2018      |                 |            |                    |             |          |              |
| Construction            | \$ 92,937       | \$ 30,307  | \$ -               | \$ 3,069    | \$ -     | \$ 126,313   |
| Residential real estate | 382,280         | 35,793     | 3,433              | 4,336       | -        | 425,842      |
| Commercial real estate  | 384,759         | 115,459    | 5,604              | 7,347       | -        | 513,169      |
| Commercial              | 83,245          | 24,569     | 645                | 364         | -        | 108,823      |
| Consumer                | 5,898           | 509        | -                  | 3           | -        | 6,410        |
| Total                   | \$ 949,119      | \$ 206,637 | \$ 9,682           | \$ 15,119   | \$ -     | \$ 1,180,557 |

| (Dollars in thousands)  | Pass/Performing | Pass/Watch | Special<br>Mention | Substandard | Doubtful | Total        |
|-------------------------|-----------------|------------|--------------------|-------------|----------|--------------|
| December 31, 2017       |                 |            |                    |             |          |              |
| Construction            | \$ 88,836       | \$ 30,674  | \$ -               | \$ 6,236    | \$ -     | \$ 125,746   |
| Residential real estate | 355,575         | 34,973     | 4,456              | 4,186       | -        | 399,190      |
| Commercial real estate  | 342,051         | 109,041    | 7,420              | 6,375       | -        | 464,887      |
| Commercial              | 72,440          | 24,102     | 308                | 434         | -        | 97,284       |
| Consumer                | 5,260           | 1,147      | -                  | -           | -        | 6,407        |
| Total                   | \$ 864,162      | \$ 199,937 | \$ 12,184          | \$ 17,231   | \$ -     | \$ 1,093,514 |

The following tables provide information on the aging of the loan portfolio as of September 30, 2018 and December 31, 2017.

Accruing

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| (Dollars in thousands)  | Current      | 30-59    | 60-89    | Greater | Total    |            | Total        |
|-------------------------|--------------|----------|----------|---------|----------|------------|--------------|
|                         |              | days     | days     | than    | past due | Nonaccrual |              |
| September 30, 2018      |              | past due | past due | 90 days |          |            |              |
| Construction            | \$ 123,262   | \$ 19    | \$ -     | \$ -    | \$ 19    | \$ 3,032   | \$ 126,313   |
| Residential real estate | 421,384      | 1,707    | 484      | -       | 2,191    | 2,267      | 425,842      |
| Commercial real estate  | 508,781      | 723      | 1,926    | -       | 2,649    | 1,739      | 513,169      |
| Commercial              | 107,632      | 519      | 348      | -       | 867      | 324        | 108,823      |
| Consumer                | 6,399        | 4        | 4        | 3       | 11       | -          | 6,410        |
| Total                   | \$ 1,167,458 | \$ 2,972 | \$ 2,762 | \$ 3    | \$ 5,737 | \$ 7,362   | \$ 1,180,557 |
| Percent of total loans  | 98.9         | % 0.3    | % 0.2    | % -     | % 0.5    | % 0.6      | % 100.0      |

| (Dollars in thousands)  | Current      | 30-59    | 60-89    | Greater | Total    |            | Total        |
|-------------------------|--------------|----------|----------|---------|----------|------------|--------------|
|                         |              | days     | days     | than    | past due | Nonaccrual |              |
| December 31, 2017       |              | past due | past due | 90 days |          |            |              |
| Construction            | \$ 122,475   | \$ 268   | \$ -     | \$ -    | \$ 268   | \$ 3,003   | \$ 125,746   |
| Residential real estate | 394,653      | 1,589    | 1,045    | 421     | 3,055    | 1,482      | 399,190      |
| Commercial real estate  | 460,998      | 1,061    | 2,461    | 218     | 3,740    | 149        | 464,887      |
| Commercial              | 96,774       | 173      | -        | -       | 173      | 337        | 97,284       |
| Consumer                | 6,395        | 6        | 6        | -       | 12       | -          | 6,407        |
| Total                   | \$ 1,081,295 | \$ 3,097 | \$ 3,512 | \$ 639  | \$ 7,248 | \$ 4,971   | \$ 1,093,514 |
| Percent of total loans  | 98.8         | % 0.3    | % 0.3    | % 0.1   | % 0.7    | % 0.5      | % 100.0      |

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three and nine months ended September 30, 2018 and September 30, 2017. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

| (Dollars in thousands)                    | Construction | Residential<br>real<br>estate | Commercial<br>real<br>estate | Commercial | Consumer | Unallocated | Total     |
|---|--------------|-------------------------------|------------------------------|------------|----------|-------------|-----------|
| For three months ended September 30, 2018 |              |                               |                              |            |          |             |           |
| Allowance for credit losses:              |              |                               |                              |            |          |             |           |
| Beginning Balance                         | \$ 2,593     | \$ 2,150                      | \$ 2,845                     | \$ 2,210   | \$ 323   | \$ -        | \$ 10,121 |
| Charge-offs                               | -            | (109 )                        | -                            | (137 )     | -        | -           | (246 )    |
| Recoveries                                | 3            | 5                             | 5                            | 122        | 11       | -           | 146       |
| Net charge-offs                           | 3            | (104 )                        | 5                            | (15 )      | 11       | -           | (100 )    |
| Provision                                 | 188          | 95                            | 87                           | 15         | (78 )    | -           | 307       |
| Ending Balance                            | \$ 2,784     | \$ 2,141                      | \$ 2,937                     | \$ 2,210   | \$ 256   | \$ -        | \$ 10,328 |

| (Dollars in thousands)                    | Construction | Residential<br>real<br>estate | Commercial<br>real<br>estate | Commercial | Consumer | Unallocated | Total    |
|---|--------------|-------------------------------|------------------------------|------------|----------|-------------|----------|
| For three months ended September 30, 2017 |              |                               |                              |            |          |             |          |
| Allowance for credit losses:              |              |                               |                              |            |          |             |          |
| Beginning Balance                         | \$ 2,349     | \$ 2,096                      | \$ 2,802                     | \$ 1,652   | \$ 233   | \$ -        | \$ 9,132 |
| Charge-offs                               | -            | (70 )                         | (100 )                       | (99 )      | (18 )    | -           | (287 )   |
| Recoveries                                | 11           | 11                            | 8                            | 67         | 8        | -           | 105      |
| Net charge-offs                           | 11           | (59 )                         | (92 )                        | (32 )      | (10 )    | -           | (182 )   |
| Provision                                 | (119 )       | 6                             | 174                          | 184        | 100      | -           | 345      |
| Ending Balance                            | \$ 2,241     | \$ 2,043                      | \$ 2,884                     | \$ 1,804   | \$ 323   | \$ -        | \$ 9,295 |



| (Dollars in thousands)                   | Residential  |             | Commercial  | Commercial | Consumer | Unallocated | Total     |
|--|--------------|-------------|-------------|------------|----------|-------------|-----------|
|  | Construction | real estate | real estate |            |          |             |           |
| For nine months ended September 30, 2018 |              |             |             |            |          |             |           |
| Allowance for credit losses:             |              |             |             |            |          |             |           |
| Beginning Balance                        | \$ 2,460     | \$ 2,284    | \$ 2,594    | \$ 2,241   | \$ 202   | \$ -        | \$ 9,781  |
| Charge-offs                              | (379 )       | (288 )      | -           | (263 )     | (24 )    | -           | (954 )    |
| Recoveries                               | 18           | 91          | 23          | 144        | 11       | -           | 287       |
| Net charge-offs                          | (361 )       | (197 )      | 23          | (119 )     | (13 )    | -           | (667 )    |
| Provision                                | 685          | 54          | 320         | 88         | 67       | -           | 1,214     |
| Ending Balance                           | \$ 2,784     | \$ 2,141    | \$ 2,937    | \$ 2,210   | \$ 256   | \$ -        | \$ 10,328 |

| (Dollars in thousands)                   | Residential  |             | Commercial  | Commercial | Consumer | Unallocated | Total    |
|--|--------------|-------------|-------------|------------|----------|-------------|----------|
|  | Construction | real estate | real estate |            |          |             |          |
| For nine months ended September 30, 2017 |              |             |             |            |          |             |          |
| Allowance for credit losses:             |              |             |             |            |          |             |          |
| Beginning Balance                        | \$ 2,787     | \$ 1,953    | \$ 2,610    | \$ 1,145   | \$ 231   | \$ -        | \$ 8,726 |
| Charge-offs                              | (54 )        | (393 )      | (100 )      | (870 )     | (33 )    | -           | (1,450)  |
| Recoveries                               | 27           | 32          | 27          | 167        | 20       | -           | 273      |
| Net charge-offs                          | (27 )        | (361 )      | (73 )       | (703 )     | (13 )    | -           | (1,177)  |
| Provision                                | (519 )       | 451         | 347         | 1,362      | 105      | -           | 1,746    |
| Ending Balance                           | \$ 2,241     | \$ 2,043    | \$ 2,884    | \$ 1,804   | \$ 323   | \$ -        | \$ 9,295 |

### Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that were in the process of foreclosure totaled \$132 thousand and \$530 thousand as of September 30, 2018 and December 31, 2017, respectively. There was one residential property included in the balance of other real estate owned of \$77 thousand at September 30, 2018 and no residential properties included in the balance of other real estate owned at December 31, 2017.

All accruing TDRs were in compliance with their modified terms. One loan was transferred to nonaccrual as of September 30, 2018. Both performing and non-performing TDRs had no further commitments associated with them as of September 30, 2018 and December 31, 2017.

Note 6 – Goodwill and Other Intangibles

The following table provides information on the significant components of goodwill and other acquired intangible assets at September 30, 2018 and December 31, 2017. On May 19, 2017, the Bank acquired three branches located in Arbutus, Owings Mills and Elkridge, Maryland from NWBI. The purchase of these branches resulted in core deposit intangibles of \$4.0 million and goodwill of \$15.0 million.

## September 30, 2018

| (Dollars in thousands)        | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
|-------------------------------|-----------------------|--------------------------------|--------------------------|---------------------|--|
| Goodwill                      | \$ 30,922             | \$ (2,637 )                    | \$ (667 )                | \$ 27,618           | -  |
| Other intangible assets       |                       |                                |                          |                     |  |
| Amortizable                   |                       |                                |                          |                     |  |
| Employment agreements         | \$ 440                | \$ -                           | \$ (440 )                | \$ -                | -  |
| Insurance expirations         | 1,270                 | -                              | (1,270 )                 | -                   | -  |
| Customer relationships        | 795                   | (95 )                          | (519 )                   | 181                 | 3.9  |
| Core deposit intangible       | 3,954                 | -                              | (827 )                   | 3,127               | 8.7  |
|                               | 6,459                 | (95 )                          | (3,056 )                 | 3,308               |  |
| Unamortizable                 |                       |                                |                          |                     |  |
| Trade name                    | 780                   | -                              | -                        | 780                 | -  |
| Total other intangible assets | \$ 7,239              | \$ (95 )                       | \$ (3,056 )              | \$ 4,088            |  |

## December 31, 2017

| (Dollars in thousands)  | Gross Carrying Amount | Accumulated Impairment Charges | Accumulated Amortization | Net Carrying Amount | Weighted Average Remaining Life (in years) |
|-------------------------|-----------------------|--------------------------------|--------------------------|---------------------|--|
| Goodwill                | \$ 30,922             | \$ (2,637 )                    | \$ (667 )                | \$ 27,618           | -  |
| Other intangible assets |                       |                                |                          |                     |  |
| Amortizable             |                       |                                |                          |                     |  |
| Employment agreements   | \$ 440                | \$ -                           | \$ (440 )                | \$ -                | -  |
| Insurance expirations   | 1,270                 | -                              | (1,270 )                 | -                   | -  |
| Customer relationships  | 795                   | (95 )                          | (484 )                   | 216                 | 4.6  |
| Core deposit intangible | 3,954                 | -                              | (231 )                   | 3,723               | 9.4  |
|                         | 6,459                 | (95 )                          | (2,425 )                 | 3,939               |  |
| Unamortizable           |                       |                                |                          |                     |  |

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|                               |         |        |             |           |   |
|-------------------------------|---------|--------|-------------|-----------|---|
| Trade name                    | 780     | -      | -           | 780       | - |
| Total other intangible assets | \$7,239 | \$ (95 | ) \$ (2,425 | ) \$4,719 |   |

The aggregate amortization expense was \$631 thousand and \$203 thousand for the nine months ended September 30, 2018 and September 30, 2017, respectively.

At September 30, 2018, estimated future remaining amortization for amortizing intangibles within the years ending December 31, is as follows:

| (Dollars in thousands)             |         |
|------------------------------------|---------|
| 2018                               | \$270   |
| 2019                               | 652     |
| 2020                               | 580     |
| 2021                               | 505     |
| 2022                               | 421     |
| 2023                               | 317     |
| Thereafter                         | 563     |
| Total amortizing intangible assets | \$3,308 |

Note 7 – Other Assets

The Company had the following other assets at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)                 | September 30, 2018 | December 31, 2017 |
|--|--------------------|-------------------|
| Restricted securities                  | \$ 8,110           | \$ 3,735          |
| Accrued interest receivable            | 3,601              | 3,502             |
| Deferred income taxes                  | 2,440              | 1,935             |
| Prepaid expenses                       | 1,546              | 1,475             |
| Cash surrender value on life insurance | 3,676              | 3,637             |
| Other assets                           | 4,327              | 3,636             |
| Total                                  | \$ 23,700          | \$ 17,920         |

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of September 30, 2018 and December 31, 2017.

| (Dollars in thousands)   | September 30,<br>2018 | December 31,<br>2017 |
|--|-----------------------|----------------------|
| Deferred tax assets:   |                       |                      |
| Allowance for credit losses  | \$ 2,801              | \$ 2,625             |
| Reserve for off-balance sheet commitments  | 81                    | 81                   |
| Net operating loss carry forward   | 397                   | 741                  |
| Write-downs of other real estate owned   | 217                   | 212                  |
| Deferred income  | 132                   | 95                   |
| Unrealized losses on available-for-sale securities                                 | 1,514                 | 460                  |
| Unrealized losses on available-for-sale securities transferred to held to maturity | 22                    | 20                   |
| Other  | 345                   | 635                  |
| Total deferred tax assets  | 5,509                 | 4,869                |
| Deferred tax liabilities:  |                       |                      |
| Depreciation   | 267                   | 408                  |
| Amortization on loans FMV adjustment   | 65                    | 84                   |
| Acquisition accounting adjustments   | 2,239                 | 1,994                |
| Deferred capital gain on branch sale   | 202                   | 207                  |
| Other  | 296                   | 241                  |
| Total deferred tax liabilities   | 3,069                 | 2,934                |
| Net deferred tax assets  | \$ 2,440              | \$ 1,935             |

The Company's deferred tax assets consist of gross net operating loss carryovers for state tax purposes of \$6.0 million that will be used to offset taxable income in future periods. The Company's state net operating loss carryovers will begin to expire in the year ending December 31, 2026 with limited amounts available through December 31, 2034.

No valuation allowance on these deferred tax assets was recorded at September 30, 2018 and December 31, 2017 as management believes it is more likely than not that all deferred tax assets will be realized.

#### Note 8 – Other Liabilities

The Company had the following other liabilities at September 30, 2018 and December 31, 2017.

| (Dollars in thousands) | September 30, 2018 | December 31, 2017 |
|------------------------|--------------------|-------------------|
|------------------------|--------------------|-------------------|

|                                 |          |          |
|---------------------------------|----------|----------|
| Accrued interest payable        | \$ 396   | \$ 65    |
| Other accounts payable          | 4,178    | 4,286    |
| Deferred compensation liability | 1,083    | 1,219    |
| Other liabilities               | 588      | 39       |
| Total                           | \$ 6,245 | \$ 5,609 |

Note 9 - Stock-Based Compensation

At the 2016 annual meeting, stockholders approved the Shore Bancshares, Inc. 2016 Stock and Incentive Plan (“2016 Equity Plan”), replacing the Shore Bancshares, Inc. 2006 Stock and Incentive Plan (“2006 Equity Plan”), which expired on that date. The Company may issue shares of common stock or grant other equity-based awards pursuant to the 2016 Equity Plan. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date and range over a one- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. As part of the 2016 Equity Plan, a performance equity incentive award program, known as the “Long-term incentive plan” allows participating officers of the Company to earn incentive awards of performance share/restricted stock units if certain pre-determined targets are achieved at the end of a three-year performance cycle. Stock-based compensation expense based on the grant date fair value is recognized ratably over the requisite service period for all awards and reflects forfeitures as they occur. The 2016 Equity Plan originally reserved 750,000 shares of common stock for grant, and 653,391 shares remained available for grant at September 30, 2018.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2018 and 2017.

| (Dollars in thousands)                                  | For Three Months Ended |        | For Nine Months Ended |        |
|---|------------------------|--------|-----------------------|--------|
|   | September 30,<br>2018  | 2017   | September 30,<br>2018 | 2017   |
| Stock-based compensation expense                        | \$ 163                 | \$ 158 | \$ 474                | \$ 748 |
| Excess tax benefits related to stock-based compensation | 11                     | 15     | 146                   | 26     |

| (Dollars in thousands)  | As of                 |              |
|---|-----------------------|--------------|
|   | September 30,<br>2018 | 2017         |
| Unrecognized stock-based compensation expense                             | \$530                 | \$1,147      |
| Weighted average period unrecognized expense is expected to be recognized | 0.8 <b>years</b>      | 1.3<br>years |

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2018 and 2017.

|                                  | Nine Months Ended September 30, 2018 |  |
|----------------------------------|--------------------------------------|--|
|                                  | Number of<br>Shares                  | Weighted Average<br>Grant Date<br>Fair Value |
| Nonvested at beginning of period | 15,913                               | \$ 15.39                                     |
| Granted                          | 14,602                               | 18.74  |
| Vested                           | (30,515 )                            | 17.04  |
| Cancelled                        | -                                    | -  |
| Nonvested at end of period       | -                                    | \$ -   |

The fair value of restricted stock awards that vested during the first nine months of 2018 and 2017 was \$520 thousand and \$309 thousand, respectively.

Restricted stock units (RSUs) are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it upon the terms and conditions of the Company's long-term incentive plans which are subject to performance milestones achieved at the end of a three-year period. Each RSU cliff vests at the end of the three-year period and entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting rights, with respect to the shares underlying awarded RSUs until the recipient becomes the holder of those shares.

During 2018, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2020. Assuming the performance metric is achieved, these awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 13,188 shares and 52,769 shares, assuming a certain performance metric is met. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

During 2017, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2019. Assuming the performance metric is achieved, these awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 12,703 shares and 50,830 shares, assuming a certain performance metric is met. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

During 2016, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2018. Assuming the performance metric is achieved, these awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 12,214 shares and 48,871 shares, assuming a certain performance metric is met. In addition, two members of the long-term incentive plan from 2015 forfeited their RSUs due to leaving the Company before the end of the vesting period. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.



The following table summarizes restricted stock units activity based on management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle for the Company under the 2016 Equity Plan for the nine months ended September 30, 2018.

|                                    | Nine Months Ended September 30, 2018 |                  |
|------------------------------------|--------------------------------------|------------------|
|                                    | Number of                            | Weighted Average |
|                                    | Shares                               | Grant Date       |
|                                    |                                      | Fair Value       |
| Outstanding at beginning of period | 90,266                               | \$ 12.08         |
| Granted                            | 26,381                               | 17.36            |
| Vested                             | (40,423 )                            | 9.49             |
| Forfeited                          | (16,308 )                            | 11.68            |
| Outstanding at end of period       | 59,916                               | \$ 15.38         |

The fair value of restricted stock units that vested during the first nine months of 2018 and 2017 was \$383 thousand and \$0, respectively.

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2018 and 2017.

|                                    | Nine Months Ended September 30, 2018 |                  |
|------------------------------------|--------------------------------------|------------------|
|                                    | Number of                            | Weighted Average |
|                                    | Shares                               | Grant Date       |
|                                    |                                      | Exercise Price   |
| Outstanding at beginning of period | 62,429                               | \$ 8.48          |
| Granted                            | -                                    | -                |
| Exercised                          | (35,180 )                            | 7.54             |
| Expired/Cancelled                  | -                                    | -                |
| Outstanding at end of period       | 27,249                               | \$ 9.68          |
| Exercisable at end of period       | 27,249                               | \$ 9.68          |

There were no stock options granted during the nine months ended September 30, 2018. The weighted average fair value of stock options granted during the nine months ended September 30, 2017 was \$10.99. The Company estimates the fair value of options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on

historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options granted in 2017.

|                                   |       |       |
|-----------------------------------|-------|-------|
|                                   | 2017  |       |
| Dividend yield                    | 0.84  | %     |
| Expected volatility               | 64.80 | %     |
| Risk-free interest rate           | 2.42  | %     |
| Expected contract life (in years) | 10    | years |

At the end of the third quarter of 2018, the aggregate intrinsic value of the options outstanding under the 2016 Equity Plan was \$222 thousand based on the \$17.82 market value per share of the Company's common stock at September 30, 2018. Similarly, the aggregate intrinsic value of the options exercisable was \$222 thousand at September 30, 2018. The intrinsic value on options exercised during the nine months ended September 30, 2018 was \$365 thousand based on the \$17.92 market value per share of the Company's common stock at January 31, 2018. The intrinsic value on options exercised in 2017 was \$8 thousand based on the \$15.89 market value per share of the Company's common stock at January 30, 2017. At September 30, 2018, the weighted average remaining contract life of options outstanding was 6.7 years.

Note 10 – Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2018 and 2017.

| (Dollars in thousands)                     | Unrealized<br>gains (losses) on<br>available for sale<br>securities | ) | Unrealized gains<br>(losses) on securities<br>transferred from<br>Available-for-sale<br>to<br>Held-to-maturity | ) | Accumulated<br>other<br>comprehensive<br>income (loss) |
|--|---|---|--|---|--|
| Balance, December 31, 2017                 | \$ (1,255   | ) | \$ (54   | ) | \$ (1,309 )  |
| Cumulative effect adjustment (ASU 2016-01) | 6   |   | -  |   | 6  |
| Other comprehensive (loss) income          | (2,778  | ) | 15   |   | (2,763 )   |
| Balance, September 30, 2018                | \$ (4,027   | ) | \$ (39   | ) | \$ (4,066 )  |
| Balance, December 31, 2016                 | \$ (931   | ) | \$ (62   | ) | \$ (993 )  |
| Other comprehensive income                 | 927   |   | 15   |   | 942  |
| Reclassification of (gains) recognized     | (3  | ) | -  |   | (3 )   |
| Balances, September 30, 2017               | \$ (7   | ) | \$ (47   | ) | \$ (54 )   |

Note 11 – Fair Value Measurements

Accounting guidance under GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This accounting guidance also 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 Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Below is a discussion on the Company's assets measured at fair value on a recurring basis.

#### Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities, if any, as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

Equity Securities

Fair value measurement for equity securities is based on quoted market prices retrieved by the Company via on-line resources. Although these securities have readily available fair market values, the Company deems that they be classified as level 2 investments in the fair value hierarchy due to not being considered traded in a highly active market.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2018 and December 31, 2017. No assets were transferred from one hierarchy level to another during the first nine months of 2018 or 2017.

| (Dollars in thousands)         | Fair Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--------------------------------|------------|-------------------------------|---|--|
| September 30, 2018             |            |                               |   |  |
| Securities available for sale: |            |                               |   |  |
| U.S. Government agencies       | \$ 41,546  | \$ -                          | \$ 41,546   | \$ -   |
| Mortgage-backed                | 126,129    | -                             | 126,129   | -  |
|                                | 167,675    | -                             | 167,675   | -  |
| Equity                         | 649        | -                             | 649   | -  |
| Total                          | \$ 168,324 | \$ -                          | \$ 168,324  | \$ -   |

| (Dollars in thousands)         | Fair Value | Quoted<br>Prices<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--------------------------------|------------|-------------------------------|---|--|
| December 31, 2017              |            |                               |   |  |
| Securities available for sale: |            |                               |   |  |
| U.S. Government agencies       | \$ 45,332  | \$ -                          | \$ 45,332   | \$ -   |
| Mortgage-backed                | 150,965    | -                             | 150,965   | -  |
| Equity                         | 658        | -                             | 658   | -  |
| Total                          | \$ 196,955 | \$ -                          | \$ 196,955  | \$ -   |

Below is a discussion on the Company's assets measured at fair value on a nonrecurring basis.

Impaired Loans

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent and these are considered Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable, discounted on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. The estimated fair value for foreclosed assets included in Level 3 are determined by independent market based appraisals and other available market information, less costs to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to the initial recognition, the Company records the foreclosed asset as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)                           | Quantitative Information about Level 3 Fair Value Measurements |                               |                         |             |
|--|--|-------------------------------|-------------------------|-------------|
|  | Fair Value   | Valuation Technique           | Unobservable Input      | Range       |
| September 30, 2018<br>Nonrecurring measurements: |  |                               |                         |             |
| Impaired loans                                   | \$303  | Appraisal of collateral       | 1 Liquidation expense   | 2 10%       |
| Impaired loans                                   | \$5,908  | Discounted cash flow analysis | 1 Discount rate         | 4% - 8.5%   |
| Other real estate owned                          | \$1,518  | Appraisal of collateral       | 1 Appraisal adjustments | 2 20% - 30% |
|  |  |                               | Liquidation expense     | 2 5% - 10%  |

| (Dollars in thousands)                          | Quantitative Information about Level 3 Fair Value Measurements |                               |                         |             |
|---|--|-------------------------------|-------------------------|-------------|
|   | Fair Value   | Valuation Technique           | Unobservable Input      | Range       |
| December 31, 2017<br>Nonrecurring measurements: |  |                               |                         |             |
| Impaired loans                                  | \$510  | Appraisal of collateral       | 1 Liquidation expense   | 2 10%       |
| Impaired loans                                  | \$6,005  | Discounted cash flow analysis | 1 Discount rate         | 4% - 8.5%   |
| Other real estate owned                         | \$1,794  | Appraisal of collateral       | 1 Appraisal adjustments | 2 20% - 30% |
|   |  |                               | Liquidation expense     | 2 5% - 10%  |

Fair value is generally determined through independent appraisals of the underlying collateral (impaired loans and (1)OREO) or discounted cash flow analyses (impaired loans), which generally include various level III inputs which are not identifiable.

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated (2)liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The following table provides information on the estimated fair values of the Company's financial assets and liabilities that are reported in the balance sheets not recorded at fair value on a recurring basis as of September 30, 2018 and December 31, 2017. The financial assets and liabilities have been segregated by their classification level in the fair value hierarchy.

|  | September 30, 2018 |                            | December 31, 2017  |                            |
|--|--------------------|----------------------------|--------------------|----------------------------|
|  | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
| (Dollars in thousands)                     |                    |                            |                    |                            |
| Financial assets                           |                    |                            |                    |                            |
| Level 1 inputs                             |                    |                            |                    |                            |
| Cash and cash equivalents                  | \$48,777           | \$48,777                   | \$31,820           | \$31,820                   |
| Level 2 inputs                             |                    |                            |                    |                            |
| Investment securities held to maturity     | \$6,037            | \$5,983                    | \$6,247            | \$6,391                    |
| Restricted securities                      | 8,110              | 8,110                      | 3,735              | 3,735                      |
| Cash surrender value on life insurance     | 3,676              | 3,676                      | 3,637              | 3,637                      |
| Level 3 inputs                             |                    |                            |                    |                            |
| Loans, net (1)                             | \$1,170,229        | \$1,139,344                | \$1,083,733        | \$1,072,951                |
| Financial liabilities                      |                    |                            |                    |                            |
| Level 2 inputs                             |                    |                            |                    |                            |
| Deposits:                                  |                    |                            |                    |                            |
| Noninterest-bearing demand                 | \$331,766          | \$331,766                  | \$328,322          | \$328,322                  |
| Checking plus interest                     | 214,898            | 214,898                    | 231,898            | 231,898                    |
| Money market                               | 216,394            | 216,394                    | 223,123            | 223,123                    |
| Savings                                    | 153,973            | 153,973                    | 156,623            | 156,623                    |
| Club                                       | 1,535              | 1,535                      | 398                | 398                        |
| Brokered Deposits                          | 23,547             | 23,519                     | -                  | -                          |
| Certificates of deposit, \$100,000 or more | 96,498             | 94,212                     | 107,343            | 105,691                    |
| Other time                                 | 143,225            | 138,187                    | 155,074            | 151,339                    |
| Short-term borrowings                      | 114,043            | 114,043                    | 21,734             | 21,734                     |

Carrying amount is net of unearned income and the allowance for credit losses. In accordance with the prospective (1) adoption of ASU No. 2016-01, the fair value of loans as of September 30, 2018 was measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entry price notion.

Note 12 – Financial Instruments with Off-Balance Sheet Risk



In the normal course of business, to meet the financial needs of its customers, the Bank is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)       | September 30, 2018 | December 31, 2017 |
|------------------------------|--------------------|-------------------|
| Commitments to extend credit | \$ 188,961         | \$ 206,065        |
| Letters of credit            | 6,816              | 7,142             |
| Total                        | \$ 195,777         | \$ 213,207        |

Note 13 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses in Maryland, Delaware and Virginia through its 21 branch network and two loan production offices. Community banking activities include small business services, retail brokerage, trust services and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit-sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

The following tables include selected financial information by business segments for the three and nine months of September 30, 2018 and 2017.

| (Dollars in thousands)                        | Community<br>Banking | Insurance Products<br>and Services | Parent<br>Company | Consolidated<br>Total |
|---|----------------------|------------------------------------|-------------------|-----------------------|
| For the three months ended September 30, 2018 |                      |                                    |                   |                       |
| Interest Income                               | \$ 14,231            | \$ -                               | \$ 5              | \$ 14,236             |
| Interest Expense                              | (1,289 )             | -                                  | -                 | (1,289 )              |
| Provision for credit losses                   | (307 )               | -                                  | -                 | (307 )                |
| Noninterest income                            | 2,464                | 2,246                              | -                 | 4,710                 |
| Noninterest expense                           | (7,166 )             | (1,978 )                           | (2,142 )          | (11,286 )             |
| Net intersegment (expense) income             | (1,893 )             | (143 )                             | 2,036             | -                     |
| Income (loss) before taxes                    | 6,040                | 125                                | (101 )            | 6,064                 |
| Income tax (expense) benefit                  | (1,586 )             | (33 )                              | 9                 | (1,610 )              |
| Net Income (loss)                             | \$ 4,454             | \$ 92                              | \$ (92 )          | \$ 4,454              |
| Total assets, September 30, 2018              |                      |                                    |                   |                       |
|   | \$ 1,455,060         | \$ 11,305                          | \$ 7,178          | \$ 1,473,543          |
| For the three months ended September 30, 2017 |                      |                                    |                   |                       |
| Interest Income                               | \$ 12,931            | -                                  | 6                 | 12,937                |
| Interest Expense                              | (611 )               | -                                  | -                 | (611 )                |
| Provision for credit losses                   | (345 )               | -                                  | -                 | (345 )                |
| Noninterest income                            | 2,178                | 2,247                              | -                 | 4,425                 |

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|                                   |              |          |          |           |
|-----------------------------------|--------------|----------|----------|-----------|
| Noninterest expense               | (6,607 )     | (2,201 ) | (1,912 ) | (10,720 ) |
| Net intersegment (expense) income | (1,906 )     | 78       | 1,828    | -         |
| Income (loss) before taxes        | 5,640        | 124      | (78 )    | 5,686     |
| Income tax (expense) benefit      | (2,255 )     | (50 )    | 31       | (2,274 )  |
| Net Income (loss)                 | \$3,385      | 74       | (47 )    | 3,412     |
| <br>                              |              |          |          |           |
| Total assets, September 30, 2017  | \$ 1,359,930 | 9,909    | 6,289    | 1,376,127 |

|  | Community<br>Banking | Insurance<br>Products<br>and<br>Services | Parent<br>Company | Consolidated<br>Total |
|--|----------------------|--|-------------------|-----------------------|
| (Dollars in thousands)                       |                      |  |                   |                       |
| For the nine months ended September 30, 2018 |                      |  |                   |                       |
| Interest Income                              | \$40,996             | \$ -                                     | \$ 17             | \$ 41,013             |
| Interest Expense                             | (3,104 )             | -  | -                 | (3,104 )              |
| Provision for credit losses                  | (1,214 )             | -  | -                 | (1,214 )              |
| Noninterest income                           | 6,899                | 7,280                                    | -                 | 14,179                |
| Noninterest expense                          | (21,178 )            | (5,953 )                                 | (6,445 )          | (33,576 )             |
| Net intersegment (expense) income            | (5,627 )             | (439 )                                   | 6,066             | -                     |
| Income (loss) before taxes                   | 16,772               | 888                                      | (362 )            | 17,298                |
| Income tax (expense) benefit                 | (4,375 )             | (233 )                                   | 213               | (4,395 )              |
| Net Income (loss)                            | \$12,397             | 655                                      | (149 )            | 12,903                |
| <br>   |                      |  |                   |                       |
| Total assets, September 30, 2018             | 1,455,060            | 11,305                                   | 7,178             | \$ 1,473,543          |
| <br>   |                      |  |                   |                       |
| For the nine months ended September 30, 2017 |                      |  |                   |                       |
| Interest Income                              | \$34,761             | \$(1 )                                   | \$ 73             | \$ 34,833             |
| Interest Expense                             | (1,674 )             | -  | -                 | (1,674 )              |
| Provision for credit losses                  | (1,746 )             | -  | -                 | (1,746 )              |
| Noninterest income                           | 6,111                | 7,300                                    | -                 | 13,411                |
| Noninterest expense                          | (18,651 )            | (6,035 )                                 | (5,884 )          | (30,570 )             |
| Net intersegment (expense) income            | (5,500 )             | (84 )                                    | 5,584             | -                     |
| Income (loss) before taxes                   | 13,301               | 1,180                                    | (227 )            | 14,254                |
| Income tax (expense) benefit                 | (5,309 )             | (472 )                                   | 91                | (5,690 )              |
| Net Income (loss)                            | \$7,992              | \$ 708                                   | \$(136 )          | \$ 8,564              |
| <br>   |                      |  |                   |                       |
| Total assets, September 30, 2017             | \$1,359,930          | \$ 9,909                                 | \$ 6,289          | \$ 1,376,127          |

#### Note 14 – Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 “*Revenue from Contracts with Customers*” (Topic 606) and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees, merchant income, and annuity and insurance commissions. However, the recognition of

these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Company's revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

### **Service Charges on Deposit Accounts**

Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Company's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Check orders and other deposit account related fees are largely transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or at the end of the month through a direct charge to customers' accounts.

### **Trust and Investment Fee Income**

Trust and investment fee income are primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Company does not earn performance-based incentives.

Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

### **Insurance Agency Commissions**

Insurance income primarily consists of commissions received on insurance premiums from customer policies. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue. The Company does not earn a significant amount of trailer fees on individual insurance policies.

### **Other Noninterest Income**

Other noninterest income consists of: fees, exchange, other service charges, safety deposit box rental fees, and other miscellaneous revenue streams. Fees and other service charges are primarily comprised of debit and credit card income, ATM fees, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, bill pay service, cashier's checks, and other services. The Company's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that rentals and renewals of safe deposit boxes will be recognized on a monthly basis consistent with the duration of the performance obligation.

The following presents noninterest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine months ended September 30, 2018 and 2017.

|                        | For Three Months Ended |      | For Nine Months Ended |      |
|------------------------|------------------------|------|-----------------------|------|
|                        | September 30,          |      | September 30,         |      |
| (Dollars in thousands) | 2018                   | 2017 | 2018                  | 2017 |

## Noninterest Income

## In-scope of Topic 606:

|   |          |          |           |           |
|---|----------|----------|-----------|-----------|
| Service charges on deposit accounts               | \$ 982   | \$ 945   | \$ 2,834  | \$ 2,657  |
| Trust and investment fee income                   | 383      | 389      | 1,197     | 1,122     |
| Gains on sales and calls of investment securities | -        | 5        | -         | 5         |
| Insurance agency commissions                      | 2,170    | 2,088    | 7,015     | 6,939     |
| Other noninterest income                          | 1,130    | 870      | 2,969     | 2,413     |
| Noninterest Income (in-scope of Topic 606)        | 4,665    | 4,297    | 14,015    | 13,136    |
| Noninterest Income (out-of-scope of Topic 606)    | 45       | 128      | 164       | 275       |
| Total Noninterest Income                          | \$ 4,710 | \$ 4,425 | \$ 14,179 | \$ 13,411 |

**Contract Balances**

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

Unless the context clearly suggests otherwise, references to “the Company”, “we”, “our”, and “us” in the remainder of this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

### **Forward-Looking Information**

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words “anticipate”, “estimate”, “should”, “expect”, “believe”, “intend”, and similar expressions, are expressions of our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the “SEC”) entitled “Risk Factors” (see Item 1A of Part II of this report and Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2017 (the “2017 Annual Report”). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

### **Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the Company’s financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the 2017 Annual Report.

Shore Bancshares, Inc. is the largest independent financial holding company headquartered on the Eastern Shore of Maryland. It is the parent company of Shore United Bank. The Bank operates 21 full service branches in Baltimore County, Howard County, Kent County, Queen Anne’s County, Talbot County, Caroline County and Dorchester County in Maryland, Kent County, Delaware and Accomack County, Virginia. The Company engages in the insurance business through an insurance producer firm, The Avon-Dixon Agency, LLC, (“Avon-Dixon”) with two specialty lines, Elliott Wilson Insurance (Trucking) and Jack Martin Associates (Marine); and an insurance premium finance company, Mubell Finance, LLC (“Mubell”) (Avon-Dixon and Mubell are collectively referred to as the “Insurance Subsidiaries”). Avon-Dixon and Mubell are wholly-owned subsidiaries of Shore Bancshares, Inc. The Company engages in the trust services business through the trust department at Shore United Bank under the trade name Wye Financial & Trust.



The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Select Market under the symbol "SHBI".

Shore Bancshares, Inc. maintains an Internet site at [www.shorebancshares.com](http://www.shorebancshares.com) on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

### **Critical Accounting Policies**

The Company's consolidated financial statements are prepared in accordance with GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based on quoted market prices, collateral value or are provided by other third-party sources, when available.

The most significant accounting policies that the Company follows are presented in Note 1 of the 2017 Annual Report. These policies, along with the disclosures presented in the notes to the financial statements and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

The allowance for credit losses represents management's estimate of credit losses inherent in the loan portfolio as of the balance sheet date. Determining the amount of the allowance for credit losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheets. Note 1 of the 2017 Annual Report describes the methodology used to determine the allowance for credit losses. A discussion of the factors driving changes in the amount of the allowance for credit losses is included in the Asset Quality - Provision for Credit Losses and Risk Management section below.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are required to be recorded at fair value at inception. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing. Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments (i.e., the Bank and Insurance Subsidiaries). If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

Deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity.

## OVERVIEW

The Company reported net income of \$4.5 million for the third quarter of 2018, or diluted income per common share of \$0.35, compared to net income of \$3.4 million, or diluted income per common share of \$0.27, for the third quarter of 2017. For the second quarter of 2018, the Company reported net income of \$4.4 million, or diluted income per common share of \$0.34. When comparing the third quarter of 2018 to the third quarter of 2017, the primary reasons for improved net income were increases in net interest income of \$621 thousand and noninterest income of \$285 thousand, partially offset by an increase in noninterest expense of \$566 thousand. In addition, the reduced federal corporate income tax rate from 35% to 21% became effective for 2018 and had a significant impact on net income. When comparing the third quarter of 2018 to the second quarter of 2018, the higher net income was primarily attributable to increases in net interest income of \$314 thousand and noninterest income of \$170 thousand, partially offset by an increase in noninterest expense of \$458 thousand.

For the first nine months of 2018, the Company reported net income of \$12.9 million, or diluted income per common share of \$1.01, compared to net income of \$8.6 million, or diluted income per common share of \$0.67, for the first nine months of 2017. Earnings improved in the 2018 period due to increases in net interest income of \$4.8 million and noninterest income of \$768 thousand, coupled with a decline in provision for credit losses of \$532 thousand. Also contributing to the increase in net income for 2018 was the reduced federal corporate income tax rate. These positive variances were partially offset by an increase in noninterest expense of \$3.0 million which are a direct result of operating four additional branches for all nine months of 2018.

## RESULTS OF OPERATIONS

### Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income was \$13.0 million for the third quarter of 2018 and \$12.4 million for the third quarter of 2017. Tax-equivalent net interest income was \$12.7 million for the second quarter of 2018. The increase in net interest income for the third quarter of 2018 when compared to the third quarter of 2017 was primarily due to an increase in interest income of \$1.3 million, or 9.8% due to improving yield and growth in interest earnings assets, partially offset by an increase in interest expense of \$678 thousand, or 111.0%. The increase in net interest income when compared to the second quarter of 2018 was the result of average loan growth of \$33.2 million, or 2.9%, partially offset by an increase in interest expense of \$248 thousand. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. The net interest margin for the third quarter of 2018 was 3.76%, which is a decrease of 3 basis points (bps) when compared to 3.79% for both the third quarter of 2017 and the second quarter of 2018.

## Interest Income

On a tax-equivalent basis, interest income increased \$1.3 million, or 9.8%, for the third quarter of 2018 when compared to the third quarter of 2017. The increase was due to a \$1.4 million, or 11.9%, increase in interest income and fees on loans, the direct result of the increase in the average balance on loans of \$140.0 million, or 13.5%. The average yield on loans decreased 7 bps from the comparable quarter in 2017 due to competitive pressure to renew loans at historically low rates. Interest on taxable investment securities and interest-bearing deposits with other banks decreased \$88 thousand, or 8.5% and \$47 thousand, or 35.9%, respectively. These decreases were attributed to decreases in the average balance in taxable investment securities of \$40.1 million, or 18.3%, and interest-bearing deposits with other banks of \$24.7 million, or 58.6%, which helped fund loan growth between the comparable quarters.

On a tax-equivalent basis, interest income increased \$562 thousand, or 4.1%, for the third quarter of 2018 when compared to the second quarter of 2018. The increase was primarily due to a \$574 thousand, or 4.5%, increase in interest income and fees on loans. This increase was due to an increase of \$33.2 million, or 2.9% in the average balance of loans. The average yield on loans increased 2bps to 4.47% and the yield on total earning assets increased 3 bps to 4.13%. Interest on taxable investment securities decreased \$35 thousand, or 3.6%, and interest-bearing deposits with other banks increased \$23 thousand, or 37.7%.

## Interest Expense

Interest expense increased \$678 thousand, or 111.0%, when comparing the third quarter of 2018 to the third quarter of 2017. The increase in interest expense was due to an increase in the average balance of short-term borrowings of \$85.7 million which equated to \$459 thousand in additional interest expense. The increase in short-term borrowings was the result of loan demand outpacing deposit growth in the near-term, which increased the cost of funding 25 bps when compared to the third quarter of 2017. The average balance of interest-bearing deposits decreased \$27.4 million, or 3.1%, primarily due to the decrease in the average balances of time deposits of \$45.3 million, or 15.7%, partially offset by an increase in brokered deposits of \$25.5 million. The decrease in time deposits is correlated with customers seeking higher rates paid on these deposits and/or utilizing these investments to self-finance capital improvements and pay down outstanding debt. Partially offsetting the decrease in time deposits was an increase in the average balance in noninterest-bearing deposits of \$9.4 million, or 2.9% between the comparable quarters, also indicating customer sentiment to have funds immediately available for alternative investment opportunities.

Interest expense increased \$248 thousand, or 23.8%, when comparing the third quarter of 2018 to the second quarter of 2018. The increase in interest expense was due to increases in the average balances of interest-bearing deposits of \$23.8 million, or 2.8%, coupled with higher rates paid on these deposits. This increase provided the opportunity for the Company to pay-down short-term borrowings which experienced an average balance decrease of \$4.1 million, or 4.4%. In addition, the average balance of noninterest-bearing deposits increased \$7.2 million, or 2.2% when compared to the second quarter of 2018. The increase in both interest-bearing and noninterest-bearing deposits was a positive transition from higher rates paid on short-term borrowings and a more sustainable approach for funding long-term loan growth.



The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2018 and 2017.

| (Dollars in thousands)                            | For Three Months Ended<br>September 30, 2018 |                       |                | For Three Months Ended<br>September 30, 2017 |                       |                |
|---|--|-----------------------|----------------|--|-----------------------|----------------|
|   | Average<br>Balance                           | Income(1)/<br>Expense | Yield/<br>Rate | Average<br>Balance                           | Income(1)/<br>Expense | Yield/<br>Rate |
| <b>Earning assets</b>                             |  |                       |                |  |                       |                |
| Loans (2), (3)                                    | \$ 1,174,513                                 | \$ 13,233             | 4.47 %         | \$ 1,034,553                                 | \$ 11,830             | 4.54 %         |
| <b>Investment securities:</b>                     |  |                       |                |  |                       |                |
| Taxable   | 178,572                                      | 947                   | 2.12           | 218,675                                      | 1,035                 | 1.89           |
| Interest-bearing deposits                         | 17,488                                       | 84                    | 1.91           | 42,204                                       | 131                   | 1.23           |
| <b>Total earning assets</b>                       | <b>1,370,573</b>                             | <b>14,264</b>         | <b>4.13 %</b>  | <b>1,295,432</b>                             | <b>12,996</b>         | <b>3.98 %</b>  |
| Cash and due from banks                           | 17,790                                       |                       |                | 16,232                                       |                       |                |
| Other assets                                      | 79,065                                       |                       |                | 75,611                                       |                       |                |
| Allowance for credit losses                       | (10,354 )                                    |                       |                | (9,300 )                                     |                       |                |
| <b>Total assets</b>                               | <b>\$ 1,457,074</b>                          |                       |                | <b>\$ 1,377,975</b>                          |                       |                |
| <b>Interest-bearing liabilities</b>               |  |                       |                |  |                       |                |
| Demand deposits                                   | \$ 221,905                                   | 178                   | 0.32 %         | \$ 224,180                                   | 132                   | 0.23 %         |
| Money market and savings deposits                 | 373,357                                      | 132                   | 0.14           | 378,711                                      | 113                   | 0.12           |
| Brokered Deposits                                 | 25,507                                       | 138                   | 2.01           | -  | -                     | -              |
| Certificates of deposit \$100,000 or more         | 97,563                                       | 170                   | 0.69           | 123,538                                      | 154                   | 0.50           |
| Other time deposits                               | 145,130                                      | 208                   | 0.57           | 164,459                                      | 208                   | 0.50           |
| Interest-bearing deposits                         | 863,462                                      | 826                   | 0.36           | 890,888                                      | 607                   | 0.27           |
| Short-term borrowings                             | 87,925                                       | 463                   | 2.09           | 2,274  | 4                     | 0.62           |
| <b>Total interest-bearing liabilities</b>         | <b>951,387</b>                               | <b>1,289</b>          | <b>0.52 %</b>  | <b>893,162</b>                               | <b>611</b>            | <b>0.27 %</b>  |
| Noninterest-bearing deposits                      | 329,383                                      |                       |                | 320,006                                      |                       |                |
| Other liabilities                                 | 6,005  |                       |                | 5,256  |                       |                |
| Stockholders' equity                              | 170,299                                      |                       |                | 159,551                                      |                       |                |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 1,457,074</b>                          |                       |                | <b>\$ 1,377,975</b>                          |                       |                |
| <b>Net interest spread</b>                        |  | <b>\$ 12,975</b>      | <b>3.61 %</b>  |  | <b>\$ 12,385</b>      | <b>3.71 %</b>  |
| <b>Net interest margin</b>                        |  |                       | <b>3.76 %</b>  |  |                       | <b>3.79 %</b>  |
| <b>Tax-equivalent adjustment</b>                  |  |                       |                |  |                       |                |
| Loans   |  | \$ 28                 |                |  | \$ 59                 |                |
| <b>Total</b>                                      |  | <b>\$ 28</b>          |                |  | <b>\$ 59</b>          |                |

All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21.0%, (1) for the third quarter of 2018 and 35.0% for third quarter of 2017, exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3)

Interest income on loans includes amortized loan fees, net of costs, and accretion of discounts on acquired loans, which are included in the yield calculations.

### **Net Interest Income**

Tax-equivalent net interest income increased \$4.7 million, or 14.0%, during the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017. The increase in net interest income was primarily due to an increase in interest income of \$6.1 million, or 17.4%, partially offset by an increase in interest expense of \$1.4 million, or 85.4%. This resulted in an improved net interest margin of 3.79% for the nine months ended September 30, 2018 compared to 3.75% for the nine months ended September 30, 2017.

### **Interest Income**

On a tax-equivalent basis, interest income increased \$6.1 million, or 17.4%, for the nine months ended September 30, 2018 when compared to the nine months ended September 30, 2017. The increase was primarily due to a \$6.0 million, or 18.9%, increase in interest income and fees on loans. This increase was due to a \$184.2 million, or 19.3% increase in the average balance of loans which was the result of the branch acquisition from NWBI and organic growth. The average yield on loans decreased 1bp to 4.45% and the yield on total earning assets increased 17 bps to 4.10%. Interest on taxable investment securities increased \$151 thousand, or 5.4%, despite a decrease in the average balance of \$11.5 million. Income from interest-bearing deposits with other banks decreased \$86 thousand, or 32.0% between the relevant periods in 2018 and 2017.

## Interest Expense

Interest expense increased \$1.4 million, or 85.4%, when comparing the nine months ended September 30, 2018 to the nine months ended September 30, 2017. The increase in interest expense was primarily due to the increase in the average balance of short-term borrowings of \$74.9 million, or 1,875.1%, which added \$1.1 million in additional interest expense. In addition, the interest on interest-bearing deposits increased \$298 thousand, or 18.0%, mostly due to the addition of brokered deposits during the second quarter of 2018 and the implementation of a new Insured Cash Sweep (“ICS”) product in which customer repurchase agreements are swept into demand deposits at a lower cost of funding than short-term borrowings and do not require the pledging of securities. The combination of both brokered deposits and the new ICS product produced an increase in the average balance of interest-bearing deposits of \$20.4 million, or 2.5%. Although these alternative funding sources increased the rate paid on interest-bearing deposits, they provided a lower cost alternative than short-term borrowings from the FHLB.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2018 and 2017.

| (Dollars in thousands)                    | For Nine Months Ended<br>September 30, 2018 |                       |                | For Nine Months Ended<br>September 30, 2017 |                       |                |
|---|---|-----------------------|----------------|---|-----------------------|----------------|
|   | Average<br>Balance                          | Income(1)/<br>Expense | Yield/<br>Rate | Average<br>Balance                          | Income(1)/<br>Expense | Yield/<br>Rate |
| <b>Earning assets</b>                     |   |                       |                |   |                       |                |
| Loans (2), (3)                            | \$1,140,925                                 | \$ 37,964             | 4.45 %         | \$956,694                                   | \$ 31,941             | 4.46 %         |
| <b>Investment securities:</b>             |   |                       |                |   |                       |                |
| Taxable                                   | 186,936                                     | 2,950                 | 2.10           | 198,383                                     | 2,799                 | 1.88           |
| Tax-exempt                                | -   | -                     | -              | 116   | 5                     | 5.41           |
| Interest-bearing deposits                 | 13,542                                      | 183                   | 1.80           | 34,506                                      | 269                   | 1.04           |
| Total earning assets                      | 1,341,403                                   | 41,097                | 4.10 %         | 1,189,699                                   | 35,014                | 3.93 %         |
| Cash and due from banks                   | 17,031                                      |                       |                | 14,988                                      |                       |                |
| Other assets                              | 78,243                                      |                       |                | 61,537                                      |                       |                |
| Allowance for credit losses               | (10,173 )                                   |                       |                | (9,072 )                                    |                       |                |
| Total assets                              | \$1,426,504                                 |                       |                | \$1,257,152                                 |                       |                |
| <b>Interest-bearing liabilities</b>       |   |                       |                |   |                       |                |
| Demand deposits                           | \$214,317                                   | 411                   | 0.26 %         | \$206,033                                   | 279                   | 0.18 %         |
| Money market and savings deposits         | 378,404                                     | 376                   | 0.13           | 325,660                                     | 300                   | 0.12           |
| Brokered Deposits                         | 12,157                                      | 190                   | 2.09           | -   | -                     | -              |
| Certificates of deposit \$100,000 or more | 98,772                                      | 425                   | 0.58           | 121,508                                     | 467                   | 0.51           |
| Other time deposits                       | 148,107                                     | 552                   | 0.50           | 151,179                                     | 610                   | 0.54           |
| Interest-bearing deposits                 | 851,757                                     | 1,954                 | 0.30           | 804,380                                     | 1,656                 | 0.28           |
| Short-term borrowings                     | 78,945                                      | 1,150                 | 1.95           | 3,997                                       | 18                    | 0.59           |
| Total interest-bearing liabilities        | 930,702                                     | 3,104                 | 0.44 %         | 808,377                                     | 1,674                 | 0.28 %         |
| Noninterest-bearing deposits              | 322,748                                     |                       |                | 285,324                                     |                       |                |
| Other liabilities                         | 5,766                                       |                       |                | 5,109                                       |                       |                |



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|  |              |        |              |        |
|--|--------------|--------|--------------|--------|
| Stockholders' equity                       | 167,288      |        | 158,342      |        |
| Total liabilities and stockholders' equity | \$ 1,426,504 |        | \$ 1,257,152 |        |
| Net interest spread                        | \$ 37,993    | 3.66 % | \$ 33,340    | 3.65 % |
| Net interest margin                        |              | 3.79 % |              | 3.75 % |
| Tax-equivalent adjustment                  |              |        |              |        |
| Loans                                      | \$ 84        |        | \$ 179       |        |
| Investment securities                      | -            |        | 2            |        |
| Total                                      | \$ 84        |        | \$ 181       |        |

All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 21.0%, (1) for all quarters during 2018 and 35.0% for all quarters during 2017, exclusive of the alternative minimum tax rate and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and accretion of discounts on acquired loans, which are included in the yield calculations.

### **Noninterest Income**

Total noninterest income for the third quarter of 2018 increased \$285 thousand, or 6.4%, when compared to the third quarter of 2017. The increase from the third quarter of 2017 was mainly due to increases in insurance agency commissions of \$82 thousand, service charges on deposit accounts of \$37 thousand and other bank fees and service charges of \$143 thousand. Noninterest income increased \$170 thousand, or 3.7%, when compared to the second quarter of 2018 mainly due to increases in bank fees and service charges.

Total noninterest income for the nine months ended September 30, 2018 increased \$768 thousand, or 5.7%, when compared to the same period in 2017. The increase in noninterest income primarily consisted of increases in service charges on deposit accounts of \$177 thousand and other noninterest income of \$445 thousand which included higher fees on bank services of \$326 thousand and higher loan fee income of \$70 thousand. Also attributing to the increase in noninterest income were increases in insurance agency commissions of \$76 thousand and trust and investment fee income of \$75 thousand, respectively.

### **Noninterest Expense**

Total noninterest expense for the third quarter of 2018 increased \$566 thousand, or 5.3%, when compared to the third quarter of 2017. The increase in noninterest expense for the third quarter of 2018 compared to the third quarter of 2017 was primarily due to increases in salary and wages and employee benefits resulting from pay increases, the filling of vacant positions throughout the Company and additional amortization of intangibles acquired in the Northwest branch acquisition in 2017. Total noninterest expenses increased \$458 thousand, or 4.2%, when compared to the second quarter of 2018. The increase when compared to the second quarter of 2018 was primarily due to increased salary and wages, increased data processing fees and a write-down on an other real estate owned (“OREO”) property of \$128 thousand.

Total noninterest expense for the nine months ended September 30, 2018 increased \$3.0 million, or 9.8%, when compared to the same period in 2017. The increase was primarily due to the cost of operating four additional branches which impacted almost all noninterest expense line items, offset by decreases in data processing fees, OREO expenses and legal and professional fees.

### **Provision for Credit Losses**

The provision for credit losses was \$307 thousand for the third quarter of 2018, \$345 thousand for the third quarter of 2017 and \$418 thousand for the second quarter of 2018. The lower level of provision for credit losses when comparing the third quarter of 2018 to the third quarter of 2017 was driven primarily by lower net charge-offs. The provision for credit losses decreased in the third quarter of 2018 compared to the second quarter of 2018 due to an overall decline in historical loss experience captured in the allowance calculation. Net charge-offs were \$100 thousand for the third quarter of 2018, \$182 thousand for the third quarter of 2017 and \$84 thousand for the second quarter of

2018. The ratio of annualized net charge-offs to average loans was 0.03% for both the third and second quarter of 2018, compared to 0.07% for the third quarter of 2017.

The provision for credit losses for the nine months ended September 30, 2018 and 2017 was \$1.2 million and \$1.7 million, respectively, while net charge-offs were \$667 thousand and \$1.2 million, respectively. The decrease in provision for credit losses was due to lower charge-offs and overall improved credit quality. The ratio of annualized net charge-offs to average loans was 0.08% for the first nine months of September 30, 2018 and 0.16% for the same period in 2017.

### **Income Taxes**

The Company reported income tax expense of \$1.6 million for the third quarter of 2018, compared to \$2.3 million for the third quarter of 2017 and \$1.5 million for the second quarter of 2018. The significant decrease in income tax expense when comparing the third quarter of 2018 and 2017 was the result of the recently enacted Tax Cuts and Jobs Act of 2017 (the "Tax Act") which reduced the federal income tax rate on corporations from 35.0% to 21.0% effective January 1, 2018. Income tax expense increased \$74 thousand when compared to the second quarter of 2018 due to improved net earnings for the Company. The effective tax rate was 26.6% for the third quarter of 2018, 40.0% for the third quarter of 2017 and 25.9% for the second quarter of 2018. Income taxes for the nine months ended September 30, 2018 decreased \$1.3 million, or 22.8%, when compared to the same period in 2017. The decrease was primarily due to the lower effective tax rate from the recently enacted Tax Act.

## **ANALYSIS OF FINANCIAL CONDITION**

### **Loans**

Loans totaled \$1.2 billion at September 30, 2018 and \$1.1 billion at December 31, 2017, an increase of \$87.0 million, or 8.0%. The increase was primarily due to organic growth of \$48.3 million in commercial real estate, \$26.7 million in residential real estate and \$11.5 million in commercial loans. Loans included deferred costs, net of deferred fees, of \$725 thousand and discounts on acquired loans of \$1.5 million at September 30, 2018, compared to \$609 thousand and \$1.8 million, respectively, at December 31, 2017. We do not engage in foreign or subprime lending activities.

See Note 5, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is generally defined as a combination of certain construction and commercial real estate loans. Construction loans were \$126.3 million, or 10.7% of total loans, at September 30, 2018 and \$125.7 million, or 11.5% of total loans at December 31, 2017. Commercial real estate loans were \$513.2 million, or 43.5% of total loans, at September 30, 2018, compared to \$464.9 million, or 42.5% of total loans, at December 31, 2017.



The federal banking regulators have issued guidance for those institutions which are deemed to have concentrations in commercial real estate lending. Pursuant to the supervisory criteria contained in the guidance for identifying institutions with a potential commercial real estate concentration risk, institutions which have (1) total reported loans for construction, land development, and other land acquisitions which represent 100% or more of an institution's total risk-based capital; or (2) total non-owner occupied commercial real estate loans representing 300% or more of the institution's total risk-based capital and the institution's non-owner occupied commercial real estate loan portfolio (including construction) has increased 50% or more during the prior 36 months are identified as having potential commercial real estate concentration risk. Institutions which are deemed to have concentrations in commercial real estate lending are expected to employ heightened levels of risk management with respect to their commercial real estate portfolios, and may be required to hold higher levels of capital. The Company, like many community banks, has a concentration in commercial real estate loans, and the Company has experienced significant growth in its commercial real estate portfolio in recent years. At September 30, 2018, non-owner-occupied commercial real estate loans (including construction, land and land development loans) represented 297.5% of total risk-based capital. At such time, construction, land and land development loans represented 85.6% of total risk-based capital.

The commercial real estate portfolio (including construction) has increased 88.1% during the prior 36 months. Management has extensive experience in commercial real estate lending, and has implemented and continues to maintain heightened risk management procedures, and strong underwriting criteria with respect to its commercial real estate portfolio. Monitoring practices include periodic stress testing analysis to evaluate changes to cash flows, owing to interest rate increases and declines in net operating income. We may be required to maintain higher levels of capital as a result of our commercial real estate concentrations, which could require us to obtain additional capital or be required to sell/participate portions of loans, which may adversely affect shareholder returns.

### **Allowance for Credit Losses**

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off loans and is decreased by current period charge-offs of uncollectible loans. Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectability. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs to maintain the allowance.

Net charge-offs were \$100 thousand for the third quarter of 2018 and \$182 thousand for the third quarter of 2017. Management remains focused on its efforts to dispose of problem loans and to prudently charge-off nonperforming loans to enable the Company to continue to improve its overall credit quality. The allowance for credit losses as a percentage of period-end loans was 0.87% at September 30, 2018, and 0.89% at September 30, 2017, and December 31, 2017. The allowance for credit losses as a percentage of period-end loans, excluding the loans acquired from Northwest Bank in the second quarter of 2017, was 0.95% at September 30, 2018, 0.97% at December 31, 2017 and

1.00% at September 30, 2017. Management believes that the provision for credit losses and the resulting allowance was adequate to provide for probable losses inherent in our loan portfolio at September 30, 2018.

The following table presents a summary of the activity in the allowance for credit losses at or for the three and nine months ended September 30, 2018 and 2017.

| (Dollars in thousands)  | At or for Three Months |             | At or for Nine Months |           |
|---|------------------------|-------------|-----------------------|-----------|
|   | Ended September 30,    |             | Ended September 30,   |           |
|   | 2018                   | 2017        | 2018                  | 2017      |
| Allowance balance - beginning of period   | \$10,121               | \$9,132     | \$9,781               | \$8,726   |
| Charge-offs:  |                        |             |                       |           |
| Construction  | -                      | -           | (379 )                | (54 )     |
| Residential real estate   | (109 )                 | (70 )       | (288 )                | (393 )    |
| Commercial real estate  | -                      | (100 )      | -                     | (100 )    |
| Commercial  | (137 )                 | (99 )       | (263 )                | (870 )    |
| Consumer  | -                      | (18 )       | (24 )                 | (33 )     |
| Total   | (246 )                 | (287 )      | (954 )                | (1,450 )  |
| Recoveries:   |                        |             |                       |           |
| Construction  | 3                      | 11          | 18                    | 27        |
| Residential real estate   | 5                      | 11          | 91                    | 32        |
| Commercial real estate  | 5                      | 8           | 23                    | 27        |
| Commercial  | 122                    | 67          | 144                   | 167       |
| Consumer  | 11                     | 8           | 11                    | 20        |
| Totals  | 146                    | 105         | 287                   | 273       |
| Net charge-offs   | (100 )                 | (182 )      | (667 )                | (1,177 )  |
| Provision for credit losses   | 307                    | 345         | 1,214                 | 1,746     |
| Allowance balance - end of period   | \$10,328               | \$9,295     | \$10,328              | \$9,295   |
| Average loans outstanding during the period   | \$1,174,513            | \$1,034,553 | \$1,140,925           | \$956,694 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during the period | 0.03                   | % 0.07      | % 0.08                | % 0.16    |
| Allowance for credit losses at period end as a percentage of total period end loans         | 0.87                   | % 0.89      | % 0.87                | % 0.89    |

### Nonperforming Assets and Accruing TDRs

As shown in the following table, nonperforming assets increased \$1.5 million to \$8.9 million at September 30, 2018 from \$7.4 million at December 31, 2017, primarily due an increase in nonaccrual loans of \$2.4 million, or 48.1% which was primarily the result of one commercial real estate customer with outstanding indebtedness to the Bank of \$2.0 million, all of which is categorized as nonaccrual. The allowance for credit losses was not impacted by this nonaccrual loan as the collateral was appraised at a value significantly higher than the outstanding loan balance. Accruing TDRs decreased \$4.4 million to \$8.9 million at September 30, 2018 from \$13.3 million at December 31, 2017. This decrease was primarily due to one significant accruing TDR, the underlying collateral of which was sold to another borrower. The ratio of nonaccrual loans and accruing TDRs to total loans decreased to 1.38% at September 30, 2018 from 1.67% at December 31, 2017.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging-off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling nonperforming loans. The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.



The following table summarizes our nonperforming assets and accruing TDRs at September 30, 2018 and December 31, 2017.

| (Dollars in thousands)                                   | September 30, 2018 | December 31, 2017 |      |   |
|--|--------------------|-------------------|------|---|
| Nonperforming assets                                     |                    |                   |      |   |
| Nonaccrual loans   |                    |                   |      |   |
| Construction   | \$ 3,032           | \$ 3,003          |      |   |
| Residential real estate                                  | 2,267              | 1,482             |      |   |
| Commercial real estate                                   | 1,739              | 149               |      |   |
| Commercial   | 324                | 337               |      |   |
| Consumer   | -                  | -                 |      |   |
| Total nonaccrual loans                                   | 7,362              | 4,971             |      |   |
| Loans 90 days or more past due and still accruing        |                    |                   |      |   |
| Construction   | -                  | -                 |      |   |
| Residential real estate                                  | -                  | 421               |      |   |
| Commercial real estate                                   | -                  | 218               |      |   |
| Commercial   | -                  | -                 |      |   |
| Consumer   | 3                  | -                 |      |   |
| Total loans 90 days or more past due and still accruing  | 3                  | 639               |      |   |
| Other real estate owned                                  | 1,518              | 1,794             |      |   |
| Total nonperforming assets                               | \$ 8,883           | \$ 7,404          |      |   |
| Accruing TDRs  |                    |                   |      |   |
| Construction   | \$ 72              | \$ 3,972          |      |   |
| Residential real estate                                  | 4,664              | 4,536             |      |   |
| Commercial real estate                                   | 4,197              | 4,818             |      |   |
| Commercial   | -                  | -                 |      |   |
| Consumer   | -                  | -                 |      |   |
| Total accruing TDRs                                      | \$ 8,933           | \$ 13,326         |      |   |
| Total nonperforming assets and accruing TDRs             | \$ 17,816          | \$ 20,730         |      |   |
| As a percent of total loans:                             |                    |                   |      |   |
| Nonaccrual loans   | 0.62               | %                 | 0.45 | % |
| Accruing TDRs  | 0.76               | %                 | 1.22 | % |
| Nonaccrual loans and accruing TDRs                       | 1.38               | %                 | 1.67 | % |
| As a percent of total loans and other real estate owned: |                    |                   |      |   |
| Nonperforming assets                                     | 0.75               | %                 | 0.68 | % |
| Nonperforming assets and accruing TDRs                   | 1.51               | %                 | 1.89 | % |
| As a percent of total assets:                            |                    |                   |      |   |
| Nonaccrual loans   | 0.50               | %                 | 0.36 | % |
| Nonperforming assets                                     | 0.60               | %                 | 0.53 | % |
| Accruing TDRs  | 0.61               | %                 | 0.96 | % |

|  |      |   |      |   |
|--|------|---|------|---|
| Nonperforming assets and accruing TDRs | 1.21 | % | 1.49 | % |
|--|------|---|------|---|

### Investment Securities

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent securities which may be sold as part of the asset/liability management strategy or in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income (loss), a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2018 and December 31, 2017, 97% of the portfolio was classified as available for sale and 3% as held to maturity. With the exception of municipal securities, our general practice is to classify all newly-purchased debt securities as available for sale. See Note 4 - Investment Securities, in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled \$174.4 million at September 30, 2018, a \$28.8 million, or 14.2%, decrease since December 31, 2017. The decrease was due to the roll-off of investment securities being redeployed to fund loan growth during the first nine months of 2018. At the end of September 2018, 75.2% of the securities available for sale were mortgage-backed and 24.8% were U.S. Government agencies, compared to 74.3%, and 22.3%, respectively, at year-end 2017. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

## **Deposits**

Total deposits at September 30, 2018 totaled \$1.2 billion, a decrease of \$20.9 million, or 1.7% when compared to the level at December 31, 2017. The decrease was due to decreases in interest-bearing checking accounts of \$17.0 million, time deposits of \$21.6 million, and money market and savings deposits of \$9.4 million, partially offset by increases in brokered deposits of \$23.5 million and noninterest-bearing deposits of \$3.4 million. The issuance of brokered deposits as an alternative to FHLB borrowings provided lower interest costs for comparative terms.

## **Short-Term Borrowings**

Short-term borrowings at September 30, 2018 and December 31, 2017 were \$114.0 million and \$21.7 million, respectively. The increase in short-term borrowings was the result of significant loan growth during the first nine months of 2018 while experiencing an outflow of deposits. Short-term borrowings generally consist of securities sold under agreements to repurchase, which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At September 30, 2018 and December 31, 2017, short-term borrowings consisted of borrowings from the FHLB and repurchase agreements.

## **Liquidity and Capital Resources**

We derive liquidity through increased customer deposits, non-reinvestment of the cash flow from the investment portfolio, loan repayments, borrowings and income from earning assets. As seen in the Consolidated Statements of Cash Flows in the Financial Statements, the net increase in cash and cash equivalents was \$17.0 million for the first nine months of 2018 compared to a decrease of \$32.0 million for the first nine months of 2017. The increase in cash and cash equivalents in 2018 was mainly due to short-term borrowings.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Bank had \$15 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at both September 30, 2018 and December 31, 2017. The Bank is also a member of the FHLB, which provides another source of liquidity. Through the FHLB, the Bank had credit availability of approximately \$119.8 million and \$205.6 million

at September 30, 2018 and December 31, 2017, respectively. The Bank has pledged, under a blanket lien, all qualifying residential and commercial real estate loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity increased \$7.7 million to \$171.4 million at September 30, 2018 when compared to December 31, 2017 primarily due to current year's earnings.

### *Basel III*

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. Under the final rules, minimum requirements increased for both the quantity and quality of capital held. The rules included a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, was also established above the regulatory minimum capital requirements. This capital conservation buffer became effective as of January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets.

The phase-in period for the final rules became effective on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2018, the Bank's capital levels remained characterized as "well-capitalized" under the new rules.

The following tables present the applicable capital ratios as of September 30, 2018 and December 31, 2017.

|                    | Tier 1<br>leverage<br>ratio |   | Common Equity<br>Tier 1<br>ratio |   | Tier 1<br>risk-based<br>capital ratio |   | Total<br>risk-based<br>capital ratio |   |
|--------------------|-----------------------------|---|----------------------------------|---|---------------------------------------|---|--------------------------------------|---|
| September 30, 2018 |                             |   |                                  |   |                                       |   |                                      |   |
| <b>Company (1)</b> | <b>N/A</b>                  |   | <b>N/A</b>                       |   | <b>N/A</b>                            |   | <b>N/A</b>                           |   |
| Shore United Bank  | 9.62                        | % | 11.79                            | % | 11.79                                 | % | 12.71                                | % |

|                   | Tier 1<br>leverage<br>ratio |   | Common Equity<br>Tier 1<br>ratio |   | Tier 1<br>risk-based<br>capital ratio |   | Total<br>risk-based<br>capital ratio |   |
|-------------------|-----------------------------|---|----------------------------------|---|---------------------------------------|---|--------------------------------------|---|
| December 31, 2017 |                             |   |                                  |   |                                       |   |                                      |   |
| Company           | 9.84                        | % | 11.90                            | % | 11.90                                 | % | 12.81                                | % |
| Shore United Bank | 9.44                        | % | 11.45                            | % | 11.45                                 | % | 12.36                                | % |

In August of 2018 the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”) directed the Federal Reserve Board (“FRB”) to revise the Small Bank Holding Company Policy Statement to raise the total (1) consolidated asset limit in the Policy Statement from \$1 billion to \$3 billion. The Company meets the conditions of the revised policy statement and is, therefore, exempt from the consolidated capital requirements at September 30, 2018.

The Company, will also begin filing less extensive and less frequent regulatory reports with the FRB, which will reduce administrative costs for the Company.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the 2017 Annual Report under the caption “Market Risk Management and Interest Sensitivity”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2017.

### Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that Shore Bancshares, Inc. files under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to management, including Shore Bancshares, Inc.’s principal executive officer (“CEO”) and its principal accounting officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide

only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls and procedures as of September 30, 2018 was carried out under the supervision and with the participation of management, including the PEO and the PAO. Based on that evaluation, the Company's management, including the PEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level at September 30, 2018.

There was no change in our internal control over financial reporting during the third quarter of 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

**Item 1. Legal Proceedings**

From time to time the Company may become involved in legal proceedings. At the present time, there are no proceedings which the Company believes will have a material adverse impact on the financial condition or earnings of the Company.

**Item 1A. Risk Factors**

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the 2017 Annual Report. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed in our 2017 Annual Report.

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

None.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

Not Applicable

**Item 5. Other Information**

None

**Item 6. Exhibits.**

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

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.

**SHORE BANCSHARES, INC.**

Date: November 8, 2018 By: /s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
President & Chief Executive Officer  
(Principal Executive Officer)

Date: November 8, 2018 By: /s/ Edward C. Allen  
Edward C. Allen  
Senior Vice President & Chief Financial Officer  
(Principal Accounting Officer)



**EXHIBIT INDEX**

**Exhibit  
Number Description**

|             |   |
|-------------|---|
| <u>31.1</u> | <u>Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).</u>  |
| <u>31.2</u> | <u>Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).</u> |
| <u>32</u>   | <u>Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).</u>                                  |
| 101         | Interactive Data File   |
| 101.INS     | XBRL Instance Document (filed herewith)   |
| 101.SCH     | XBRL Taxonomy Extension Schema (filed herewith)   |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase (filed herewith)   |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase (filed herewith)  |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase (filed herewith)   |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase (filed herewith)  |