Management's Discussion and Analysis of Financial Condition and Results of Operations

This section provides a narrative discussion and analysis of the consolidated financial condition and results of operations of Fentura Financial, Inc. (the Corporation), together with its subsidiaries, The State Bank (the Bank), and Fentura Holdings, LLC ("FHLLC"), for the years ended December 31, 2016, 2015, 2014, 2013, and 2012. The supplemental financial data included throughout this discussion should be read in conjunction with the audited financial statements.

TABLE 1 **Selected Financial Data**

000s omitted except per share data and ratios	**2016**	**2015**	**2014**	**2013**	**2012**
Summary of Consolidated Statements of Income:					
Interest income	$ 18,645	$ 16,653	$ 14,655	$ 12,481	$ 12,193
Interest expense	2,372	2,153	1,713	1,454	1,945
Net interest income	16,273	14,500	12,942	11,027	10,248
Provision for loan losses	(900)	(1,000)	(450)	7	(508)
Net interest income after provision	17,173	15,500	13,392	11,020	10,756
Total non-interest income	6,658	6,575	5,725	5,583	4,842
Acquisition expenses	728	-	-	-	-
Total non-interest expense	17,097	14,976	14,029	13,235	14,261
Income before income taxes	6,734	7,099	5,088	3,368	1,337
Federal income taxes (benefit)	2,293	2,407	1,728	(5,118)	73
Net income	$ 4,441	$ 4,692	$ 3,360	$ 8,486	$ 1,264
Pre-tax, pre-provision, pre-acquisition net income	$ 6,562	$ 6,099	$ 4,638	$ 3,375	$ 829
Income per share – basic*	$ 1.70	$ 1.87	$ 1.35	$ 3.44	$ 0.52
Income per share – diluted*	$ 1.70	$ 1.87	$ 1.35	$ 3.44	$ 0.52
Summary of Consolidated Balance Sheets:					
Assets	$703,350	$446,402	$393,582	$335,225	$310,722
Securities	72,458	25,708	33,008	36,574	48,249
Gross loans, including loans held for sale	519,644	381,560	319,969	263,978	200,526
Deposits	603,367	375,971	327,923	283,341	275,839
Borrowings	45,000	34,775	34,817	24,855	14,891
Shareholders' equity	50,660	32,474	28,142	24,762	16,203
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets (Bank)	10.72%	11.00%	11.70%	11.80%	12.06%
Total capital to risk weighted assets (Bank)	11.24%	11.90%	12.90%	13.10%	13.34%
Tier 1 capital to average assets (Bank)	11.69%	9.90%	9.70%	10.00%	8.73%
Impaired loans	3,447	4,226	5,925	8,657	16,528
Net charge-offs	(246)	(99)	44	69	2,694
Book value per share	$ 14.00	$ 12.90	$ 11.24	$ 9.97	$ 6.69
Tangible book value per share	$ 12.42	$ 12.90	$ 11.24	$ 9.97	$ 6.69
Year end market price per share	$ 16.00	$ 13.86	$ 9.90	$ 6.97	$ 3.50
Return on average shareholders' equity	9.99%	15.48%	13.03%	41.43%	8.19%
Return on average assets	0.75%	1.12%	0.94%	2.63%	0.41%
Net interest margin	3.81%	3.90%	4.04%	4.16%	4.00%
Total equity to assets at year end	7.20%	7.27%	7.15%	7.39%	5.21%

*Per share data calculated using average shares outstanding in each year

RESULTS OF OPERATIONS

The Corporation posted net income of $4.4 million for the year ended December 31, 2016 compared to $4.7 million for the same period in 2015, a decrease of 6.4%, or $300,000. Pre-tax, pre-provision, pre-acquisition ("PPP") earnings increased year over year by 8.2%, or $500,000, from $6.1 million in 2015 to $6.6 million in 2016. Net interest income for the year ended 2016 increased by $1.8 million, or 12.2% compared to 2015. Continued solid credit quality eliminated the need for provision for loan losses in both 2016 and 2015, actually resulting in $900,000 and $1.0 million credits for provisions taken in prior years, respectively. Other operating income for the year ended 2016 increased by $100,000, or 1.5%. Other operating expense increased by $2.1 million, or 14.2% for the year ended 2016 compared to 2015. These variances from period to period are detailed over the next several pages.

Standard performance indicators used in the banking industry help management evaluate the Corporation's performance. Two of these performance indicators are return on average assets and return on average equity. For 2016 and 2015 respectively, the Corporation posted a return on average assets of 0.75% (1.11% "PPP") and 1.12% (1.44% "PPP"). Return on average equity was 9.99% (14.76% "PPP") in 2016 and 15.48% (20.12% "PPP") in 2015. Pre-tax, pre-provision, pre-acquisition expense ("PPP") numbers are shown in order to illustrate core earnings. The Corporation's capital position experienced an increase in equity of $18.2 million or 56.0% during 2016. Total assets increased $257.0 million, or 57.6% during 2016. Income per share was $1.87 in 2015 compared to $1.70 in 2016. Core earnings per share as previously referenced, was $2.54 in 2016 compared to $2.43 in 2015, a 4.5% increase.

NET INTEREST INCOME

Table 2 summarizes the changes in net interest income resulting from changes in volume and rates for the years ended December 31, 2016 and 2015. Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the last two years are shown in Table 2. Net interest income increased by $1.8 million, or 12.3% in 2016 when compared to 2015. For the year ended December 31, 2016, the Corporation's net interest margin was 3.81% compared with 3.90% in 2015. The decrease in net interest margin in 2016 is primarily attributable to the lower rate environment suppressing the yields available on loans. On the asset side, continued pricing pressure is being experienced in the marketplace and further erosion in the yield is expected should interest rates continue at their current levels. While the rate increase late in the year may provide some benefit, the competitive environment may not allow much of that to translate to the bottom line without continued increases in overnight rates. The Corporation monitors its exposure to changing interest rates using various tools including monitoring the maturities of its various financial instruments.

Average earning assets at December 31, 2016 increased $51.3 million, or 13.7%. Total loans, the highest yielding component of earning assets, increased from 91.8% in 2015 to 94.6% in 2016 as a percentage of earning assets. Management remains comfortable with this level and would expect this ratio to remain relatively constant in the near future. Average interest bearing liabilities increased 9.6%, or $26.8 million during 2016, while non-interest bearing deposits increased 20.3%, or $21.0 million. Non-interest bearing deposits rose to 29.2% of average earning assets in 2016 compared with 27.6% in 2015. It is anticipated that should interest rates increase significantly that the non-interest balances may see some decline. Various levels of reallocation of these balances to term deposits are modeled on at least a quarterly basis and management is comfortable that the Corporation has sufficient liquidity to sustain any deposit outflows that may occur. The growth in non-interest deposits was largely in new municipal and commercial relationships. Additionally, the acquisition of Community State Bank will have an impact on the average balances in 2017, while the timing of the transaction effectively eliminated the impact on average balances in 2016.

TABLE 2

Dollars in thousands	Dec-16 Average Balance	Dec-16 Income	Dec-16 Yield	Dec-15 Average Balance	Dec-15 Income	Dec-15 Yield	Variance due to: Rate	Variance due to: Volume
Assets:								
Short term investment	$ 3,900	$ 13	0.33%	$ 1,300	$ 4	0.31%	$ -	$ 9
Securities:								
Taxable	17,142	414	2.41%	23,887	616	2.58%	(38)	(164)
Tax-exempt	5,850	99	2.60%	2,879	50	2.67%	(1)	50
Total Securities	22,992	513	2.46%	26,766	666	2.50%	(39)	(114)
Loans:								
Commercial loans	240,598	11,705	4.86%	218,537	10,853	4.98%	(254)	1,106
Consumer loans	30,576	1,368	4.46%	28,132	1,256	4.46%	(1)	113
Mortgage loans	131,481	5,046	3.83%	96,885	3,874	4.00%	(159)	1,331
Total Loans	402,655	18,119	4.49%	343,554	15,983	4.66%	(414)	2,550
Total earning assets/interest income	425,646	18,645	4.35%	374,328	16,653	4.48%	(453)	2,445
Cash and cash equivalents	31,532			24,320				
Investment security fair value adjustment	197			361				
Allowance for loan losses	(3,605)			(4,435)				
Other non-earning assets	26,172			11,683				
Total assets	$ 484,042			$ 423,562				
Liabilities:								
Deposits:								
Interest bearing DDA	$ 2,963	$ 3	0.09%	$ 2,617	$ 2	0.08%	(1)	-
Money market savings	57,278	81	0.14%	53,034	70	0.13%	3	5
Savings	109,187	122	0.11%	94,180	96	0.10%	4	7
Retail time deposits	61,303	677	1.10%	62,125	649	1.04%	18	11
Brokered time deposits	32,629	511	1.56%	32,940	514	1.56%	16	249
Total Deposits	263,359	1,394	0.53%	244,896	1,331	0.54%	40	272
Borrowings:								
Federal funds purchased	-	-	-	-	-	-	-	-
Advances from FHLB of Indianapolis	29,126	441	1.51%	20,791	378	1.82%	52	131
Trust preferred securities	14,108	537	3.80%	14,108	444	3.15%	(55)	3
Other borrowings	-	-	0.00%	-	-	0.00%	-	-
Total Borrowings	43,255	978	2.25%	34,899	822	2.53%	(3)	134
Total interest bearing liabilities/interest expense	306,614	2,372	0.76%	279,795	2,153	0.77%	37	406
Non-interest bearing deposits	124,189			103,162				
Other non-rate bearing liabilities	10,021			3,741				
Shareholders' equity	43,218			36,864				
Total liabilities and shareholders' equity	$ 484,042			$ 423,562				
Interest spread		$ 16,273	3.59%		$ 14,500	3.71%	$(339)	$ 1,893
Net Interest Margin			3.81%			3.90%		

NON-INTEREST INCOME

Non-interest income increased $100,000, or 1.5% from $6.6 million in 2015 to $6.7 million in 2016. Mortgage banking revenue contributed to the bulk of the increase year over year, rising almost 43% to $3.0 million. This level of gain is not necessarily anticipated to continue in future years, as this revenue is highly dependent on market rates and therefore difficult to predict on a prospective basis. Virtually offsetting this increase were declines in gains on sales of securities, falling $500,000 or 100.0% and other income, falling $400,000, or 21.1%. The other income decline is primarily due to the termination of an agreement to provide IT services for an unrelated 3rd party financial institution.

NON-INTEREST EXPENSE

Total non-interest expense was $17.1 million and $15.0 million in 2016 and 2015, respectively, an increase of $2.1 million or 14.0%. Almost one-third of the increase, $728,000, was due to expenses related to the acquisition of Community State Bank. These expenses are not expected to recur in any material fashion barring additional acquisition activity. Compensation expense increased 8.0%, or $700,000 to $9.5 million year over year. The increase was due primarily to increased commissions on mortgage banking income as well as employee raises and increased bonus payouts in the company-wide plan. Other professional service fees including audit fees, consulting fees, legal fees, branch security costs, and various other professional service fees were $1.5 million in 2016 compared to $1.1 million in 2015, a variance of 36.4%. The variance was primarily due to contract services of information technology staffing and other risk management consulting services.

FINANCIAL CONDITION

The Corporation's total assets increased $257.0 million, or 57.6% during 2016. Both loans and deposits, the Corporation's primary customer accounts, saw significant growth during the year both including and excluding the impact of the acquisition. Gross portfolio loans increased $138.1 million, or 36.2%. Approximately $84.1 million of this increase came through the acquisition, with organic growth accounting for the remaining $54.0 million. The organic increase would represent a 14.3% increase over the prior year ending balance. This increase was funded almost exclusively through core deposit growth, largely municipal and commercial customers. Total deposits grew 60.5% from $376.0 million at December 31, 2015 to $603.4 million at December 31, 2016. The organic growth of $56.0 million would represent an increase in total deposits of 14.9% over December 31, 2015. Both interest-bearing and non-interest bearing accounts increased during 2016. Management anticipates that some of this increase may disintermediate should rates return to historical norms. The loan pipeline remains strong and management is optimistic about loan and deposit growth prospects for the future, though both markets have become intensely competitive.

CREDIT QUALITY

At December 31, 2016, the allowance for loan losses was $2.9 million or 0.55% of total loans. This compares with $3.5 million or 0.92% at December 31, 2015, which represents a decrease of $600,000 during 2016. Net recoveries totaled $99,000 and $246,000, during 2016 and 2015 respectively, an improvement of $147,000 year over year. Management understands that the level of the reserve appears low relative to historical levels, but believes that the credit quality of the underlying assets supports this reserve amount. Additionally, the gross portfolio loan amount includes $84,071 of loans that are carried at fair value at December 31, 2016. When adjusting for those acquired loans the reserve amount to gross loans would be 0.66% at December 31, 2016.

Table 3 summarizes loan losses and recoveries from 2012 through 2016. All of the loan portfolios with the exception of commercial showed declines in net charge-offs compared to 2015. While commercial loans did not experience the recoveries as in 2015 there were no net charge-offs experienced in 2016. The decrease in charge-offs is a reflection of the improvement in the market value of real estate in Michigan as well as a more aggressive collection and restructuring efforts.

TABLE 3
Analysis of the Allowance for Loan Losses

(000s omitted)	Years Ended December 31, 2016	2015	2014	2013	2012
Balance Beginning of Year	$ 3,505	$ 4,406	$ 4,900	$ 4,692	$ 8,164
Charge-offs:					
Commercial	-	-	(14)	(154)	(785)
Commercial real estate	(8)	(146)	(296)	(630)	(2,249)
Residential real estate	-	(33)	(12)	(73)	(424)
Installment loans	(3)	(27)	(53)	(12)	(37)
Home equity	-	-	(39)	(33)	(291)
Total Charge-offs	(11)	(206)	(414)	(902)	(3,786)
Recoveries:					
Commercial	-	90	67	145	71
Commercial real estate	138	170	269	580	976
Residential real estate	102	-	2	19	3
Installment loans	9	5	12	33	21
Home equity	8	40	20	56	21
Total Recoveries	257	305	370	833	1,092
Net Charge-offs	246	99	(44)	(69)	(2,694)
Provision for loan losses	(900)	(1,000)	(450)	7	(508)
Balance at End of Year	$ 2,851	$ 3,505	$ 4,406	$ 4,900	$ 4,962
Net Charge-Offs/Period End Loans	(0.05%)	(0.03%)	0.01%	0.03%	1.35%

Non-performing assets include loans on which interest accruals have ceased, loans past due 90 days or more and still accruing, and real estate acquired through foreclosure or deed-in-lieu of foreclosure (ORE). Table 4 shows a history of the Corporation's originated non-performing assets. Non-performing loans remain at low levels primarily due to ongoing diligent attention to collection efforts. Additionally, loans delinquent 30-89 days, a leading indicator of future non-performing loans, remain at levels below industry norms. In fact, the originated portfolio showed no loans delinquent as of December 31, 2016.

TABLE 4
Non-Performing Assets and Past Due Loans

	December 31,				
(000s omitted)	2016	2015	2014	2013	2012
Non-performing loans:					
Loans past due 90 days or more & still accruing	$ -	$ 187	$ -	$ -	$ 102
Non-accrual loans	-	226	187	1,980	5,583
Total non-performing loans	-	413	187	1,980	5,685
Other non-performing assets:					
Other real estate	250	397	2,488	2,594	2,579
Other real estate owned in redemption	-	-	-	99	714
Total other non-performing assets	250	397	2,488	2,693	3,293
Total non-performing assets	$ 250	$ 810	$ 2,675	$ 4,673	$ 8,978
Non-performing loans as a % of total loans	0.00%	0.11%	0.06%	0.75%	2.84%
Non-performing assets as a % of total loans and ORE	0.05%	0.21%	0.84%	1.75%	4.42%
Allowance for loan losses as a % of non-performing loans	NM	848.67%	2,356.15%	247.47%	87.28%
Non-performing assets as a % of total assets	0.04%	0.18%	0.68%	1.39%	2.89%

FORWARD LOOKING STATEMENTS

This discussion and analysis of financial condition and results of operations, and other sections of the Consolidated Financial Statements and this annual report, contain forward looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and about the Corporation itself. Words such as "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "is likely," "plans," "projects," variations of such words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("Future Factors"), which are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecast in such forward looking statements. The Corporation undertakes no obligation to update, amend or clarify forward looking statements as a result of new information, future events, or otherwise.

Future factors that could cause a difference between an ultimate actual outcome and a preceding forward looking statement include, but are not limited to, changes in interest rate and interest rate relationships, demands for products and services, the degree of competition by traditional and non-traditional competitors, changes in banking laws or regulations, changes in tax laws, change in prices, the impact of technological advances, government and regulatory policy changes, the outcome of pending and future litigation and contingencies, trends in customer behavior as well as their ability to repay loans, and the local and national economy.