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, 2015, 2014, 2013, 2012, and 2011. Davison State Bank, West Michigan Community Bank, and West Michigan Mortgage Company, LLC have been reclassified into Discontinued Operations for all periods. 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	2015	2014	2013	2012	2011
Summary of Consolidated Statements of Income:					
Interest income	$ 16,653	$ 14,655	$ 12,481	$ 12,193	$ 13,143
Interest expense	2,153	1,713	1,454	1,945	2,983
Net interest income	14,500	12,942	11,027	10,248	10,160
Provision for loan losses	(1,000)	(450)	7	(508)	3,142
Net interest income after provision	15,500	13,392	11,020	10,756	7,018
Total non-interest income	6,575	5,725	5,583	4,842	4,858
Total non-interest expense	14,976	14,029	13,235	14,261	13,827
Income (loss) before income taxes	7,099	5,088	3,368	1,337	(1,951)
Federal income taxes (benefit)	2,407	1,728	(5,118)	73	52
Income (loss) from continuing operations	4,692	3,360	8,486	1,264	(2,003)
Discontinued operations, net of tax	-	-	-	-	491
Net income (loss)	$ 4,692	$ 3,360	$ 8,486	$ 1,264	$ (1,512)
Pre-tax, pre-provision net income	$ 6,099	$ 4,638	$ 3,375	$ 829	$ 1,682
Income (loss) per share – basic*	$ 1.87	$ 1.35	$ 3.44	$ 0.52	$ (0.65)
Income (loss) per share – diluted*	$ 1.87	$ 1.35	$ 3.44	$ 0.52	$ (0.65)
Summary of Consolidated Balance Sheets:					
Assets	$446,042	$393,582	$335,225	$310,722	$298,861
Securities, including FHLB stock	26,689	33,008	36,574	48,249	62,311
Gross loans, including loans held for sale	381,560	319,969	263,978	200,526	205,890
Deposits	375,971	327,923	283,341	275,839	265,881
Borrowings	34,775	34,817	24,855	14,891	14,923
Shareholders' equity	32,474	28,142	24,762	16,203	14,660
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets (Bank)	11.00%	11.70%	11.80%	12.06%	11.00%
Total capital to risk weighted assets (Bank)	11.90%	12.90%	13.10%	13.34%	12.30%
Tier 1 capital to average assets (Bank)	9.90%	9.70%	10.00%	8.73%	8.10%
Impaired loans	2,054	5,925	8,657	16,528	30,091
Net charge-offs	(99)	44	69	2,694	6,202
Book value per share*	$ 12.90	$ 11.24	$ 9.97	$ 6.69	$ 6.27
Year end market price per share*	$ 13.86	$ 9.90	$ 6.97	$ 3.50	$ 2.16
Return on average shareholders' equity	15.48%	13.03%	41.43%	8.19%	-9.29%
Return on average assets	1.12%	0.94%	2.63%	0.41%	-0.48%
Net interest margin	3.90%	4.04%	4.16%	4.00%	3.78%
Total equity to assets at year end	7.27%	7.15%	7.39%	5.21%	4.91%

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

RESULTS OF OPERATIONS

The Corporation posted net income of $4.7 million for the year ended December 31, 2015 compared to $3.4 million for the same period in 2014, an increase of 38.2%, or $1.3 million. Pre-tax, pre-provision earnings increased year over year by 31.5%, or $1.5 million, from $4.6 million in 2014 to $6.1 million in 2015. Net interest income for the year ended 2015 increased by $1.6 million, or 12.4% compared to 2014. Continued solid credit quality eliminated the need for provision for loan losses in both 2015 and 2014, actually resulting in $1.0 million and $450,000 credits for provisions taken in prior years, respectively. Other operating income for the year ended 2015 increased by $900,000, or 15.8%. Other operating expense increased by $1.0 million, or 7.1% for the year ended 2015 compared to 2014. 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 2015 and 2014 respectively, the Corporation posted a return on average assets of 1.12% (1.46% pre-tax, pre-provision) and 0.94% (1.29% pre-tax, pre-provision). Return on average equity was 15.48% (26.72% pre-tax) in 2015 and 13.03% (21.48%) in 2014. Pre-tax, pre-provision numbers are shown in order to illustrate core profitability. The Corporation's capital position experienced an increase in equity of $4.4 million or 15.7% in 2015. Total assets increased $52.8 million, or 13.4% during 2015. Income per share was $1.87 in 2015 compared to $1.35 in 2014.

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, 2015 and 2014. 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 $1.6 million, or 12.4% in 2015 when compared to 2014. For the year ended December 31, 2015, the Corporation's net interest margin was 3.90% compared with 4.04% in 2014. The decrease in net interest margin in 2015 is primarily attributable to the lower rate environment suppressing the yields available on loans combined with slightly higher funding costs, due to a nominal increase in wholesale funding costs. These Non-core funding sources, which consist of Brokered CDs, listing service CDs and FHLB Advances provided 14.20% of deposits and 13.46% of funding. 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. 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, 2015 increased $51.4 million, or 15.9%. Total loans, the highest yielding component of earning assets, increased from 89.0% in 2014 to 91.8% in 2015 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 14.5%, or $35.5 million during 2015, while non-interest bearing deposits increased 20.3%, or $17.4 million. Non-interest bearing deposits rose to 27.6% of average earning assets in 2015 compared with 26.6% in 2014. 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.

TABLE 2

Dollars in thousands	Dec-15			Dec-14			Variance due to:	
	Average Balance	Income	Yield	Average Balance	Income	Yield	Rate	Volume
Assets:								
Short term investment	$ 1,300	$ 4	0.31%	$ 667	$ 2	0.30%	$ -	$ 2
Securities:								
Taxable	21,936	535	2.44%	26,431	635	2.40%	10	(110)
Tax-exempt	7,538	131	2.67%	8,472	169	3.07%	(20)	(18)
Total Securities	29,474	666	2.50%	34,903	804	2.56%	(10)	(128)
Loans:								
Commercial loans	218,537	10,853	4.98%	187,445	9,673	5.17%	(351)	1,531
Consumer loans	28,132	1,256	4.46%	26,378	1,258	4.77%	40	(42)
Mortgage loans	96,885	3,874	4.00%	73,482	2,919	3.97%	19	936
Total Loans	343,554	15,983	4.66%	287,305	13,850	4.83%	(292)	2,425
Total earning assets/interest income	374,328	16,653	4.48%	322,875	14,656	4.57%	(302)	2,299
Cash and cash equivalents	24,320			15,010				
Investment security fair value adjustment	361			244				
Bank premises and equipment	9,620			10,024				
Bank owned life insurance	6,442			6,261				
Other real estate	1,243			2,317				
Allowance for loan losses	(4,435)			(4,859)				
Other non-earning assets	11,683			7,200				
Total assets	$ 423,562			$ 359,072				
Liabilities:								
Deposits:								
Interest bearing DDA	$ 2,617	$ 2	0.08%	$ 2,529	$ 3	0.12%	(1)	-
Money market savings	53,034	70	0.13%	49,296	62	0.13%	3	5
Savings	94,180	96	0.10%	87,260	85	0.10%	4	7
Retail time deposits	62,125	649	1.04%	61,040	620	1.02%	18	11
Brokered time deposits	32,940	514	1.56%	16,893	249	1.47%	16	249
Total Deposits	244,896	1,331	0.54%	217,018	1,019	0.47%	40	272
Borrowings:								
Federal funds purchased	-	-	-	57	-	-	-	-
Advances from FHLB of Indianapolis	20,791	378	1.82%	13,186	195	1.48%	52	131
Trust preferred securities	14,108	444	3.15%	14,018	496	3.54%	(55)	3
Other borrowings	-	-	0.00%	-	-	0.00%	-	-
Total Borrowings	34,899	822	2.36%	27,261	691	2.53%	(3)	134
Total interest bearing liabilities/interest expense	279,795	2,153	0.77%	244,279	1,710	0.70%	37	406
Non-interest bearing deposits	103,162			85,754				
Other non-rate bearing liabilities	3,741			3,255				
Shareholders' equity	36,864			25,785				
Total liabilities and shareholders' equity	$ 423,562			$ 359,072				
Interest spread		$ 14,500	3.71%		$ 12,946	3.87%	$(339)	$ 1,893
Net Interest Margin			3.90%			4.04%		

NON-INTEREST INCOME

Non-interest income increased $900,000, or 15.8% from $5.7 million in 2014 to $6.6 million in 2015. Mortgage banking revenue contributed to the bulk of the increase year over year, rising almost 70% to $2.2 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. Additionally, gains on sales of securities increased year over year, rising $71,000 or 18.2%. Offsetting this increase was a decline in service charges on deposit accounts, which fell 8.6%, or $76,000 year over year.

NON-INTEREST EXPENSE

Total non-interest expense was $15.0 million and $14.0 million in 2015 and 2014, respectively, an increase of $1.0 million or 7.1%. Loan and collection expenses continued to decline, falling from $652,000 in 2014 to $565,000 in 2015. As stated in the prior year, the continued decline in loan and collection expenses is the result of the decreased ORE carrying costs and decreased valuation adjustments as well as declines in the volume of filing and recording costs, appraisal expenses, collection expenses and expenses related to impaired loans. It is anticipated that these expenses will see a slight decrease on an ongoing basis as the pool of impaired loans continues to decrease. Other professional service fees including audit fees, consulting fees, legal fees, branch security costs, and various other professional service fees were $1.1 million in 2015 compared to $1.0 million in 2014, a variance of 10.0%. The variance was primarily due to contract services of information technology staffing and other consulting services. Finally, Salaries and benefits increased 11.4%, or $900,000 to $8.8 million year over year. The increase was due primarily to increased commissions on mortgage banking income as well as employee raises, increased bonus payouts in the company-wide plan and increased 401(k) match expense as the match was restored during the middle of 2014.

FINANCIAL CONDITION

The Corporation's total assets increased $52.8 million, or 13.4% during 2015. Both loans and deposits, the Corporation's primary customer accounts, saw significant growth during the year. The loan portfolio increased $60.1 million, or 18.9%. This increase was funded almost exclusively through core deposit growth, largely municipal and commercial customers. Total deposits grew 14.7% from $327.9 million at December 31, 2014 to $376.0 million at December 31, 2015. Both interest-bearing and non-interest bearing accounts increased during 2015. Management anticipates some of this increase to flow out 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, 2015, the allowance for loan losses was $3.5 million or 0.92% of total loans. This compares with $4.4 million or 1.38% at December 31, 2014, which represents a decrease of $900,000 during 2015. During 2014 net charge-offs totaled $44,000, while 2015 saw net recoveries of $99,000, an improvement of $143,000 year over year.

Table 3 summarizes loan losses and recoveries from 2011 through 2015. During 2014, the Corporation experienced net charge-offs of $44,000, compared with net recoveries of $99,000 in 2015. All of the loan portfolios showed continual declines in net charge offs compared to 2013. 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, 2015	2014	2013	2012	2011
Balance Beginning of Year	$ 4,406	$ 4,900	$ 4,692	$ 8,164	$ 11,224
Charge-offs:					
Commercial	-	(14)	(154)	(785)	(178)
Commercial real estate	(146)	(296)	(630)	(2,249)	(6,066)
Residential real estate	(33)	(12)	(73)	(424)	(114)
Installment loans	(27)	(53)	(12)	(37)	(179)
Home equity	-	(39)	(33)	(291)	(74)
Total Charge-offs	(206)	(414)	(902)	(3,786)	(6,611)
Recoveries:					
Commercial	90	67	145	71	95
Commercial real estate	170	269	580	976	253
Residential real estate	-	2	19	3	4
Installment loans	5	12	33	21	31
Home equity	40	20	56	21	26
Total Recoveries	305	370	833	1,092	409
Net Charge-offs	99	(44)	(69)	(2,694)	(6,202)
Provision for loan losses	(1,000)	(450)	7	(508)	3,142
Balance at End of Year	$ 3,505	$ 4,406	$ 4,900	$ 4,962	$ 8,164
Net Charge-Offs/Period End Loans	(0.03%)	0.01%	0.03%	1.35%	3.01%

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 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.

TABLE 4
Non-Performing Assets and Past Due Loans

	December 31,				
(000s omitted)	2015	2014	2013	2012	2011
Non-performing loans:					
Loans past due 90 days or more & still accruing	$ -	$ -	$ -	$ 102	$ 488
Non-accrual loans	226	187	1,980	5,583	16,558
Total non-performing loans	226	187	1,980	5,685	17,046
Other non-performing assets:					
Other real estate	397	2,488	2,594	2,579	1,949
Other real estate owned in redemption	-	-	99	714	223
Total other non-performing assets	397	2,488	2,693	3,293	2,172
Total non-performing assets	$ 623	$ 2,675	$ 4,673	$ 8,978	$ 19,218
Non-performing loans as a % of total loans	0.06%	0.06%	0.75%	2.84%	8.28%
Non-performing assets as a % of total loans and ORE	0.16%	0.84%	1.75%	4.42%	9.25%
Allowance for loan losses as a % of non-performing loans	275.66%	2,356.15%	247.47%	87.28%	47.89%
Non-performing assets as a % of total assets	0.14%	0.68%	1.39%	2.89%	6.43%

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.