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), Fentura Holdings, LLC ("FHLLC") as well as Fentura Mortgage Company, for the years ended December 31, 2012, 2011, 2010, 2009 and 2008. Davison State Bank, and West Michigan Community Bank, and West Michigan Mortgage Company, LLC have been reclassified into Discontinued Operations in 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	**2012**	**2011**	**2010**	**2009**	**2008**
Summary of Consolidated Statements of Income:					
Interest income	$ 12,193	$ 13,143	$ 15,536	$ 18,521	$ 20,803
Interest expense	1,945	2,983	4,552	6,925	9,307
Net interest income	10,248	10,160	10,984	11,596	11,496
Provision for loan losses	(508)	3,142	8,107	11,134	5,552
Net interest income after provision	10,756	7,018	2,877	462	5,944
Total other operating income	4,842	4,858	4,773	3,390	3,060
Total other operating expense	14,261	13,827	13,209	14,712	14,455
Income (loss) before income taxes	1,337	(1,951)	(5,559)	(10,860)	(5,451)
Federal income taxes (benefit)	73	52	(207)	2,283	(2,149)
Income (loss) from continuing operations	1,264	(2,003)	(5,352)	(13,143)	(3,302)
Discontinued operations, net of tax	-	491	(33)	(3,837)	(8,863)
Net income (loss)	$ 1,264	$ (1,512)	$ (5,385)	$ (16,980)	$ (12,165)
Income (loss) per share – basic*	$ 0.52	$ (0.65)	$ (2.37)	$ (7.70)	$ (5.60)
Income (loss) per share – diluted*	$ 0.52	$ (0.65)	$ (2.37)	$ (7.70)	$ (5.60)
Summary of Consolidated Balance Sheets:					
Assets	$310,722	$298,861	$424,228	$ 522,079	$ 578,604
Securities, including FHLB stock	48,249	62,311	46,965	40,200	44,999
Loans, including loans held for sale	200,526	205,890	218,981	243,384	293,561
Assets of discontinued operations	0	0	113,314	178,312	199,428
Deposits	275,839	265,881	275,977	311,551	331,992
Borrowings	14,891	14,923	15,833	15,145	17,507
Liabilities of discontinued operations	0	0	113,321	172,077	191,116
Shareholders' equity	16,203	14,660	16,055	20,532	36,124
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets	9.76%	8.80%	6.50%	6.50%	10.20%
Total capital to risk weighted assets	11.00%	10.10%	7.80%	7.80%	11.40%
Tier 1 capital to average assets	7.00%	6.50%	4.90%	5.00%	8.80%
Impaired loans	16,528	30,091	35,413	28,439	27,884
Net Charge-offs	2,694	6,202	5,669	9,779	5,183
Book value per share*	$ 6.69	$ 6.27	$ 6.95	$ 9.13	$ 16.53
Year end market price per share*	$ 3.50	$ 2.16	$ 1.75	$ 1.36	$ 6.75
Return on average shareholders' equity	8.19%	-9.29%	-28.52%	-61.18%	-25.13%
Return on average assets	0.41%	-0.48%	-1.15%	-3.02%	-2.03%
Net interest margin	4.00%	3.78%	3.77%	3.61%	3.33%
Total equity to assets at year end	5.21%	4.91%	3.78%	3.93%	6.24%

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

RESULTS OF OPERATIONS

The Corporation posted net income from continuing operations of $1.3 million for the year ended December 31, 2012 compared to a loss of $2.0 million for the same period in 2011. Net interest income for the year ended 2012 increased by $88,000 compared to 2011. The provision for loan losses taken for the year ended 2012 decreased $3.6 million compared to 2011. This was due primarily to improvement in credit quality as noted in the discussion below. Other operating income for the year ended 2012 was basically flat with the prior year, decreasing by only $16,000. Other operating expense increased by $500,000 for the year ended 2012 compared to 2011. 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 2012 and 2011 respectively, the Corporation posted a return on average assets of 0.41% and (0.48%). Return on average equity was 8.19% in 2012 and (9.29%) in 2011. The Corporation's capital position experienced an increase in equity of $1.5 million or 10.5% in 2012. Total assets increased $11.8 million in 2012 and decreased $125.3 million in 2011. The significant decrease in 2011 was largely the result of the sale of a subsidiary bank during the first quarter of 2011. Diluted income (loss) per share was $0.52 in 2012, ($0.65) in 2011 and ($2.37) in 2010.

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, 2012 and 2011. Net interest income (displayed with consideration of full tax equivalency), average balance sheet amounts, and the corresponding yields for the last three years are shown in Table 3. Net interest income increased by $88,000, or 0.9% in 2012 when compared to 2011. For the year ended December 31, 2012, the Corporation's net interest margin was 4.00% compared with 3.78% in 2011. The improvement in 2012 is primarily attributable to decreased funding costs exceeding the reduction in earning rates on assets. The bulk of the decreases in funding costs were in maturing time deposits. The majority of this portfolio has repriced at December 31, 2012 and continued reduction in time deposit costs are not anticipated. The volume of brokered time deposits will provide some reduction in funding cost in the near term as these deposits are not currently being replaced given the Corporation's current liquidity position. On the asset side, continued pricing pressure is being experienced in the marketplace and further erosion in the yield is expected. The Corporation monitors its exposure to changing interest rates using various tools and monitoring the maturities of its various financial instruments.

Average earning assets at December 31, 2012 were essentially flat with the prior year, decreasing $3.8 million, or 1.4%. Reduced loan balances were the primary cause of the decrease in average earning assets. Loan balances, including loans held for sale, the highest yielding component of earning assets, as a percentage of earning assets was consistent at 75.2% in both 2012 and 2011. Average interest bearing liabilities decreased 5.9% in 2012 and decreased 11.3% in 2011. Non-interest bearing deposits amounted to 27.0% of average earning assets in 2012 compared with 22.8% in 2011. It is anticipated that when interest rates increase to more historical levels that the non-interest balances will also see some decline.

TABLE 2

Dollars in thousands	Dec-12			Dec-11			Variance due to:	
	Avg. Bal.	Income	Yield	Avg. Bal.	Income	Yield	Rate	Volume
Assets:								
Short term investment	$ 9,200	$ 23	0.25%	$ 9,344	$ 35	0.37%	(11)	(1)
Securities:								
Taxable	53,494	1,081	2.02%	53,779	1,354	2.52%	(266)	(7)
Tax-exempt	3,336	119	5.49%	3,712	150	6.22%	(17)	(14)
Total Securities	56,830	1,200	2.22%	57,491	1,504	2.76%	(276)	(28)
Loans:								
Commercial loans	146,966	8,293	5.65%	154,107	8,815	5.75%	(139)	(383)
Consumer loans	24,369	1,350	5.52%	27,117	1,566	5.77%	(65)	(151)
Mortgage loans	28,817	1,327	4.59%	21,903	1,223	5.58%	(134)	238
Total Loans	200,152	10,970	5.48%	203,127	11,604	5.73%	(446)	(188)
Total earning assets/interest income	266,182	12,193	4.75%	269,962	13,143	4.89%	(737)	(213)
Cash and cash equivalents	21,316			20,379				
Investment security fair value adjustment	261			106				
Bank premises and equipment	10,248			10,287				
Bank owned life insurance	5,999			5,864				
Other real estate	2,692			3,517				
Allowance for loan loss	(7,262)			(9,345)				
Other non-earning assets	4,308			3,819				
Total Assets	$ 303,744			$ 304,589				
Liabilities:								
Deposits:								
Interest bearing DDA	$ 2,665	$ 2	0.07%	$ 2,326	$ 2	0.09%	-	-
Money market savings	46,750	56	0.12%	44,352	52	0.12%	1	3
Savings	72,162	66	0.09%	68,540	63	0.09%	-	3
Retail time deposits	64,684	997	1.54%	70,409	1,328	1.89%	(230)	(101)
Brokered time deposits	9,932	378	3.80%	23,439	1,033	4.41%	(127)	(528)
Total Deposits	196,193	1,499	0.76%	209,066	2,478	1.19%	(350)	(629)
Borrowings:								
Federal funds purchased	-	-	0.00%	-	-	0.00%	-	-
Advances from FHLB of Indianapolis	903	66	7.29%	935	68	7.27%	-	(2)
Trust preferred securities	14,036	380	2.70%	14,000	437	3.12%	(58)	1
Other borrowings	-	-	0.00%	404	-	0.00%	-	-
Total Borrowings	14,939	446	2.98%	15,339	505	3.29%	(58)	(1)
Total interest bearing liabilities/interest expense	211,132	1,945	0.92%	224,405	2,983	1.33%	(405)	(633)
Non-interest bearing deposits	71,914			61,457				
Other non-rate bearing liabilities	3,329			3,261				
Shareholders' equity	17,369			15,466				
Total liabilities and shareholders' equity	303,744			304,589				
Interest spread		10,248	3.83%		10,160	3.56%	(135)	223
Net Interest Margin			4.00%			3.78%		

NON-INTEREST INCOME

Non-interest income declined slightly from $4.86 million in 2011 to $4.84 million in 2012. Services charges on deposit accounts declined $125,000 year over year, mostly due to new regulations restricting the amount of overdraft fees that the Corporation is permitted to charge. Other income and fees declined $283,000 primarily due to a reduction in fee income from providing information technology services to a 3rd party. In addition, in the third quarter of 2011, the Bank sold a former retail office location and accordingly recorded a gain on sale of $350,000 which was not repeated in 2012. These declines were mostly offset by increases in mortgage banking income of $613,000 and trust and investment services of $111,000.

NON-INTEREST EXPENSE

Total non-interest expense was $14.26 million and $13.83 million in 2012 and 2011, respectively an increase of $430,000 or 3.1%. Loan and collection expenses were $944,000 in 2012 compared to $1.22 million in 2011. The decrease 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 expense, collection expenses and expenses related to impaired loans. It is anticipated that as the pool of impaired loans continues to decrease that these expenses will see a slight decrease on an ongoing basis. Advertising expenses were $164,000 in 2012 compared to $129,000 in 2011, an increase of 27.1%. The Corporation has resumed advertising campaigns with the goal of attracting new customers for lending and deposit products, while also strengthening our presence in local communities through sponsorships of community events. Other professional service fees include audit fees, consulting fees, legal fees, branch security costs, and various other professional services. Other professional services were $1.05 million in 2012 compared to $1.17 million in 2011. The variance was primarily caused by reduced non-loan legal expenses. Other general and administrative expenses, including telephone and communication services, were $3.0 million in 2012, an increase of $840,000 or 38.9%, compared to $2.16 million in 2011. The increase was driven mostly by losses on robberies and other retail fraud of $384,000, increased FDIC assessment accruals of $216,000 and deficiency settlements on previously sold mortgage loans of $362,000. None of these items are anticipated to recur in future periods.

FINANCIAL CONDITION

The Corporation's total assets increased $11.86 million, or 3.97% during 2012. The bulk of the increase in total assets was in cash and cash equivalents as declines were seen in both investment securities and the loan portfolio. The low rate environment created little incentive to deploy excess funds into the investment portfolio which declined 24.1% or $14.16 million and the competitive environment for loans, along with significant progress in working out of problem credits, caused a 2.9% reduction in the loan portfolio. Non-interest bearing deposits grew significantly from $62.71 million at December 31, 2011 to $80.55 million at December 31, 2012, an increase of $17.84 million, or 28.4%. This increase was also likely caused by the low rate environment incenting depositors to leave money in historically lower yielding, fully insured accounts. Management anticipates some of this increase to flow out should rates return to historical norms. Interest bearing accounts declined modestly from the prior year primarily due to maturing time deposits. Finally, capital levels were strengthened as a result of the Corporation's net income.

CREDIT QUALITY

At December 31, 2012, the allowance for loan losses was $5.0 million or 2.48% of total loans. This compares with $8.2 million or 3.97% at December 31, 2011, which represents a decrease of $3.2 million during 2012. The recorded investment in impaired loan levels decreased $13.6 million when comparing amounts outstanding at December 31, 2012 to December 31, 2011. Net charge-offs decreased $3.5 million during 2012 compared to 2011. The majority of the charge-offs in 2012 related to loans for which specific allocations were recorded at December 31, 2011.

Table 3 summarizes loan losses and recoveries from 2008 through 2012. During 2012, the Corporation experienced net charge-offs of $2.7 million, compared with net charge-offs of $6.2 million in 2011. The year to year decrease in charge offs was primarily due to a decrease in commercial real estate loan charge offs. The decrease in charge offs is a reflection of and improvement in the market value of real estate in Michigan as well as a more aggressive collection and restructuring efforts. Commercial loan charge offs increased $607,000, mortgage loan charge offs increased by $310,000, installment loan charge offs decreased $142,000 and home equity charge offs increased by $217,000. Total recoveries increased by $683,000 comparing 2012 with 2011. The bulk of this increase in recoveries related to one large commercial credit charged off during 2011.

TABLE 3
Analysis of the Allowance for Loan Losses

(000s omitted)	2012	2011	Years Ended December 31, 2010	2009	2008
Balance Beginning of Year	$ 8,164	$ 11,224	$ 8,786	$ 7,546	$ 5,158
Charge-offs:					
Commercial	(785)	(178)	(438)	(1,487)	(1,077)
Commercial real estate	(2,249)	(6,066)	(5,276)	(7,090)	(1,917)
Residential real estate	(424)	(114)	(333)	(716)	(203)
Installment loans	(37)	(179)	(212)	(286)	(203)
Home equity	(291)	(74)	(331)	(603)	(163)
Total Charge-offs	(3,786)	(6,611)	(6,590)	(10,182)	(3,563)
Recoveries:					
Commercial	71	95	180	51	222
Commercial real estate	976	253	633	192	0
Residential real estate	3	4	41	4	23
Installment loans	21	31	59	46	70
Home equity	21	26	8	15	84
Total Recoveries	1,092	409	921	308	399
Net Charge-offs	(2,694)	(6,202)	(5,669)	(9,874)	(3,164)
Provision for loan losses	(508)	3,142	8,107	11,114	5,552
Balance at End of Year	$ 4,962	$ 8,164	$ 11,224	$ 8,786	$ 7,546
Ratio of Net Charge-Offs During the Year	1.35%	3.01%	2.60%	3.92%	1.05%

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 (ORE) or deed-in-lieu of foreclosure. Table 4 shows a history of the Corporation’s non-performing assets. Non-performing loans decreased considerably from December 31, 2011 primarily due to more aggressive collection efforts. Additionally, loans delinquent 30-89 days, a leading indicator of future non-performing loans, declined from $3.3 million at December 31, 2011 to $328,000 at December 31, 2012.

TABLE 4
Non-Performing Assets and Past Due Loans

			December 31,		
(000s omitted)	2012	2011	2010	2009	2008
Non-performing loans:					
Loans past due 90 days or more & still accruing	$ 102	$ 488	$ 133	$ 319	$ 865
Non-accrual loans	5,583	16,558	20,132	15,025	21,204
Total non-performing loans	5,685	17,046	20,265	15,344	22,069
Other non-performing assets:					
Other real estate	2,579	1,949	3,407	4,201	2,651
Other real estate owned in redemption	714	223	1,632	3,602	1,005
Other non-performing assets	0	0	0	0	25

Total other non-performing assets	3,293	2,172	5,039	7,803	3,681
Total Non-Performing Assets	$ 8,978	$ 19,218	$ 25,304	$23,147	$ 25,750
Non-performing loans as a % of total loans	2.84%	8.28%	9.25%	6.30%	7.52%
Non-performing assets as a % of Total Loans and ORE	4.42%	9.25%	11.38%	9.35%	8.69%
Allowance for loan losses as a % of non-performing loans	87.28%	47.89%	55.39%	57.26%	34.19%
Non-performing assets as a % of total assets	2.89%	6.43%	5.96%	4.43%	4.45%

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.