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, 2013, 2012, 2011, 2010 and 2009. 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	**2013**	**2012**	**2011**	**2010**	**2009**
Summary of Consolidated Statements of Income:					
Interest income	$ 12,481	$ 12,193	$ 13,143	$ 15,536	$ 18,521
Interest expense	1,454	1,945	2,983	4,552	6,925
Net interest income	11,027	10,248	10,160	10,984	11,596
Provision for loan losses	7	(508)	3,142	8,107	11,134
Net interest income after provision	11,020	10,756	7,018	2,877	462
Total non-interest income	5,583	4,842	4,858	4,773	3,390
Total non-interest expense	13,235	14,261	13,827	13,209	14,712
Income (loss) before income taxes	3,368	1,337	(1,951)	(5,559)	(10,860)
Federal income taxes (benefit)	(5,118)	73	52	(207)	2,283
Income (loss) from continuing operations	8,486	1,264	(2,003)	(5,352)	(13,143)
Discontinued operations, net of tax	-	-	491	(33)	(3,837)
Net income (loss)	$ 8,486	$ 1,264	$ (1,512)	$ (5,385)	$ (16,980)
Income (loss) per share – basic*	$ 3.44	$ 0.52	$ (0.65)	$ (2.37)	$ (7.70)
Income (loss) per share – diluted*	$ 3.44	$ 0.52	$ (0.65)	$ (2.37)	$ (7.70)
Summary of Consolidated Balance Sheets:					
Assets	$335,225	$310,722	$298,861	$424,228	$ 522,079
Securities, including FHLB stock	36,574	48,249	62,311	46,965	40,200
Gross loans, including loans held for sale	263,978	200,526	205,890	218,981	243,384
Assets of discontinued operations	0	0	0	113,314	178,312
Deposits	283,341	275,839	265,881	275,977	311,551
Borrowings	24,855	14,891	14,923	15,833	15,145
Liabilities of discontinued operations	0	0	0	113,321	172,077
Shareholders' equity	24,762	16,203	14,660	16,055	20,532
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets (Bank)	11.04%	12.06%	11.00%	8.70%	7.60%
Total capital to risk weighted assets (Bank)	12.30%	13.34%	12.30%	10.00%	8.90%
Tier 1 capital to average assets (Bank)	9.50%	8.73%	8.10%	6.50%	6.20%
Impaired loans	8,657	16,528	30,091	35,413	28,439
Net Charge-offs	69	2,694	6,202	5,669	9,779
Book value per share*	$ 9.97	$ 6.69	$ 6.27	$ 6.95	$ 9.13
Year end market price per share*	$ 6.97	$ 3.50	$ 2.16	$ 1.75	$ 1.36
Return on average shareholders' equity	41.43%	8.19%	-9.29%	-28.52%	-61.18%
Return on average assets	2.63%	0.41%	-0.48%	-1.15%	-3.02%
Net interest margin	4.16%	4.00%	3.78%	3.77%	3.61%
Total equity to assets at year end	7.39%	5.21%	4.91%	3.78%	3.93%

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

RESULTS OF OPERATIONS

The Corporation posted net income of $8.5 million for the year ended December 31, 2013 compared to $1.3 million for the same period in 2012, an increase of 571.4%, driven largely by the $4.9 million reversal of a significant portion of the valuation allowance on the deferred tax asset along with continued growth in core earnings. Net interest income for the year ended 2013 increased by $779,000, or 7.6% compared to 2012. Continued solid credit quality eliminated the need for significant provision for loan losses in 2013, compared to the reversal of prior reserves taken in 2012. Other operating income for the year ended 2012 increased by $741,000, or 15.3%. Other operating expense decreased by $1.0 million, or 7.2% for the year ended 2013 compared to 2012. 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 2013 and 2012 respectively, the Corporation posted a return on average assets of 2.63% and 0.41%. Return on average equity was 41.43% in 2013 and 8.19% in 2012. The Corporation’s capital position experienced an increase in equity of $8.6 million or 52.8% in 2013. Total assets increased $24.5 million, or 7.9% during 2013. Diluted income per share was $3.44 in 2013 compared to $0.52 in 2012.

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, 2013 and 2012. 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 $779,000, or 7.6% in 2013 when compared to 2012. For the year ended December 31, 2013, the Corporation’s net interest margin was 4.16% compared with 4.00% in 2012. The improvement in 2013 is primarily attributable to decreased funding costs along with the redeployment of low-yielding cash and investments into the loan portfolio. The bulk of the decreases in funding costs were in maturing time deposits. The majority of this portfolio has repriced at December 31, 2013 and continued reduction in time deposit costs are not anticipated, absent a decline in interest rates. Brokered deposit maturities provided over 50% of the cost savings as those were not replaced during 2013. This product will likely be reintroduced in the future as part of the Corporation’s overall funding plan and interest rate risk mitigation strategy. The current marketplace in which the Corporation operates does not provide much opportunity to match desired loan maturities with retail time deposits, so as a result either wholesale funding or synthetic hedges may be used to manage interest rate risk. 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 including monitoring the maturities of its various financial instruments.

Average earning assets at December 31, 2013 were essentially flat with the prior year, increasing $2.5 million, or 0.9%. As discussed previously, decreases in cash and investments were more than offset by increased loan balances. As such, total Loans, the highest yielding component of earning assets, as a percentage of earning assets was increased from 75.2% in 2012 to 83.9% in 2013. Management is comfortable with this level and would expect this ratio to remain relatively constant in the near future. Average interest bearing liabilities decreased 0.6% in 2013, while non-interest bearing deposits increased 13.8%, or $9.9 million, more than offsetting the decline in rate bearing accounts. Non-interest bearing deposits grew to 30.4% of average earning assets in 2013 compared with 27.0% in 2012. It is anticipated that when interest rates increase to more historical levels that the non-interest balances may see some decline.

TABLE 2

Dollars in thousands	Dec-13			Dec-12			Variance due to:	
	Avg. Bal.	Income	Yield	Avg. Bal.	Income	Yield	Rate	Volume
Assets:								
Short term investment	$ 2,000	$ 6	0.30%	$ 9,200	$ 23	0.25%	1	(18)
Securities:								
Taxable	33,634	560	1.66%	53,494	1,081	2.02%	(168)	(354)
Tax-exempt	7,724	169	3.37%	3,336	119	5.49%	(21)	72
Total Securities	41,358	729	1.98%	56,830	1,200	2.22%	(189)	(282)
Loans:								
Commercial loans	158,330	8,699	5.51%	146,966	8,293	5.65%	(188)	594
Consumer loans	24,386	1,253	5.14%	24,369	1,350	5.52%	(98)	1
Mortgage loans	42,602	1,794	4.21%	28,817	1,327	4.59%	(98)	565
Total Loans	225,318	11,746	5.23%	200,152	10,970	5.48%	(384)	1,160
Total earning assets/interest income	268,676	12,481	4.71%	266,182	12,193	4.75%	(572)	860
Cash and cash equivalents	27,491			21,316				
Investment security fair value adjustment	(6)			261				
Bank premises and equipment	10,202			10,248				
Bank owned life insurance	6,123			5,999				
Other real estate	2,484			2,692				
Allowance for loan loss	(4,873)			(7,262)				
Other non-earning assets	2,904			4,308				
Total Assets	$ 313,001			$ 303,744				
Liabilities:								
Deposits:								
Interest bearing DDA	$ 2,719	$ 3	0.11%	$ 2,665	$ 2	0.07%	1	-
Money market savings	49,282	62	0.13%	46,750	56	0.12%	3	3
Savings	80,554	74	0.09%	72,162	66	0.09%	-	8
Retail time deposits	60,182	700	1.16%	64,684	997	1.54%	(232)	(66)
Brokered time deposits	1,156	26	2.25%	9,932	378	3.80%	(111)	(241)
Total Deposits	193,893	865	0.45%	196,193	1,499	0.76%	(339)	(296)
Borrowings:								
Federal funds purchased	-	-	0.00%	-	-	0.00%	-	-
Advances from FHLB of Indianapolis	2,036	71	3.49%	935	66	7.29%	(3)	8
Trust preferred securities	14,000	518	3.70%	14,000	380	2.70%	140	(1)
Other borrowings	-	-	0.00%	-	-	0.00%	-	-
Total Borrowings	16,036	589	3.67%	14,935	446	2.98%	(137)	7
Total interest bearing liabilities/interest expense	209,929	1,454	0.69%	211,132	1,945	0.92%	(202)	(289)
Non-interest bearing deposits	81,779			71,914				
Other non-rate bearing liabilities	3,152			3,329				
Shareholders' equity	18,141			17,369				
Total liabilities and shareholders' equity	313,001			303,744				
Interest spread		11,027	4.02%		10,248	3.83%	(370)	1,149
Net Interest Margin			4.16%			4.00%		

NON-INTEREST INCOME

Non-interest income increased $741,000, or 15.3% from $4.8 million in 2013 to $5.6 million in 2013. Increased mortgage banking income was the primary driver of the increase, rising $652,000 or 67.8%. The increased activity tapered off slightly in the latter half of the year, but remained strong relative to prior periods and was due primarily to the continued low interest rate environment and bolstered further by a slight improvement in local real estate values. A similar increase is not anticipated going forward. Other income and fees also showed a significant increase, rising 18.3% or $322,000 year over year. This increase was primarily derived from gains on sales of ORE and other gains from settlement of troubled debts. This level of gain is not anticipated to be sustained in the future. Offsetting these increases was a decline in service charges on deposit accounts of $133,000, or 12.9% mostly due to continued market pressures on deposit fees and more significantly to new regulations limiting the Bank's ability to charge NSF fees on checking accounts.

NON-INTEREST EXPENSE

Total non-interest expense was $13.2 million and $14.3 million in 2013 and 2012, respectively, a decrease of $1.0 million or 7.2%. Loan and collection expenses were $688,000 in 2013 compared to $944,000 in 2012. 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. Advertising expenses were $314,000 in 2013 compared to $164,000 in 2012, an increase of 91.5%. The Corporation has continued to invest in marketing 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 service fees. Other professional services were $877,000 in 2013 compared to $1.05 million in 2012. The variance was primarily caused by reduced audit costs and non-lending related legal fees. These decreases were largely caused by the decision made in the fourth quarter of 2012 to deregister from SEC reporting. Other general and administrative expenses, including telephone and communication services, were $2.3 million in 2013, a decrease of $895,000 or 28.2%, compared to $3.2 million in 2012. The decrease was driven mostly by the absence in 2013 of items recognized in 2012. These items included losses on robberies and other retail fraud which declined $411,000, and deficiency settlements on previously sold mortgage loans which declined $157,000. Additionally, FDIC assessment accruals decreased $400,000 year over year, largely due to the improved financial condition of The State Bank. These declines were partially offset by the cost of increased security measures at a specific branch location in response to the robberies in 2012, which increased $121,000. None of these items are anticipated to recur in future periods.

FINANCIAL CONDITION

The Corporation's total assets increased $24.5 million, or 7.9% during 2013. The bulk of the increase in total assets was in the loan portfolio, which increased $63.3 million, or 32.5%. This increase was funded largely through decreases in both investment securities and cash and cash equivalents. Cash and cash equivalents decreased $32.8 million, or 71.9% while investment security balances declined $11.7 million or 24.5%. Additionally, a significan portion of the deferred tax asset valuation allowance was reversed in 2013, causing a $4.9 million increase in total assets. The remainder of the funding for the loan growth came in the form of a $7.5 million, or 2.7% increase in total deposits. Both interest-bearing and non-interest bearing accounts increased, though the highest cost time deposit portfolio showed a decline year over year. As with the prior year, this increase was 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. During the fourth quarter the Bank took out a $10.0 million advance from the Federal Home Loan Bank primarily for Asset/Liability Management purposes to reduce exposure to rising rates. Finally, capital levels were strengthened as a result of the Corporation's net income and the aforementioned reversal of a significant portion of the deferred tax asset valuation allowance.

CREDIT QUALITY

At December 31, 2013, the allowance for loan losses was $4.9 million or 1.86% of total loans. This compares with $5.0 million or 2.48% at December 31, 2012, which represents a decrease of $100,000 during 2013. Loans on non-accrual status decreased $3.7 million when comparing amounts outstanding at December 31, 2013 and December 31, 2012. Net charge-offs decreased $2.6 million during 2013.

Table 3 summarizes loan losses and recoveries from 2009 through 2013. During 2013, the Corporation experienced net charge-offs of $69,000, compared with net charge-offs of $2.7 million in 2012. All of the loan portfolios showed significant declines in net charge offs compared to 2012. 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, 2013	2012	2011	2010	2009
Balance Beginning of Year	$ 4,692	$ 8,164	$ 11,224	$ 8,786	$ 7,546
Charge-offs:					
Commercial	(154)	(785)	(178)	(438)	(1,487)
Commercial real estate	(630)	(2,249)	(6,066)	(5,276)	(7,090)
Residential real estate	(73)	(424)	(114)	(333)	(716)
Installment loans	(12)	(37)	(179)	(212)	(286)
Home equity	(33)	(291)	(74)	(331)	(603)
Total Charge-offs	(902)	(3,786)	(6,611)	(6,590)	(10,182)
Recoveries:					
Commercial	145	71	95	180	51
Commercial real estate	580	976	253	633	192
Residential real estate	19	3	4	41	4
Installment loans	33	21	31	59	46
Home equity	56	21	26	8	15
Total Recoveries	833	1,092	409	921	308
Net Charge-offs	(69)	(2,694)	(6,202)	(5,669)	(9,874)
Provision for loan losses	7	(508)	3,142	8,107	11,114
Balance at End of Year	$ 4,900	$ 4,962	$ 8,164	$ 11,224	$ 8,786
Net Charge-Offs/Period End Loans	0.03%	1.35%	3.01%	2.60%	3.92%

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, 2012 primarily due to more aggressive collection efforts. Additionally, loans delinquent 30-89 days, a leading indicator of future non-performing loans, remain at very low levels.

TABLE 4
Non-Performing Assets and Past Due Loans

(000s omitted)	December 31, 2013	2012	2011	2010	2009
Non-performing loans:					
Loans past due 90 days or more & still accruing	$ -	$ 102	$ 488	$ 133	$ 319
Non-accrual loans	1,980	5,583	16,558	20,132	15,025
Total non-performing loans	1,980	5,685	17,046	20,265	15,344
Other non-performing assets:					
Other real estate	2,594	2,579	1,949	3,407	4,201
Other real estate owned in redemption	99	714	223	1,632	3,602
Total other non-performing assets	2,693	3,293	2,172	5,039	7,803
Total Non-Performing Assets	$ 4,673	$ 8,978	$ 19,218	$ 25,304	$23,147
Non-performing loans as a % of total loans	0.75%	2.84%	8.28%	9.25%	6.30%
Non-performing assets as a % of Total Loans and ORE	1.75%	4.42%	9.25%	11.38%	9.35%
Allowance for loan losses as a % of non-performing loans	247.47%	87.28%	47.89%	55.39%	57.26%
Non-performing assets as a % of total assets	1.39%	2.89%	6.43%	5.96%	4.43%

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.