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, 2014, 2013, 2012, 2011, and 2010. 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	**2014**	**2013**	**2012**	**2011**	**2010**
Summary of Consolidated Statements of Income:					
Interest income	$ 14,655	$ 12,481	$ 12,193	$ 13,143	$ 15,536
Interest expense	1,713	1,454	1,945	2,983	4,552
Net interest income	12,942	11,027	10,248	10,160	10,984
Provision for loan losses	(450)	7	(508)	3,142	8,107
Net interest income after provision	13,392	11,020	10,756	7,018	2,877
Total non-interest income	5,725	5,583	4,842	4,858	4,773
Total non-interest expense	14,029	13,235	14,261	13,827	13,209
Income (loss) before income taxes	5,088	3,368	1,337	(1,951)	(5,559)
Federal income taxes (benefit)	1,728	(5,118)	73	52	(207)
Income (loss) from continuing operations	3,360	8,486	1,264	(2,003)	(5,352)
Discontinued operations, net of tax	-	-	-	491	(33)
Net income (loss)	$ 3,360	$ 8,486	$ 1,264	$ (1,512)	$ (5,385)
Income (loss) per share – basic*	$ 1.35	$ 3.44	$ 0.52	$ (0.65)	$ (2.37)
Income (loss) per share – diluted*	$ 1.35	$ 3.44	$ 0.52	$ (0.65)	$ (2.37)
Summary of Consolidated Balance Sheets:					
Assets	$393,582	$335,225	$310,722	$298,861	$424,228
Securities, including FHLB stock	33,008	36,574	48,249	62,311	46,965
Gross loans, including loans held for sale	319,969	263,978	200,526	205,890	218,981
Assets of discontinued operations	-	-	-	-	113,314
Deposits	327,923	283,341	275,839	265,881	275,977
Borrowings	34,817	24,855	14,891	14,923	15,833
Liabilities of discontinued operations	-	-	-	-	113,321
Shareholders' equity	28,142	24,762	16,203	14,660	16,055
Other Financial and Statistical Data:					
Tier 1 capital to risk weighted assets (Bank)	11.70%	11.80%	12.06%	11.00%	8.70%
Total capital to risk weighted assets (Bank)	12.90%	13.10%	13.34%	12.30%	10.00%
Tier 1 capital to average assets (Bank)	9.70%	10.00%	8.73%	8.10%	6.50%
Impaired loans	5,925	8,657	16,528	30,091	35,413
Net charge-offs	44	69	2,694	6,202	5,669
Book value per share*	$ 11.24	$ 9.97	$ 6.69	$ 6.27	$ 6.95
Year end market price per share*	$ 9.90	$ 6.97	$ 3.50	$ 2.16	$ 1.75
Return on average shareholders' equity	13.03%	41.43%	8.19%	-9.29%	-28.52%
Return on average assets	0.94%	2.63%	0.41%	-0.48%	-1.15%
Net interest margin	4.04%	4.16%	4.00%	3.78%	3.77%
Total equity to assets at year end	7.15%	7.39%	5.21%	4.91%	3.78%

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

RESULTS OF OPERATIONS

The Corporation posted net income of $3.4 million for the year ended December 31, 2014 compared to $8.5 million for the same period in 2013, a decrease of 60.4%, driven largely by the $4.9 million reversal of a significant portion of the valuation allowance on the deferred tax asset in 2013. Pre-tax earnings increased year over year by 51.1%, or $1.7 million, from $3.4 million in 2013 to $5.1 million in 2014. Net interest income for the year ended 2014 increased by $1.9 million, or 17.4% compared to 2013. Continued solid credit quality eliminated the need for provision for loan losses in 2014, actually resulting in a credit for provisions taken in prior years. Other operating income for the year ended 2014 increased by $142,000, or 2.5%. Other operating expense increased by $793,000, or 6.0% for the year ended 2014 compared to 2013. 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 2014 and 2013 respectively, the Corporation posted a return on average assets of 0.94% (1.42% pre-tax) and 2.63% (1.04% pre-tax). Return on average equity was 13.03% (19.73% pre-tax) in 2014 and 41.43% (16.44%) in 2013. Pre-tax numbers are shown due to the significant impact of the tax benefit in 2013. The Corporation's capital position experienced an increase in equity of $3.4 million or 13.6% in 2014. Total assets increased $58.3 million, or 17.4% during 2014. Income per share was $1.35 in 2014 compared to $3.44 in 2013.

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, 2014 and 2013. 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 $1.9 million, or 17.4% in 2014 when compared to 2013. For the year ended December 31, 2014, the Corporation's net interest margin was 4.04% compared with 4.16% in 2013. The decrease in net interest margin in 2014 is primarily attributable to the higher cost of wholesale funding utilized to lengthen the maturity of liabilities in order to mitigate future interest rate risk. In 2014, the marketplace in which the Corporation operates continued to be averse to term deposits desired to match terms of new assets originated, therefore, some wholesale funding was used to manage interest rate risk. Brokered CDs, Qwickrate CDs and FHLB Advances contributed to 16.32% of deposits and 14.03% of funding. Depending on our continued ability to generate variable rate assets, this strategy may be set aside to focus on short-term funding. 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, 2014 increased $54.2 million, or 20.2%. Total loans, the highest yielding component of earning assets, increased from 83.9% in 2013 to 89.0% in 2014 as a percentage of earning assets. Management is comfortable with this level and would expect this ratio to remain relatively constant in the near future. Average interest bearing liabilities increased 16.4%, or $34.3 million during 2014, while non-interest bearing deposits increased 4.9%, or $4 million. Non-interest bearing deposits fell to 26.6% of average earning assets in 2014 compared with 30.4% in 2013. It is anticipated that when interest rates increase to historical levels 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.

TABLE 2

Dollars in thousands	Dec-14			Dec-13			Variance due to:	
	Average Balance	Income	Yield	Average Balance	Income	Yield	Rate	Volume
Assets:								
Short term investment	$ 667	$ 2	0.30%	$ 2,000	$ 6	0.30%	$ -	$ (4)
Securities:								
Taxable	26,431	635	2.40%	33,634	560	1.66%	145	(70)
Tax-exempt	8,472	169	3.07%	7,724	169	3.37%	-	-
Total Securities	34,903	804	2.56%	41,358	729	1.98%	145	(70)
Loans:								
Commercial loans	187,445	9,673	5.17%	158,330	8,699	5.51%	(486)	1,460
Consumer loans	26,378	1,258	4.77%	24,386	1,253	5.14%	(38)	43
Mortgage loans	73,482	2,919	3.97%	42,602	1,794	4.21%	(96)	1,221
Total Loans	287,305	13,850	4.83%	225,318	11,746	5.23%	(620)	2,724
Total earning assets/interest income	322,875	14,656	4.57%	268,676	12,481	4.71%	(474)	2,650
Cash and cash equivalents	15,010			27,491				
Investment security fair value adjustment	244			(111)				
Bank premises and equipment	10,024			10,202				
Bank owned life insurance	6,261			6,123				
Other real estate	2,317			2,484				
Allowance for loan losses	(4,859)			(4,873)				
Other non-earning assets	7,200			3,009				
Total assets	$ 359,072			$ 313,001				
Liabilities:								
Deposits:								
Interest bearing DDA	$ 2,529	$ 3	0.12%	$ 2,719	$ 3	0.11%	-	-
Money market savings	49,296	62	0.13%	49,282	62	0.13%	-	-
Savings	87,260	85	0.10%	80,554	74	0.09%	4	7
Retail time deposits	61,040	620	1.02%	60,182	700	1.16%	(90)	10
Brokered time deposits	16,893	249	1.47%	1,156	26	2.25%	(6)	229
Total Deposits	217,018	1,019	0.47%	193,893	865	0.45%	(92)	246
Borrowings:								
Federal funds purchased	57	-	-	-	-	0.00%	-	-
Advances from FHLB of Indianapolis	13,186	195	1.48%	2,036	71	3.49%	(15)	139
Trust preferred securities	14,018	496	3.54%	14,000	518	3.70%	(23)	1
Other borrowings	-	-	0.00%	-	-	0.00%	-	-
Total Borrowings	27,261	691	2.53%	16,036	589	3.67%	(38)	140
Total interest bearing liabilities/interest expense	244,279	1,710	0.70%	209,929	1,454	0.69%	(130)	386
Non-interest bearing deposits	85,754			81,779				
Other non-rate bearing liabilities	3,255			3,152				
Shareholders' equity	25,785			18,141				
Total liabilities and shareholders' equity	$ 359,072			$ 313,001				
Interest spread		$ 12,946	3.87%		$11,027	4.02%	$(344)	$ 2,264
Net Interest Margin			4.04%			4.16%		

NON-INTEREST INCOME

Non-interest income increased $142,000, or 2.5% from $5.6 million in 2013 to $5.7 million in 2014. Gains on sales of securities contributed to the bulk of the increase year over year. This level of gain is not anticipated to continue in future years. Additionally, trust income, primarily fixed annuity income, also increased year over year, rising $232,000 or 23.3%. Offsetting this increase was a decline in mortgage banking revenue, which fell 17.0%, or $274,000 year over year. This revenue is highly dependent on market rates and therefore difficult to predict on a prospective basis.

NON-INTEREST EXPENSE

Total non-interest expense was $14.0 million and $13.2 million in 2014 and 2013, respectively, an increase of $794,000 or 6.0%. Loan and collection expenses were $652,000 in 2014 compared to $688,000 in 2013. 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 $382,000 in 2014 compared to $314,000 in 2013, an increase of 21.7%. 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 $1.0 million in 2014 compared to $877,000 in 2013. The variance was primarily caused by an increase in payroll fees and an increase in Michigan financial institution taxes. Other general operating expenses, including telephone and communication services, were $1.7 million in 2014, a decrease of $424,000 or 19.6%, compared to $2.1 million in 2013. This decrease was due largely to a reduction in mortgage buyback activity from 2013 to 2014. Additionally, FDIC assessment accruals decreased $170,000 year over year, largely due to the continuous improved financial condition of The State Bank.

FINANCIAL CONDITION

The Corporation's total assets increased $58.3 million, or 17.4% during 2014. The increase in total assets was a combination of loans and deposits. The loan portfolio increased $56.0 million, or 21.2%. This increase was funded largely through wholesale funding, which in turn, stabilized the Corporation's interest rate risk. Total deposits also did well increasing 15.7% from $283.3 million at December 31, 2013 to $327.9 million at December 31, 2014. Both interest-bearing and non-interest bearing accounts increased in 2014, however a significant portion of this increase was from brokered time deposits as mentioned before. Management anticipates some of this increase to flow out should rates return to historical norms. During the fourth quarter of 2014 the Bank took out an additional $10.0 million advance from the Federal Home Loan Bank primarily for Asset/Liability Management purposes to reduce exposure to rising rates.

CREDIT QUALITY

At December 31, 2014, the allowance for loan losses was $4.4 million or 1.38% of total loans. This compares with $4.9 million or 1.86% at December 31, 2013, which represents a decrease of $494,000 during 2014. Net charge-offs decreased $25,000 during 2014.

Table 3 summarizes loan losses and recoveries from 2010 through 2014. During 2014, the Corporation experienced net charge-offs of $44,000, compared with net charge-offs of $69,000 in 2013. 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, 2014	2013	2012	2011	2010
Balance Beginning of Year	$ 4,900	$ 4,692	$ 8,164	$ 11,224	$ 8,786
Charge-offs:					
Commercial	(14)	(154)	(785)	(178)	(438)
Commercial real estate	(296)	(630)	(2,249)	(6,066)	(5,276)
Residential real estate	(12)	(73)	(424)	(114)	(333)
Installment loans	(53)	(12)	(37)	(179)	(212)
Home equity	(39)	(33)	(291)	(74)	(331)
Total Charge-offs	(414)	(902)	(3,786)	(6,611)	(6,590)
Recoveries:					
Commercial	67	145	71	95	180
Commercial real estate	269	580	976	253	633
Residential real estate	2	19	3	4	41
Installment loans	12	33	21	31	59
Home equity	20	56	21	26	8
Total Recoveries	370	833	1,092	409	921
Net Charge-offs	(44)	(69)	(2,694)	(6,202)	(5,669)
Provision for loan losses	(450)	7	(508)	3,142	8,107
Balance at End of Year	$ 4,406	$ 4,900	$ 4,962	$ 8,164	$ 11,224
Net Charge-Offs/Period End Loans	0.01%	0.03%	1.35%	3.01%	2.60%

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 continue to decrease from December 31, 2013 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, 2014	2013	2012	2011	2010
Non-performing loans:					
Loans past due 90 days or more & still accruing	$ -	$ -	$ 102	$ 488	$ 133
Non-accrual loans	187	1,980	5,583	16,558	20,132
Total non-performing loans	187	1,980	5,685	17,046	20,265
Other non-performing assets:					
Other real estate	2,488	2,594	2,579	1,949	3,407
Other real estate owned in redemption	-	99	714	223	1,632
Total other non-performing assets	2,488	2,693	3,293	2,172	5,039
Total non-performing assets	$ 2,675	$ 4,673	$ 8,978	$ 19,218	$ 25,304
Non-performing loans as a % of total loans	0.06%	0.75%	2.84%	8.28%	9.25%
Non-performing assets as a % of total loans and ORE	0.84%	1.75%	4.42%	9.25%	11.38%
Allowance for loan losses as a % of non-performing loans	2,356.15%	247.47%	87.28%	47.89%	55.39%
Non-performing assets as a % of total assets	0.68%	1.39%	2.89%	6.43%	5.96%

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.