100883

Consolidated Financial Statements
Years Ended December 31, 2017 and 2016

Fentura Financial, Inc.

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INDEPENDENT AUDITORS' REPORT

March 21, 2018

Shareholders and Board of Directors Fentura Financial, Inc.
Fenton, Michigan

We have audited the accompanying consolidated financial statements of ***Fentura Financial, Inc.*** (the "Corporation"), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Independent Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Fentura Financial, Inc. as of December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Consolidated Balance Sheets
(Dollars in thousands except per share amounts)

	December 31	
	2017	2016
ASSETS		
Cash and due from banks	$ 15,928	$ 59,713
Federal funds sold	-	18,600
Cash and cash equivalents	**15,928**	**78,313**
Securities, available-for-sale (AFS)	51,720	68,572
Securities, held-to-maturity (HTM)	3,603	3,886
Total securities	**55,323**	**72,458**
Loans held for sale	**2,067**	**3,869**
Loans	672,530	515,775
Less allowance for loan losses	3,603	2,851
Net loans	**668,927**	**512,924**
Premises and equipment, net	14,448	12,113
Bank owned life insurance	9,763	9,649
Federal Home Loan Bank (FHLB) stock	2,925	1,774
Accrued interest receivable	2,393	1,896
Other real estate owned	92	250
Goodwill	3,219	3,219
Core deposit intangibles	1,895	2,526
Other assets	4,463	4,359
Total assets	**$ 781,443**	**$ 703,350**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Noninterest-bearing deposits	$ 216,607	$ 160,903
Interest-bearing deposits	456,898	442,464
Total deposits	**673,505**	**603,367**
FHLB advances	30,000	30,000
Subordinated debentures	14,000	14,000
Federal funds purchased	2,000	-
Senior debt	-	1,000
Accrued interest and other liabilities	2,491	4,323
Total liabilities	**721,996**	**652,690**
Shareholders' equity		
Common stock, no par value; 5,000,000 shares authorized, 3,631,933 in 2017 (3,619,282 in 2016) shares issued and outstanding	58,961	58,734
Retained earnings (accumulated deficit)	156	(7,847)
Accumulated other comprehensive income (loss)	330	(227)
Total shareholders' equity	**59,447**	**50,660**
Total liabilities and shareholders' equity	**$ 781,443**	**$ 703,350**

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income
(Dollars in thousands except per share amounts)

	Year Ended December 31	
	2017	2016
Interest and dividend income		
Loans, including fees	$ 28,765	$ 18,119
Investments		
Taxable	939	355
Tax-exempt	238	99
Cash and cash equivalents	88	13
Federal Home Loan Bank Stock	81	59
Total interest and dividend income	**30,111**	**18,645**
Interest expense		
Deposits	1,890	1,394
Borrowings	1,230	978
Total interest expense	3,120	**2,372**
Net interest income	26,991	**16,273**
Provision for loan losses	609	(900)
Net interest income, after provision for loan losses	26,382	**17,173**
Noninterest income		
Service charges on deposit accounts	1,217	779
ATM and debit card income	1,474	1,150
Net gain on sales of mortgage loans	1,231	1,886
Trust and investment services	1,424	1,367
Other income and fees	3,642	1,476
Total noninterest income	8,988	**6,658**
Noninterest expenses		
Compensation	12,437	9,544
Occupancy	1,569	1,142
Furniture and equipment	1,706	1,192
Loan and collection	548	561
Advertising and promotional	598	524
Telephone and communication	433	267
Acquisition related	646	728
Professional services	2,533	1,469
Other general and administrative	3,348	1,670
Total noninterest expenses	**23,818**	**17,097**
Income before federal income taxes	11,552	6,734
Federal income taxes	2,876	2,293
Net income	$ 8,676	$ 4,441
Earnings per share	$ 2.39	$ 1.70

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Comprehensive Income

(Dollars in thousands)

	Year Ended December 31	
	2017	2016
Net Income	$ 8,676	$ 4,441
Other comprehensive income (loss)		
Unrealized gains (losses) on investment securities available for sale	527	(110)
Net unrealized cash flow hedge gains (losses) arising during the year	98	(49)
Reclassification from AOCI resulting from the enactment of the Tax Act. [1]	(52)	-
Other comprehensive income (loss) before income taxes	**573**	**(159)**
Income tax (provision) benefit related to other comprehensive income (loss)	(16)	54
Other comprehensive income (loss)	**557**	**(105)**
Comprehensive income	**$ 9,233**	**$ 4,336**

[1] The reclassification from accumulated comprehensive income (loss) to retained earnings (accumulated deficit) is due to the early adoption of ASU 2018-02; refer to Notes 1 and 14 for futher details on the adoption.

The accompanying notes are an integral part of these consolidated financial statements.

Consoldiated Statements of Shareholders' Equity
(Dollars in thousands except per share amounts)

	Common Stock				
	Common Shares Outstanding	Amount	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
Balances, January 1, 2016	**2,517,748**	**$ 43,873**	**$ (11,277)**	**$ (122)**	**$ 32,474**
Issuance of common shares under stock purchase and dividend reinvestment plans	30,106	422	-	-	422
Issuance of common shares in private placements, net of issuance costs	1,071,428	14,439	-	-	14,439
Cash dividends paid	-	-	(1,011)	-	(1,011)
Comprehensive income	-	-	4,441	(105)	4,336
Balances, December 31, 2016	3,619,282	58,734	**(7,847)**	**(227)**	50,660
Issuance of common shares under stock purchase and dividend reinvestment plans	12,651	227	-	-	227
Reclassification from AOCI resulting from the enactment of the Tax Act. [1]			52	(52)	-
Cash dividends paid	-	-	(725)	-	(725)
Comprehensive income	-	-	8,676	609	9,285
Balances, December 31, 2017	**3,631,933**	**$ 58,961**	**$ 156**	**$ 330**	**$ 59,447**

[1] The reclassification from accumulated comprehensive income (loss) to retained earnings (accumulated deficit) is due to the early adoption of ASU 2018-02; refer to Notes 1 and 14 for futher details on the adoption.

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

(Dollars in thousands)

	Year Ended December 31	
	2017	2016
Cash flows from operating activities		
Net income	$ 8,676	$ 4,441
Adjustments to reconcile net income to net cash provided by operating activities, net in 2016 of business combination		
Depreciation	910	750
Net amortization (accretion) on securities	417	(169)
Amortization of mortgage servicing rights	538	477
Amortization of core deposit intangibles	631	-
Provision for loan losses	609	(900)
Mortgage loans originated for sale	(77,540)	(101,628)
Proceeds from sale of mortgage loans	80,573	102,550
Net (gains) losses on sales of mortgage loans	(1,231)	(1,886)
Net (gains) losses on sales of foreclosed assets	(11)	(11)
Write-down of foreclosed assets	46	-
Net (gains) losses on sales of premises and equipment	150	-
Net (gains) losses on redemptions of bank owned life insurance	(1,155)	-
Deferred income tax (benefit) expense	2,468	1,296
Increase in cash surrender value of bank owned life insurance	(217)	(217)
Net (increase) decrease in interest receivable and other assets	(3,525)	(76)
Net increase (decrease) in accrued interest payable and other liabilities	(1,832)	999
Net cash provided by (used in) operating activities	**9,507**	**5,626**
Cash flows from investing activities		
Activity in AFS securities		
Sales, calls, maturities, and principal paydowns	22,291	7,259
Purchases	(5,293)	-
Activity in HTM securities		
Sales, calls, maturities, and principal paydowns	247	414
Purchases	-	(2,124)
Net loan principal (originations) collections	(156,681)	(52,792)
Proceeds from sales of foreclosed assets	192	206
Purchases of FHLB stock	(1,151)	(464)
Net purchases of premises and equipment	(3,395)	(498)
Proceeds from redemption of bank owned life insurance	1,258	-
Acquisition, net of cash acquired	-	21,170
Net cash provided by (used in) investing activities	**(142,532)**	**(26,829)**
Cash flows from financing activities		
Net increase (decrease) in deposits	70,138	56,016
Cash dividends paid	(725)	(1,011)
Net advances (repayments) on line of credit	(1,000)	1,000
Net advances (repayments) from FHLB	2,000	9,225
Net proceeds from common stock issuance	227	14,861
Net cash provided by (used in) financing activities	**70,640**	**80,091**
Net change in cash and cash equivalents	**(62,385)**	**58,888**
Cash and cash equivalents, beginning of year	78,313	19,425
Cash and cash equivalents, end of year	**$ 15,928**	**$ 78,313**
Supplemental cash flows information:		
Interest paid	$ 3,014	$ 2,331
Income taxes paid	$ 2,275	$ 169
Transfers of loans to other real estate	$ 69	$ 98
Loans provided for sales of other real estate owned	$ -	$ 162
Business Combinations		
Fair value of tangible assets acquired	$ -	$ 144,481
Goodwill, mortgage servicing rights, and core deposit intangible asset acquired	$ -	$ 5,925
Liabilities assumed	$ -	$ 171,576

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands except per share amounts)

Note 1 – Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations and Principles of Consolidation

The consolidated financial statements include Fentura Financial, Inc. (the "Parent") and its wholly owned subsidiaries Fentura Holdings LLC ("FHLLC") and The State Bank ("the Bank"), (collectively the "Corporation"). Intercompany transactions and balances are eliminated in consolidation.

The Corporation provides banking and trust services principally to individuals, small businesses and governmental entities through its fifteen community banking offices in Genesee, Livingston, Oakland, Saginaw and Shiawassee Counties in central and southeastern Michigan. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets and real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by both residential and commercial real estate. The Corporation's exposure to credit risk is substantially affected by the economy in the Corporation's market area and by changes in commercial real estate values. While the loan portfolio is substantially commercial based, the Corporation is not dependent on any single borrower. Refer to Note 6 for further disclosures related to the composition of the loan portfolio.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the consolidated financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the fair value amounts related to business combinations, the fair values of securities and derivatives, and other financial instruments, other-than-temporary impairment of securities, goodwill and other intangible asset impairment and the carrying value of deferred income taxes are particularly subject to change.

Business Combinations

Pursuant to the guidance of Accounting Standards Codification ("ASC") Topic 805, Business Combinations ("ASC 805"), the Corporation recognizes assets acquired, including identified intangible assets, and the liabilities assumed in acquisitions at their fair values as of the acquisition date, with the acquisition-related transaction costs expensed in the period incurred.

On December 31, 2016, the Corporation acquired all of the outstanding common stock of Community Bancorp, Inc. in St. Charles, Michigan ("Community") for total cash consideration of approximately $21.6 million. The Corporation recorded approximately $3.2 million of goodwill in conjunction with the acquisition, which represented the purchase price over the fair value of identifiable net assets acquired. Additionally, the Corporation recorded approximately $2.5 million of identifiable core deposit intangible assets in conjunction with the acquisition related to total deposits acquired of approximately $171.4 million.

See Note 2 for further information regarding the Corporation's acquisition activity.

Basis of Presentation

The cash consideration of $21.6 million paid to acquire Community was not actually disbursed to the transfer agent until January 4, 2017, though the transaction legally closed effective December 31, 2016. The 2016 consolidated financial statements presented herein reflect the effect of this cash transfer as if it had occurred on December 31, 2016.

Cash and Cash Equivalents

Cash and cash equivalents (see preceding paragraph), includes cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions and short-term borrowings.

Restrictions on Cash

Cash on hand or on deposit with the Federal Reserve Bank of $0 and $223 was required to meet regulatory reserve and clearing requirements at December 31, 2017 and 2016, respectively. Such amounts are included in cash and due from banks in the consolidated balance sheets.

Investment Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income.

Interest income includes amortization or accretion of purchase premiums or discounts. Premiums and discounts on securities are amortized or accreted on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Premiums are amortized to call date whereby discounts are accreted to maturity. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or it is more likely than not it will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether the Corporation intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If the Corporation intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Corporation does not intend to sell the security and it is not more likely than not that, the Corporation will not be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held for sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

Originated Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loan origination fees, net of are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Interest income on mortgage and commercial loans is discontinued and placed on non-accrual status at the time the loan is 90 days delinquent unless the loan is well-secured and in the process of collection. Mortgage loans are charged off at 180 days past due and commercial loans are charged off to the extent principal or interest is deemed uncollectible. Consumer and credit card loans continue to accrue interest until they are charged-off (no later than 120 days past due unless the loan is in the process of collection). Past-due

status is based on the contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Under the cost-recovery method, interest income is not recognized until the loan balance is reduced to zero. Under the cash-basis method, interest income is recorded when the payment is received in cash. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Acquired Loans

Purchased loans are recorded at fair value at the date of acquisition based on a discounted cash flow methodology that considered various factors including the type of loan and related collateral, classification status, fixed or variable interest rate, term of loan and whether or not the loan was amortizing, and a discount rate reflecting the Corporation's assessment of risk inherent in the cash flow estimates. These cash flow evaluations are inherently subjective as they require material estimates, all of which may be susceptible to significant change.

Purchased credit impaired loans are accounted for in accordance with the provisions of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Subtopic 310-30, "Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality" ("ASC 310-30"). The cash flows expected to be collected on purchased loans are estimated based upon the expected remaining life of the underlying loans, which includes the effects of estimated prepayments. Purchased loans are considered credit impaired if there is evidence of credit deterioration at the date of purchase and if it is probable that not all contractually required payments will be collected. Purchased credit impaired loans are not classified as nonperforming assets as the loans are considered performing under ASC 310-30. Interest income, through accretion of the difference between the carrying value of the loans and the expected cash flows is recognized on all purchased loans accounted for under ASC 310-30. Expected cash flows are re-estimated at least annually for all loans accounted for under ASC 310-30. A decline in the present value of current expected cash flows compared to the previously estimated expected cash flows, due in any part to change in credit, is referred to as credit impairment and recorded as provision for loan losses during the period. Declines in the present value of expected cash flows only from the expected timing of such cash flows is referred to as timing impairment and recognized prospectively as a decrease in yield on the loan. Improvement in expected cash flows is recognized prospectively as an adjustment to the yield on the loan once any previously recorded impairment is recaptured. Accelerated discounts on acquired loans result from the accelerated recognition of a portion of the loan discount that would have been recognized over the expected life of the loan and occur when a loan is paid in full or otherwise settled.

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual weighted average loss history experienced by the Corporation over a range of the most recent 4 quarters to the most recent 20 quarters. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential real estate, installment loans and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are