**Introduction**

On May 2, 2012 the Company filed a Form 15-12G with the Securities and Exchange Commission (the "SEC") to terminate the registration of its common stock under Section 12(G) of the Securities Exchange Act of 1934 and thereby suspend its duty to file reports with the SEC under Sections 13 and 15(D) of the Act. As a result, the Form 10Q filed for the period ended March 31, 2012 is the final financial report filed with the SEC by the Company. Related to the report below, Management intends to continue to prepare and publish quarterly interim and annual financial reports with similar information as previously reported to the SEC to ensure investors have access to timely, meaningful information related to the Company's results. These financial reports will be published on the Company's website at intervals consistent with the comparable SEC filing deadlines.

On January 22, 2016 the Company filed a Regulation A Offering Statement on Form 1-A with the SEC for the purpose of qualifying the common shares to be issued in connection with the acquisition of First Avenue National Bank. Amendments to this filing were submitted to the SEC on February 23, 2016 and February 25, 2016. The SEC issued a notice of qualification of the filing on February 29, 2016. After filing Form 1-Z of Regulation A May 9, 2016, our duty to file reports with the SEC under Sections 13 and 15(D) of the Act was again suspended.

A more complete history of Coastal Banking Company, Inc. (the "Company") may be found at the Company's website http://www.coastalbanking.com/about-us.html

**Forward-Looking Statements**

This report contains "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of management, as well as assumptions made by and information currently available to management. The words "may," "will," "anticipate," "should," "would," "believe," "contemplate," "expect," "estimate," "continue," "may," and "intend," as well as other similar words and expressions of the future, are intended to identify forward-looking statements.

## Results of Operations

The following discussion describes our results of operations for 2016 as compared to 2015 and also analyzes our financial condition as of December 31, 2016 as compared to December 31, 2015. Like most community banks, we derive a significant portion of our income from interest we receive on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets and the expense on our interest-bearing liabilities. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb possible losses on existing loans that may become uncollectible. We establish and maintain this allowance by charging a provision for loan losses against our operating earnings. Please see the section entitled "Provision and Allowance for Loan Losses" for additional detail.

In addition to earning interest on our loans and investments, we earn income through fees, gains on sales of loans and marketable securities, cash surrender value of life insurance, and other service charges to our customers. The Company's most significant sources of revenue are from Gain on Sale of Mortgage Loans and SBA Loan Income as discussed in the sections entitled "Mortgage Banking Operations" and "SBA Lending". We describe these gains and the other various components of noninterest income, as well as our noninterest expense, in the sections entitled "Noninterest Income" and "Noninterest Expense."

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with the financial statements and the related notes and the other statistical information also included in this report.

**Overview**

Net income for 2016 was $6,956,000 or $2.05 per diluted common share, compared to net income of $5,052,000, or $1.85 per diluted common share in 2015. The 2015 results are net of preferred dividends of $784,000 paid through November 15, 2015 when all preferred shares outstanding were redeemed and replaced by a $10 million holding company borrowing. Net

income per basic common share was $2.10 for 2016, compared to $1.89 for 2015.

Net interest income was $19,494,000 for the year ended December 31, 2016 compared to net interest income of $16,652,000 for the year ended December 31, 2015, a year over year increase of 17.1%. The Company's net interest margin slightly decreased from 3.89% for 2015 to 3.85% for 2016.

The provision for loan losses in 2016 was $1,450,000 compared to $394,000 in 2015. The significant year over year increase to the provision for loan losses reflects the growth in the balance of portfolio loans, particularly from the increase in loans from our acquisition of First Avenue Bank ("FANB") in April of 2016. The provision for loan losses recorded each year reflects the amount calculated by our allowance for loan losses methodology, which also takes into account current economic conditions, loan quality measures and the underlying collateral value securing many of our loans.

Noninterest income for the year ended December 31, 2016 totaled $22,686,000 representing a 26.9% increase from the $17,871,000 for the year ended December 31, 2015. This increase was driven primarily by a higher level of mortgage banking noninterest income at $18,225,000, a year over year increase of $2,539,000 or 16.2%, which was supplemented by a 38.8% increase in SBA loan noninterest income from 1,414,000 in 2015 to $1,962,000 in 2016. The increase in mortgage banking income was driven by continued long term interest rates at historically low levels for much of 2016 which had a favorable impact on demand for residential mortgage lending. As a result of increased loan demand, residential mortgage loans originated totaled $3.05 billion in 2016 compared to $2.81 billion in 2015. The year over year increase in SBA loan income reflects increased selling volume in 2016 of the guaranteed portion of SBA loans. Service charges on deposit accounts and other service charges, commissions and fees both increased in 2016 over 2015 in part due to the addition of FANB. Other income increased from $23,000 in 2015 to $1,536,000 in 2016 due to the recognition of bargain purchase gains as a result of the FANB acquisition.

Noninterest expenses in 2016 were $29,743,000, a $5,213,000, or 21.3% year over year increase, primarily as a result of the acquisition of FANB as noted above. The largest contributor to this increase was salaries and benefits, which increased by $2,402,000 or 16.0%. Various other noninterest expenses also increased primarily as a result of the acquisition from the three FANB branches and their related operating costs. The continued improvement in asset quality resulted in a reduction of other real estate expenses, typically associated with the maintenance and disposition of Other Real Estate Owned, which was $617,000 for 2016, down from $741,000 last year. The increase in Other operating expense in 2016 was largely due to the recording of $674,000 of non-recurring acquisition related expenses for FANB. The Company's efficiency ratio, which is a measure of total noninterest expenses as a percentage of net interest income and noninterest income, declined slightly from 71.05% in 2015 to 70.52% in 2016.

In 2016 we incurred an income tax expense of $4,031,000 compared to $3,764,000 in 2015. Our effective tax rate was 36.7% in 2016 and 39.2% in 2015. The current year decrease in effective tax rate reflects an increase in non-taxable income in 2016.

### Supplemental Segment Information

The Bank has three reportable business segments: Community Banking, SBA Lending, and Mortgage Banking Operations. All direct costs and revenues generated by each business segment are allocated to the segment; however, there is no allocation of indirect corporate overhead costs to the SBA Lending or Mortgage Banking segments. Additionally, interest expense is allocated to the SBA Lending and Mortgage Banking segments based on the Bank's monthly average cost of funds plus 1.50%. The interest expense allocation was increased in 2016 from average cost of funds plus 0.375% in 2015. The Bank's reportable business segments are strategic business units that offer different products and services to a different customer base. They are managed separately because each segment has different types and levels of credit and interest rate risk.

| **(In thousands)** | **Community Banking** | | **SBA Lending Operations** | | **Mortgage Banking Operations** | |
|---|---|---|---|---|---|---|
| **Twelve months ended December 31,** | **2016** | **2015** | **2016** | **2015** | **2016** | **2015** |
| Interest income | $ 12,701 | $ 8,968 | $ 4,899 | $ 3,208 | $ 5,936 | $ 6,979 |
| Interest expense | (2,047) | (74) | 1,983 | 639 | 3,430 | 1,688 |
| Net interest income | 14,748 | 9,042 | 2,916 | 2,569 | 2,506 | 5,291 |
| Provision for loan losses | 1,211 | 162 | 76 | 63 | 163 | 169 |
| Net interest income after provision | 13,537 | 8,880 | 2,840 | 2,506 | 2,343 | 5,122 |
| Non-interest income | 2,772 | 1,072 | 1,963 | 1,414 | 68,407 | 56,636 |
| Non-interest expense | 14,508 | 9,921 | 3,330 | 2,329 | 61,514 | 52,859 |
| Net income before tax expense | 1,801 | 31 | 1,473 | 1,591 | 9,236 | 8,899 |
| Income tax expense (benefit) | 402 | (67) | 582 | 628 | 3,648 | 3,515 |
| Net income (loss) | $ 1,399 | $ 98 | $ 891 | $ 963 | $ 5,588 | $ 5,384 |

### Mortgage Banking Operations

The Bank has operated a residential mortgage lending division headquartered in Atlanta, Georgia since September 2007. The division originates and funds residential mortgage loans submitted by mortgage brokers, as well as loan applications submitted directly from borrowers, and then sells these mortgage loans into the secondary market. We expanded this division in 2011 by opening retail residential loan production offices throughout the country. This new group is known as our National Retail Group (NRG). As of December 31, 2016, the mortgage banking division operates 13 retail residential loan production offices in the 8 states of Florida, Georgia, Illinois, Maryland, Michigan, North Carolina, Tennessee and Ohio. This lending channel subjects us to various risks, including credit, liquidity, and interest rate risks. We reduce credit and liquidity risks by selling virtually all the mortgage loans originated through this division. From time to time, we may decide to hold loans originated through this division as additions to our residential real estate loan portfolio. We determine whether the loans will be held in our portfolio or sold in the secondary market at the time of origination. We may also subsequently change our intent to hold loans in portfolio and subsequently sell some or all of these loans from our portfolio as part of our corporate asset/liability management strategy.

As part of our mortgage banking activities, we enter into commitments to fund residential mortgage loans by a specified future date. A mortgage loan commitment is an interest rate lock that binds us to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock, subject to the loan applicant satisfying the underwriting conditions required for approval of their loan application. These loan commitments are derivative loan commitments and the loans that result upon exercise of the loan commitments are held for sale. These derivative loan commitments are recognized at fair value in the balance sheet with changes in fair value recorded as part of mortgage banking noninterest income. We record no value for the loan commitment at inception. Subsequent to inception, however, we recognize the fair value of the derivative loan commitment based upon (i) estimated changes in the fair value of the underlying loan that would result from the exercise of that commitment and (ii) changes in the probability that the underlying loan will fund within the terms of the commitment (referred to as the “pull through” rate). The value of the underlying loan is affected primarily by changes in interest rates and the passage of time.

Outstanding derivative loan commitments expose us to the risk that the value of the loans underlying the commitments might decline due to increases in mortgage interest rates from the date of the inception of the rate lock to the funding of the loan. To effectively hedge this interest rate risk, we enter into forward sale contracts with secondary market investors to sell the underlying loans by a future date at an agreed upon price.

The primary source of direct income generated by this division is the gain on sale of mortgage loans which was $18,225,000 for 2016 compared to $15,686,000 during 2015, an increase of 16.2%. The direct noninterest expenses incurred by the division were $11,117,000 during 2016, a 4.6% decrease over the 2015 expenses of $11,653,000. The largest contributors to this decrease were in salaries and benefits due to a change in compensation structure, and in legal and professional fees due to reduced legal expense.

Beginning in 2016, the Company changed its financial statement presentation to reclassify the direct lending costs incurred by its Mortgage Segment’s National Retail Group (NRG) against that group’s origination income. This change only affects reported noninterest income and noninterest expense, and provides for a better reflection of the Company’s efficiency ratio. The Company’s financials for 2015 were restated for this change for comparability purposes. This change had no effect on the Company’s reported net income for 2016 or 2015. Income and expense discussed above includes this change as well.

### SBA Lending

SBA Lending has been a part of the Company’s banking operations since 1999. Headquartered in Fernandina Beach, Florida, SBA operations were expanded in April 2010, including government guaranteed loan originations throughout the southeastern United States. Loans are generated by experienced, lending professionals through 7 SBA offices with loan administration, including approval, centralized in Fernandina Beach. Income from the division is generated through premiums on sale and servicing income of the guaranteed amounts, typically 75% of the loan. SBA noninterest income for 2016 totaled $1,962,000, up 38.8% from $1,414,000 during 2015. Strategically, the division continues to retain the majority of production. In 2016, the SBA loan portfolio increased $25,300,000, from $70,600,000 in 2015 to $95,900,000at December 31, 2016. Retaining the guaranteed amounts provides increased interest income while maintaining the ability to create potential non-interest income through participation sales at a future date. This hold versus sale strategy remains a crucial part of management’s plan moving forward.

### Community Banking

At the end of 2015, the Bank had 3 branches in Fernandina Beach, Florida, and Beaufort and Port Royal, South Carolina. With the acquisition of First Avenue Bank, 3 additional branches were added in April, 2016 in the Ocala, Florida area. The

acquisition significantly increased the magnitude and importance of this segment to the Company. The primary source of income generated by this division is interest and fees on loans, service charges and other income from typical retail banking sources. Net income for Community Banking increased from $98,000 in 2015 to $1,399,000 for 2016. Approximately $428,000 of the increase in net income is attributable, however, to one-time, non-recurring net gains from the FANB acquisition. These net gains consist of the bargain purchase gain, fixed asset write-downs and one-time merger expenses. Additionally, the increased interest expense allocation percentage discussed above benefitted Community Banking in 2016. Net interest income increased 63.1%, noninterest income increased 158.6% and noninterest expense increased 46.2% from 2015 to 2016 as a result of the changes above. However, for 2016 and 2015, all non-allocated administrative income and expense of the Bank remain included in Community Banking in arriving at its segment net income.

**Net Interest Income**

For the year ended December 31, 2016, net interest income totaled $19,494,000, up by 17.1% from $16,652,000 in 2015. This increase to net interest income was largely driven by a 32.0% increase in the average balance of earning assets, offset by a 26.8% increase in interest bearing liabilities. Interest income from loans, including fees, increased $4,347,000 to $22,709,000 for the year ended December 31, 2016. The average balance of loans was $475.8 million in 2016 compared to $396.0 million in 2015, for a year over year rise of 20.1%. The weighted average rate earned on loans increased 17 basis points to 4.77% for 2016. The favorable impact of the year over year increase to interest income was slightly offset by a corresponding increase in the amount of interest expense, which totaled $4,048,000 for the year ended December 31, 2016, compared to $2,508,000 in 2015. The net interest margin was 3.85% for the year ended December 31, 2016 and 3.89% for the year ended December 31, 2015.

**Average Balances and Interest Rates**

The table below shows the average balance outstanding for each category of interest-earning assets and interest-bearing liabilities for 2016 and 2015, and the average rate of interest earned or paid thereon. Average balances have been derived from the daily balances throughout the period indicated. Non-accrual loans and the interest income recorded on these loans, if any, are included in the yield calculation for loans in all periods reported. Amounts are presented on a tax equivalent basis.

| ( In thousands) | 2016 Average Balance | 2016 Interest | 2016 Yield/ Rate | 2015 Average Balance | 2015 Interest | 2015 Yield/ Rate |
|---|---|---|---|---|---|---|
| Assets: | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans | $ 475,753 | $ 22,709 | 4.77% | $ 395,975 | $ 18,363 | 4.64% |
| Taxable investments | 22,955 | 690 | 3.01% | 25,033 | 676 | 2.70% |
| Tax-free investments | 3,560 | 175 | 4.92% | 3,379 | 172 | 5.10% |
| Interest-bearing deposits in other banks | 3,313 | 15 | 0.45% | 2,544 | 8 | 0.33% |
| Federal funds sold | 431 | 13 | 2.96% | 201 | <1 | 0.09% |
| Total interest-earning assets | 506,012 | 23,602 | 4.66% | 427,132 | 19,219 | 4.50% |
| Other noninterest earning assets | 34,539 | | | 23,090 | | |
| Total assets | $ 540,551 | | | $ 450,223 | | |
| Liabilities and shareholders' equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand and savings deposits | $ 237,991 | $ 857 | 0.36% | $ 168,777 | $ 467 | 0.28% |
| Time deposits | 147,111 | 1,566 | 1.06% | 134,950 | 1,136 | 0.84% |
| Other borrowings | 99,865 | 1,626 | 1.63% | 98,823 | 902 | 0.91% |
| Total interest-bearing liabilities | 484,967 | 4,048 | 0.83% | 402,551 | 2,506 | 0.62% |
| Other noninterest bearing liabilities | 12,313 | | | 9,229 | | |
| Shareholders' equity | 43,271 | | | 38,443 | | |
| Total liabilities and shareholders' equity | $ 540,551 | | | $ 450,223 | | |
| Excess of interest-earning assets over interest bearing liabilities | $ 43,271 | | | $ 41,243 | | |
| Ratio of interest-earning assets to interest-bearing liabilities | 104% | | | 106% | | |
| Tax equivalent adjustment | | (60) | | | (59) | |
| Net interest income | | $ 19,494 | | | $ 16,655 | |
| Net interest spread | | | 3.83% | | | 3.88% |
| Net interest margin | | | 3.85% | | | 3.89% |

**Interest Rate Sensitivity and Asset Liability Management**

Interest rate sensitivity measures the timing and magnitude of the repricing of assets compared with the repricing of liabilities and is an important part of asset/liability management of a financial institution. The objective of interest rate sensitivity management is to generate stable growth in net interest income, and to manage the risks associated with interest rate movements. Management constantly reviews interest rate risk exposure under various interest rate scenarios so that adjustments in interest rate sensitivity can be made on a timely basis. Net interest income is the primary component of recurring net income for financial institutions. Net interest income is affected by the timing and magnitude of repricing as well as the mix of interest sensitive and noninterest sensitive assets and liabilities. “Gap” is a static measurement of the difference between the contractual maturities or repricing dates of interest sensitive assets and interest sensitive liabilities for a given time period. The projected Gap exposure is expressed as a ratio of interest sensitive assets to interest sensitive liabilities in an attempt to predict the behavior of the Company’s net interest income during periods of moving interest rates.

The following table summarizes the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2016, that are expected to mature, prepay, or reprice in each of the future time periods shown. Except as stated below, the amount of assets or liabilities that mature or reprice during a particular period was determined in accordance with the contractual terms of the asset or liability. Adjustable rate loans are included in the period in which interest rates are next scheduled to adjust rather than in the period in which they are due, and fixed-rate loans and mortgage-backed securities are included in the periods in which they are anticipated to be repaid based on maturities. The Bank’s savings accounts and interest-bearing demand accounts (NOW and money market deposit accounts) that are not contractually tied to an adjusting index are grouped into categories based on the Company’s historical repricing practices. Money market accounts, which are contractually tied to repricing indexes, reprice monthly and are grouped in the three month or less category. Many of these money market accounts are tied to a Treasury index.

**At December 31, 2016 Maturing or Repricing in:**

| ( In Thousands) | 3 Months or Less | 4 Months to 12 Months | 1 to 5 Years | Over 5 Years | Total |
|---|---|---|---|---|---|
| Mortgage-Backed Securities | $ 711,294 | $ 2,822,047 | $ 6,109,376 | $ 3,247,988 | $ 12,890,705 |
| Fed Funds Sold | 387,123 | | | 0 | 387,123 |
| Other Investments | 3,784,170 | 700,165 | 4,106,560 | 5,503,992 | 14,094,887 |
| Total Investments | $ 4,882,587 | $ 3,522,212 | $ 10,215,936 | $ 8,751,980 | $ 27,372,715 |
| Commercial Loans | $ 80,656,499 | $ 2,280,942 | $ 3,998,963 | $ 4,168,893 | $ 91,105,297 |
| Real Estate Loans | 194,196,756 | 66,290,587 | 65,237,654 | 28,654,302 | 354,379,299 |
| Installment Loans | 27,585,255 | 8,223,141 | 10,101,011 | 9,358,563 | 55,267,970 |
| Total Loans | $ 302,438,510 | $ 76,794,670 | $ 79,337,628 | $ 42,181,758 | $ 500,752,566 |
| **Total Interest-Bearing Earning Assets** | **$ 307,321,097** | **$ 80,316,882** | **$ 89,553,564** | **$ 50,933,738** | **$ 528,125,281** |
| Certificates of Deposit | $ 28,469,141 | $ 75,286,604 | $ 46,227,631 | $ 0 | $ 149,983,376 |
| Transaction Accounts | 72,218,074 | 6,862,122 | 36,706,044 | 58,325,938 | $ 174,112,178 |
| Senior Debentures | 7,217,000 | | | | 7,217,000 |
| Junior Subordinated Debentures | 8,916,667 | | | | 8,916,667 |
| FHLB Advances | 46,060,005 | 6,500,000 | 10,500,000 | | 63,060,005 |
| **Total Interest-Bearing Liabilities** | **$ 162,880,887** | **$ 88,648,726** | **$ 93,433,675** | **$ 58,325,938** | **$ 403,289,226** |
| Interest Sensitive Assets | $ 307,321,097 | $ 80,316,882 | $ 89,553,564 | $ 50,933,738 | $ 528,125,281 |
| Interest Sensitive Liabilities | $ 162,880,887 | $ 88,648,726 | $ 93,433,675 | $ 58,325,938 | $ 403,289,226 |
| Gap | $ 144,440,210 | $ -8,331,844 | $ -3,880,111 | $ -7,392,200 | $ 124,836,055 |
| **Cumulative Gap** | **$ 144,440,210** | **$ 136,108,366** | **$ 132,228,255** | **$ 124,836,055** | |
| **Gap Ratio** | **1.89** | **0.91** | **0.96** | **0.87** | **1.31** |
| **Cumulative Gap Ratio** | **1.89** | **1.54** | **1.38** | **1.31** | |

| Cumulative Gap as % of EA | 27.3% | 25.8% | 25.0% | 23.6% |
|---|---|---|---|---|

At December 31, 2016, the Company, as measured by Gap, is asset sensitive with a cumulative projected Gap ratio of 1.89 over a three month period and a cumulative projected Gap ratio of 1.54 over a one year period. At December 31, 2016, the Company had $144,440,000 more assets than liabilities repricing or maturing within three months, and $136,108,000 more assets than liabilities repricing over a one-year time period. Generally, the Company's Gap ratios indicate that net interest income will increase if rates rise. However, Gap analysis does not take into account the potential decreased demand for Mortgage loans and other loans in an increasing interest rate environment that might reduce the Company's noninterest income (i.e. Gain on Sale income).

Management regularly evaluates its interest rate risk, including deposit pricing policies, loan demand, and changes in the mix of various types of interest bearing assets and liabilities. The Company forecasts its sensitivity to interest rate changes not less than quarterly using modeling software.

**Provision and Allowance for Loan Losses**

There are risks inherent in making all loans, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We establish and maintain an allowance for loan losses based on a number of quantitative and qualitative factors including, among other things, historical experience, evaluation of economic conditions, regular reviews of delinquencies and loan portfolio quality and a number of assumptions about future events, which we believe to be reasonable, but which may not prove to be accurate. We believe that changes in economic and industry conditions capture the impact of general declines in the value of collateral property, and in this way our factors reflect general declines in collateral values.

The provision for loan losses is the periodic charge to operating earnings that management believes is necessary to maintain the allowance for possible loan losses at an adequate level. The amounts of these periodic charges are based on management's analysis of the potential risk in the loan portfolio. This analysis includes, among other things, evaluation of the trends in key loan portfolio metrics as follows:

| (In thousands) | December 31, 2016 | September 30, 2016 | June 30, 2016 | March 31, 2016 | December 31, 2015 | September 30, 2015 | June 30, 2015 | March 31, 2015 |
|---|---|---|---|---|---|---|---|---|
| Portfolio loans, gross | $ 408,743 | $ 398,686 | $ 393,146 | $ 298,933 | $ 285,933 | $ 274,704 | $ 272,115 | $ 270,230 |
| Loans past due > 30 days and still accruing interest | $ 3,191 | $ 795 | $ 4,177 | $ 1,056 | $ 123 | $ 2,302 | $ 1,752 | $ 2 |
| Loans on nonaccrual | $ 6,070 | $ 5,867 | $ 4,478 | $ 1,936 | $ 2,478 | $ 3,484 | $ 2,787 | $ 4,176 |
| (as a % of loans, gross) | 1.49% | 1.47% | 1.14% | 0.65% | 0.87% | 1.27% | 1.08% | 1.53% |
| Net loan charge offs (recoveries) | $ (70) | $ (56) | $ (29) | $ 869 | $ 16 | $ 8 | $ 21 | $ (77) |
| (as a % of loans, gross) | (0.02)% | (0.02)% | (0.01%) | 0.29% | 0.01% | 0.00% | 0.01% | (0.03)% |

***"Portfolio loans, gross"*** addresses the impact on the provision for loan losses from changes in the size and composition of our loan portfolio. We apply various reserve factors to our portfolio based on historical levels and trends to establish various reserve percentages based on the relative inherent risk for a particular loan type and grade. The inherent risk is established based on peer group data, information from regulatory agencies, the experience of the Bank's lending officers, and recent trends in portfolio losses. These reserve factors are continuously evaluated and subject to change depending on trends in national and local economic conditions, the depth of experience of the Bank's lenders, delinquency trends and other factors. We have made an effort over the last several years to lower the risk profile of our loan portfolio. In doing so, the increase in our loan portfolio size over the last two years reflects a shift in composition from higher risk-rated real estate construction loans to comparably lower risk-rated owner occupied residential real estate loans. This has moderated to some degree the inherent risk in an expanding loan portfolio.

***"Loans past due greater than 30 days and still accruing interest"*** has proven to be a useful leading indicator of directional trends in future loan losses. As the level of this metric rises, expectations are for a comparable increase in loans moving into a nonaccrual status and ultimately foreclosure resulting in increased losses. This pattern has been observed in the past where increases in loans past due greater than 30 days and still accruing are followed in future quarters with the same directional

changes in the level of loans on nonaccrual. The level of loans past due greater than 30 days and still accruing interest totaled $3,191,000 at December 31, 2016, an increase of $2,396,000 from the prior quarter end, and $3,068,000 higher than the $123,000 level at December 31, 2015. While the long term trend in credit quality over the last several years has improved, we continue to experience ups and downs throughout the process and so management will continue to carefully monitor past due loans and work aggressively to manage loan delinquency levels.

***"Loans on nonaccrual"*** has been another leading indicator of potential future losses from loans. We typically place loans on nonaccrual status when they become 90 days past due. In addition to the interest lost when a loan is placed on nonaccrual status, there is an increased probability of a loan on nonaccrual moving into foreclosure with a potential loss outcome. The December 31, 2016 balance increased to $6,070,000, or 1.49% of loans compares to $5,867,000, or 1.47% of loans, at the prior quarter end, and $2,478,000 or 0.87% of gross loans, as of December 31, 2015. All of the ratios above exclude loans held for sale. Management intends to remain vigilant in our loan monitoring and loss mitigation efforts to either rehabilitate these credits or maximize recovery if required.

***"Net loan charge offs or recoveries"*** reflect our practice of charging recognized losses to the allowance and adding subsequent recoveries back to the allowance. For 2016, net charges offs were $714,000, or 0.13% of loans, compared to net loan recoveries of $32,000, or 0.01% of loans, for the full year 2015.

In addition to considering the metrics described above, we evaluate the collectability of individual loans, the balance of impaired loans, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans and a review of specific problem loans. Based on this process and as shown below, the provision charged to expense was $1,450,000 for the year ended December 31, 2016, as compared to $394,000 for the year ended December 31, 2015.

| (In thousands) | December 31, 2016 | September 30, 2016 | June 30, 2016 | March 31, 2016 | December 31, 2015 | September 30, 2015 | June 30, 2015 | March 31, 2015 |
|---|---|---|---|---|---|---|---|---|
| Provision during quarter ended | $ 1,001 | $ 56 | $ 360 | $ 33 | $ 44 | $ 57 | $ 33 | $ 260 |
| Provision added in excess of (less than) net charge-offs | $ 1,071 | $ 112 | $ 389 | $ -835 | $ 28 | $ 49 | $ 12 | $ 336 |
| Allowance for loan losses | $ 5,991 | $ 4,920 | $ 4,808 | $ 4,419 | $ 5,254 | $ 5,226 | $ 5,177 | $ 5,165 |
| (as a % of loans, gross) | 1.47% | 1.23% | 1.22% | 1.48% | 1.84% | 1.90% | 1.90% | 1.91% |

As shown above, during the three months ended December 31, 2016 the $1,001,000 provision for loan losses resulted in an increase to the allowance for loan losses to a level of $5,991,000, or 1.47% of gross loans outstanding at December 31, 2016, as compared to $4,920,000, or 1.23% of gross loans outstanding at September 30, 2016. The allowance for loan losses was $5,254,000, or 1.84% of loans, at December 31, 2015. These ratios of the allowance to gross loans excludes loans held for sale.

Management continues to carefully monitor past due and nonaccrual loans. Management acknowledges that future asset quality results may vary from our estimates and expectations, resulting in negative asset quality metrics, which could have a material adverse effect on our results of operations and financial condition.

**Noninterest Income**

Noninterest income was $22,686,000 for the year ended December 31, 2016, which was an increase of $4,815,000, or 26.9%, from $17,871,000 noninterest income earned during the year ended December 31, 2015. The largest factor in this year-over-year increase occurred in mortgage banking noninterest income, which was $18,225,000 for the year ended December 31, 2016 compared to $15,686,000 for the year ended December 31, 2015. This rise in mortgage banking income was driven by an increase in mortgages funded for the twelve month period ending December 31, 2016 to $3.05 billion compared to $2.81 billion the same period in 2015. The Mortgage noninterest income above for 2016 and 2015 again reflect the reclassification of the income and direct lending costs of the NRG as previously discussed. SBA loan noninterest income increased by 38.8% to $1,963,000 for 2016 compared to $1,414,000 during 2015. SBA loan participations sold into the secondary market increased from $10,180,000 in 2015 to $16,490,000 in 2016. The amount of SBA portfolio loans available for sale also increased from $13,536,000 at December 31, 2015 to $26,445,000 at December 31, 2016.

Service charges on deposit accounts increased by 17.7% to $247,000 for the year ended December 31, 2016 due to the

addition of three branches and related deposits acquired in the FANB acquisition. Other service charges, commissions and fees increased 35.4% to $614,000 primarily for the same reason.

Other income increased significantly to $1,536,000 in 2016 from $23,000 in 2015. In 2016, the Company recognized $1,508,000 in bargain purchase gain from the FANB acquisition.

**Noninterest Expense**

Total noninterest expense for the year ended December 31, 2016 was $29,743,000 as compared to $24,530,000 for 2015. The year-over-year increase in noninterest expense of $5,212,000 reflects the new expenses associated with the acquired FANB operations subsequent to the acquisition in April, 2016. Noninterest expense associated with the three FANB branches totaled $4,075,000 in 2016.

Salaries and benefits totaled $17,373,000 for the year ended December 31, 2016, compared to $14,971,000 for the same period a year ago, for an increase of $2,401,000, primarily due to increases to staff from the FANB acquisition. Occupancy and equipment expense increased $942,000 to $3,147,000 for 2016 compared to $2,204,000 during 2015, reflecting an increase in costs relating to the three new FANB branches. Expense increases were also experienced in advertising, audit fees, data processing, director fees and, exam fees. Other operating expense was also up in 2016 in part due to $674,000 in one-time merger and acquisition expense not included in the above. In 2016, Other Real Estate Owned expense declined 16.7% from $741,000 in 2015 to $617,000 in 2016.

**Income Taxes**

During 2016, we recognized income tax expense of $4,031,000 compared to income tax expense of $3,764,000 during 2015. Our effective tax rate was 36.7% in 2016 and 39.2% in 2015. The fluctuation in effective tax rates reflects the impact of increased non-taxable earnings in 2016.

## Financial Condition

Total assets increased to $561,389,000 at December 31, 2016 from $464,667,000 at December 31, 2015. The primary source of the increase in assets was due to an increase in portfolio loans and assets acquired in the FANB acquisition. The SBA portfolio loan increased $25,300,000 and the Company's Community Banking loan portfolio grew $104,300,000, of which $81,300,000 was acquired as part of the acquisition. Mortgage loans held in the portfolio decreased slightly in 2016 by $6,700,000. Additionally, premises and equipment increased $6,400,000 due primarily due to the FANB acquisition. These increases were partially offset by decreases in loans held for sale, investment securities and other real estate owned.

During 2016, total liabilities increased $78,265,000, when compared to December 31, 2015. The increase in liabilities was driven by additional deposits acquired from FANB. Deposits increased $133,478,000 from $283,839,000 at December 31, 2015 to $417,317,000 at December 31, 2016. A total of $98,215,000 in deposits were acquired from FANB at the acquisition date. Borrowings declined $57,450,000 from December 31, 2015 to December 31, 2016 in relation to the decline in loans held for sale which occurred near the end of 2016 due to a decline in mortgage volume.

Consolidated Stockholders Equity increased from $33,259,000 at December 31, 2015 to $51,715,000 at December 31, 2016. The Company's total risk based capital ratio was 19.74% at December 31, 2016 compared to 19.89% at December 31, 2015. The Company's Tier 1 leverage ratio was 10.01% at year-end 2016 compared to 9.54% at year-end 2015.

**Investment Securities**

The balance of investment securities available for sale declined to $24,660,000 at December 31, 2016 from $27,307,000 at December 31, 2015 primarily due to paydowns throughout 2016 in the portfolio. Growth in portfolio loans in 2016 minimized the need to purchase additional investment securities.

The following table presents the investments by category at the end of the last three years.

| *Available for sale* | 2016 | | 2015 | |
|---|---|---|---|---|
| **(In thousands)** | **Amortized Cost** | **Estimated Fair Value** | **Amortized Cost** | **Estimated Fair Value** |
| State and municipal securities | $ 4,461 | $ 4,634 | $ 3,135 | $ 3,454 |
| Corporate | 956 | 971 | - | - |
| Mortgage-backed securities | 13,929 | 14,063 | 16,945 | 17,071 |
| | $ 19,346 | $ 19,668 | $ 20,080 | $ 20,525 |

The following table presents the maturities of investment securities at carrying value and the weighted average yields for each range of maturities presented. Yields are based on amortized cost of securities.

| Maturities at December 31, 2016 (In thousands) | State and Municipal Securities | Weighted Average Yield | Corporate Securities | Weighted Average Yield | Mortgage Backed Securities | Weighted Average Yield |
|---|---|---|---|---|---|---|
| Within 1 year | $ - | % | $ - | - | $ 82 | 4.50% |
| After 1 through 5 years | 1,070 | 3.45% | - | - | 11,182 | 2.37% |
| After 5 through 10 years | 3,191 | 3.01% | 956 | 2.64 % | 1,462 | 2.35% |
| After 10 years | - | % | - | - | 1,203 | 3.11% |
| Totals | $ 4,461 | 3.12% | $ 956 | 2.64% | $ 13,929 | 2.61% |

Mortgage-backed securities are included in the maturities categories in which they are anticipated to be repaid based on scheduled maturities.

## Loans

Gross loans totaled $408,743,000 at December 31, 2016, a 43.0% increase from the $285,933,000 at December 31, 2015 Loans of $81,426,000 were acquired in the FANB acquisition. Balances within the major loans receivable categories and geographic concentration of the loan portfolio are presented below.

| | Geographic Concentration of Loan Portfolio December 31, 2016 | | | |
|---|---|---|---|---|
| (In thousands) | Florida | Georgia | South Carolina | Other |
| Commercial and financial | $ 21,594 | $ 3,842 | $ 2,792 | $ 1,074 |
| Real estate – construction, commercial | 16,687 | 3,188 | 4,998 | 2,462 |
| Real estate – construction, residential | 9,807 | 6,302 | 2,610 | 231 |
| Real estate – mortgage, commercial | 100,625 | 20,522 | 32,907 | 8,275 |
| Real estate – mortgage, residential | 72,950 | 45,529 | 26,383 | 10,023 |
| Real estate – mortgage, farmland | 5,640 | 164 | - | 4,789 |
| Consumer installment loans | 4,357 | 217 | 728 | 47 |
| | $ 231,660 | $ 79,764 | $ 70,418 | $ 26,901 |

| | Geographic Concentration of Loan Portfolio December 31, 2015 | | | |
|---|---|---|---|---|
| (In thousands) | Florida | Georgia | South Carolina | Other |
| Commercial and financial | $ 10,952 | $ 3,203 | $ 2,803 | $ 1,836 |
| Real estate – construction, commercial | 9,075 | 2,058 | 7,042 | 2,461 |
| Real estate – construction, residential | 4,230 | 4,113 | 4,287 | 271 |
| Real estate – mortgage, commercial | 54,123 | 16,510 | 27,776 | 6,304 |
| Real estate – mortgage, residential | 46,898 | 39,695 | 25,458 | 11,766 |
| Real estate – mortgage, farmland | 3,594 | 252 | - | - |
| Consumer installment loans | 329 | 265 | 570 | 62 |
| | $ 129,201 | $ 66,096 | $ 67,936 | $ 22,700 |

## Other Real Estate Owned (OREO)

Other real estate owned (OREO) represents collateral property taken back from borrowers in partial or full satisfaction of their defaulted debt obligation to the Company. OREO declined from $6,116,000 at December 31, 2015 to $5,062,000 at December 31, 2016 as the Company continued the downward trend and reduced loss exposure over the past few years. We track our historical experience of loans that ultimately convert to OREO by collateral type and by geographic exposure as shown on the following tables:

| | Book Value of Other Real Estate Owned at December 31, 2016 | | | |
|---|---|---|---|---|
| (In thousands) | Florida | South Carolina | Other | Total |
| Residential | $ - | $ - | $ - | $ - |
| Commercial | 1,721 | 844 | 749 | 3,314 |
| Finished lots | - | 32 | - | 32 |

| | | | | |
|---|---|---|---|---|
| Raw land | 1,716 | - | - | 1,716 |
| | $ 3,437 | $ 876 | $ 749 | $ 5,062 |

| | Book Value of Other Real Estate Owned at December 31, 2015 | | | |
|---|---|---|---|---|
| (In thousands) | Florida | South Carolina | Other | Total |
| Residential | $ 158 | $ - | $ - | $ 158 |
| Commercial | 2,277 | 961 | - | 3,238 |
| Finished lots | 227 | 571 | - | 798 |
| Raw land | 1,726 | 196 | - | 1,922 |
| | $ 4,388 | $ 1,728 | $ - | $ 6,116 |

During the year ended December 31, 2016 we sold a total of 48 OREO properties with a total book value of $1,497,000. During the year ended December 31, 2015 we sold a total of 13 OREO properties with a total book value of $1,486,000. Georgia did not have an OREO balance for 2016 or 2015.

## Deposits

Deposits increased from $283,839,000 at December 31, 2015 to $417,317,000 at December 31, 2016. A total of $98,215,000 in deposits were acquired in the FANB acquisition. Balances within the major deposit categories are as follows:

| | December 31, 2016 | | | |
|---|---|---|---|---|
| (In thousands) | Core Retail Deposits | Core CDAR's Deposits | Brokered Deposits | Total Deposits |
| Noninterest-bearing demand deposits | $ 77,603 | $ 0 | $ 0 | $ 77,603 |
| Interest-bearing demand deposits | 174,114 | 0 | 0 | 174,114 |
| Savings deposits | 15,618 | 0 | 0 | 15,618 |
| Certificates of deposit $100,000 and over | 59,739 | 37,441 | 0 | 97,180 |
| Other time deposits | 1,119 | 1,109 | 50,576 | 52,804 |
| | $ 328,193 | $ 38,550 | $ 50,576 | $ 417,319 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| (In thousands) | Core Retail Deposits | Core CDAR's Deposits | Brokered Deposits | Total Deposits |
| Noninterest-bearing demand deposits | $ 42,157 | $ — | $ — | $ 42,157 |
| Interest-bearing demand deposits | 118,889 | — | — | 118,889 |
| Savings deposits | 5,180 | — | — | 5,180 |
| Certificates of deposit $100,000 and over | 38,355 | 28,759 | 2,848 | 69,962 |
| Other time deposits | 2,040 | 1,029 | 44,582 | 47,651 |
| | $ 206,621 | $ 29,788 | $ 47,430 | $ 283,839 |

## Other Borrowings and Liquidity

Federal Home Loan Bank (FHLB) borrowings totaled $63,050,000 at December 31, 2016, a decrease from $120,500,000 outstanding on December 31, 2015. The Bank maintains relationships with six other correspondent banks that can provide funds on short notice unsecured advances for up to $44,000,000. The Bank also has non-core funding available of $195,711,000 at December 31, 2016 over the amount outstanding at year-end of $27,968,000. Additionally, the discount window at the Federal Reserve is available to provide as much as $33,983,000.

As of December 31, 2016, the Company had $454,473,000, in total borrowing capacity, of which we had utilized $91,018,000 or 20.0%, leaving remaining available liquidity of $363,455,000. The following tables present available sources of liquidity at December 31, 2016 and December 31, 2015:

| (In Thousands) | December 31, 2016 | | |
|---|---|---|---|
| | Total Line of Credit | Funds Borrowed | Funds Available |
| **Available Sources of Liquidity** | | | |
| Federal Funds Purchased Lines of Credit | $ 44,000 | $ 0 | $ 44,000 |
| Total Non-Core Deposit Sources | 223,679 | 27,968 | 195,711 |
| Federal Reserve Borrowing Capacity at Discount Window | 33,983 | 0 | 33,983 |
| Federal Home Loan Bank Advance Availability | 152,811 | 63,050 | 89,761 |
| Total Sources of Liquidity | $ 454,473 | $ 91,018 | $ 363,455 |
| Borrowing Sources Utilized % | 20.0% | | |

| | December 31, 2015 | | |
|---|---|---|---|
| | Total Line of Credit | Funds Borrowed | Funds Available |
| **Available Sources of Liquidity** | | | |
| Federal Funds Purchased Lines of Credit | $ 37,000 | $ 0 | $ 37,000 |
| Total Non-Core Deposit Sources | 182,144 | 21,369 | 160,775 |
| Federal Reserve Borrowing Capacity at Discount Window | 26,580 | 0 | 26,580 |
| Federal Home Loan Bank Advance Availability | 131,563 | 120,500 | 11,063 |
| Total Sources of Liquidity | $ 377,287 | $ 141,869 | $ 235,418 |
| Borrowing Sources Utilized % | 37.6% | | |