Coastal Banking Company, Inc.

Quarterly Financial Results (Unaudited)

As of June 30, 2016

Coastal Banking Company
Consolidated Balance Sheets

		June 30, 2016 (unaudited)		December 31, 2015 (audited)
Assets				
Cash and due from banks	$	4,780,335	$	3,058,112
Interest-bearing deposits in banks		2,383,088		1,772,456
Federal funds sold		103,894		82,642
Securities available for sale, at fair value		21,264,827		20,524,668
Securities held to maturity, at cost		100,000		—
Restricted equity securities, at cost		7,648,608		6,781,900
Loans held for sale, at fair value		48,683,349		35,725,005
Loans, net of unearned income		393,145,710		285,932,549
Less allowance for loan losses		4,808,392		5,254,407
Loans, net		388,337,318		280,678,142
Premises and equipment, net		13,741,240		7,174,034
Cash surrender value of life insurance		2,598,458		2,521,887
SBA loan servicing rights		1,457,880		1,544,682
Core deposit intangible		1,004,497		—
Other real estate owned		5,146,302		6,115,715
Loan sales receivable		105,645,425		92,456,618
Other assets		12,711,788		6,231,111
Total assets	$	615,607,009	$	464,666,972
Liabilities and Shareholders’ Equity				
Deposits:				
Noninterest-bearing	$	71,417,215	$	42,156,742
Interest-bearing		341,619,841		241,682,642
Total deposits		413,037,056		283,839,384
Other borrowings		121,975,000		120,500,000
Senior note payable		9,416,667		9,916,667
Junior subordinated debentures		7,217,000		7,217,000
Other liabilities		16,770,961		9,935,021
Total liabilities		568,416,684		431,408,072
Commitments and contingencies				
Shareholders’ Equity:				
Common stock, par value $.01; 10,000,000 shares authorized; 3,595,700 shares issued and outstanding at June 30, 2016; 2,684,478 shares issued and outstanding at December 31, 2015		35,957		26,845
Additional paid-in capital		52,683,135		41,764,823
Accumulated deficit		(6,061,904)		(8,825,989)
Accumulated other comprehensive income		533,137		293,221
Total shareholders’ equity		47,190,325		33,258,900
Total liabilities and shareholders’ equity	$	615,607,009	$	464,666,972

See accompanying notes to unaudited consolidated financial statements.

Coastal Banking Company
Consolidated Statements of Income
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Interest income:				
Interest and fees on loans	$ 5,944,222	$ 4,848,191	$ 10,453,130	$ 9,103,246
Interest on taxable securities	178,963	169,498	344,406	346,002
Interest on nontaxable securities	28,228	28,495	56,486	57,017
Interest on deposits in other banks	5,224	2,297	9,667	3,812
Interest on federal funds sold	3,787	55	4,132	82
Total interest income	6,160,424	5,048,536	10,867,821	9,510,159
Interest expense:				
Interest on deposits	617,191	412,948	1,029,110	812,817
Interest on junior subordinated debentures	48,812	43,252	98,369	85,298
Interest on other borrowings	331,707	171,766	637,332	317,596
Total interest expense	997,710	627,966	1,764,811	1,215,711
Net interest income	5,162,714	4,420,570	9,103,010	8,294,448
Provision for loan losses	359,523	32,779	392,932	293,125
Net interest income after provision for loan losses	4,803,191	4,387,791	8,710,078	8,001,323
Non-interest income:				
Service charges on deposit accounts	65,242	50,246	118,087	101,216
Other service charges, commissions and fees	170,763	116,612	280,881	219,548
SBA loan income	153,975	71,813	734,120	153,998
Mortgage banking income	16,412,132	16,474,055	28,690,895	30,772,915
Gain on sale of securities available for sale	18,373	—	18,373	—
Income from investment in life insurance contracts	20,252	19,650	41,918	40,780
Other income	496,136	6,901	498,740	12,251
Total other income	17,336,873	16,739,277	30,383,014	31,300,708
Non-interest expenses:				
Salaries and employee benefits	14,927,865	15,007,751	26,452,792	28,161,674
Occupancy and equipment expense	1,267,895	884,207	2,272,897	1,750,720
Mortgage loan expense	765,321	790,696	1,572,067	1,516,798
Data processing fees	609,025	360,649	1,053,212	760,556
Other real estate expenses	90,382	111,984	110,513	116,581
Legal and other professional fees	451,491	255,461	628,914	373,073
Advertising fees	176,538	135,534	330,026	242,940
Audit fees	117,293	114,601	211,670	226,955
FDIC insurance expense	81,000	75,655	162,000	148,958
Director fees	104,900	59,000	179,000	122,350
OCC examination fees	42,523	28,844	80,113	61,743
Other operating	1,362,461	552,903	1,970,606	1,075,928
Total other expenses	19,996,694	18,377,285	35,023,810	34,558,276
Income before income tax (benefits)	2,143,370	2,749,783	4,069,282	4,743,755
Income tax expense (benefits)	597,230	1,147,441	1,305,198	1,970,661
Net income	$ 1,546,140	$ 1,602,342	$ 2,764,084	$ 2,773,094
Preferred stock dividends	—	223,875	—	447,750
Net income available to common shareholders	$ 1,546,140	$ 1,378,467	$ 2,764,084	$ 2,325,344
Basic earnings per common share	$ 0.47	$ 0.52	$ 0.92	$ 0.87
Diluted earnings per common share	$ 0.46	$ 0.51	$ 0.90	$ 0.86

See accompanying notes to unaudited consolidated financial statements.

Coastal Banking Company
Consolidated Statements of Comprehensive Income
For the Six Months Ended June 30, 2016 and 2015
(Unaudited)

	2016	2015
Net income	$ 2,764,084	$ 2,773,094
Other comprehensive income (loss), net of tax:		
Net unrealized holding gains (losses) arising during period, net of tax (benefit) of $123,593 and $(18,364)	239,916	(35,647)
Total other comprehensive income (loss)	239,916	(35,647)
Comprehensive income	$ 3,004,000	$ 2,737,447

See accompanying notes to unaudited consolidated financial statements.

Coastal Banking Company
Consolidated Statements of Cash Flows
For the Six Months Ended June 30, 2016 and 2015
(Unaudited)

	2016	2015
Cash flows from operating activities:		
Net income	$ 2,764,084	$ 2,773,094
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	367,914	357,859
Stock-based compensation expense	24,000	34,089
Provision for loan losses	392,932	293,125
Gain on sale of securities available for sale	(18,373)	—
Loss on sale/abandonment of premises and equipment	90,281	1,476
Net (increase) in loan sales receivable	(13,188,807)	(60,295,575)
Write downs and losses on sale of other real estate owned	20,131	69,336
Proceeds from sales of other real estate owned	—	708,568
Increase in cash value of life insurance	(76,571)	(75,489)
Originations of mortgage loans held for sale	(850,341,965)	(1,576,702,289)
Proceeds from sales of mortgage loans held for sale	866,074,516	1,545,389,320
Net (increase) in interest receivable	(412,408)	(23,040)
Net increase (decrease) in interest payable	32,421	(8,939)
SBA loan income	(734,120)	(153,998)
Mortgage banking income	(28,690,895)	(30,772,915)
Bargain purchase gain	(583,824)	—
Net other operating activities	15,040,421	473,299
Net cash used in operating activities	(9,240,263)	(117,932,079)
Cash flows from investing activities:		
Net increase (decrease) in interest-bearing deposits in banks	4,284,342	(428,834)
Net (increase) in federal funds sold	(21,252)	(14,008)
Proceeds from maturities of securities available for sale	1,268,451	1,986,183
Proceeds from sale of other investments	2,864	—
Proceeds from sale of fixed assets	—	—
Purchases of securities held to maturity	—	(100,000)
Purchases of securities available for sale	—	—
Net change in restricted equity securities	(361,922)	(2,726,000)
Net (increase) decrease in loans	(27,284,744)	215,812
Purchase of premises and equipment	(189,878)	(123,144)
Net cash used in investing activities	(22,302,139)	(1,189,991)
Cash flows from financing activities:		
Net increase in deposits	32,054,033	37,659,352
Net increase in securities sold under agreements to repurchase	—	5,000,000
Net increase in fed funds purchased	—	9,006,512
Proceeds from exercise of stock options	38,260	—
Proceeds from employee stock purchase plan	197,332	79,510
Repayment of loan payable, long term	(500,000)	—
Net increase in other borrowings	1,475,000	68,450,000
Net cash provided by financing activities	33,264,625	120,195,374
Net increase in cash and due from banks	1,722,223	1,073,304
Cash and due from banks at beginning of period	3,058,112	2,726,911
Cash and due from banks at end of period	$ 4,780,335	$ 3,800,215
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest expense	$ 1,732,390	$ 1,224,650
Federal and State income taxes	$ 1,995,772	$ 1,576,498
Noncash Transactions:		
Principal balances of loans transferred to other real estate owned	$ 273,037	$ 481,068
Issuance of common stock in acquisition	10,667,832	—

See accompanying notes to unaudited consolidated financial statements.

Notes to Consolidated Financial Statements – June 30, 2016 and 2015 (Unaudited) and December 31, 2015

Note 1 - Basis of Presentation

For corporate history of Coastal Banking Company, Inc. (the "Company") [click here]

On May 2, 2012 the Company filed a Form 15-12G with the Securities and Exchange Commission 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 was the final financial report filed with the SEC by the Company until the SEC Form 1-A was filed on January 22, 2016 in order to qualify 885,345 shares of common stock for issuance pursuant to the merger with First Avenue National Bank of Ocala, FL. Management has continued to prepare and publish quarterly and annual financial reports with similar information as required in filings with the SEC to ensure that investors have access to timely, meaningful information related to the Company's financial conditions and results of operations. These financial reports will be published on the Company's web site at intervals consistent with the comparable SEC filing deadlines.

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, CBC National Bank (the "Bank"). All intercompany accounts and transactions have been eliminated in consolidation.

The financial statements for the interim periods ended June 30, 2016 and June 30, 2015 are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The results of operations for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. The financial information as of December 31, 2015 has been derived from the audited financial statements as of that date.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates that affect the amounts of assets and liabilities and changes therein. Actual results could differ from those estimates.

Note 2 – Business Combination

On April 8, 2016, the Company completed its acquisition of First Avenue National Bank. ("FANB"), a bank headquartered in Ocala, Florida. At that time, FANB merged with and into the Bank. The acquisition expanded the Company's Florida market presence, as FANB had a total of three full-service branches located in Ocala and The Villages, Florida. Under the terms of the merger, FANB's common shareholders received 0.4848 shares of Coastal common stock for each share of FANB common stock they previously held, plus cash of $12.14 times any fractional share of Coastal common stock received in the exchange. As a result, the Company issued 885,345 common shares at a fair value of $10,818,916 and will pay cash to former shareholders of FANB for fractional shares of Coastal common stock in the total amount of $1,238.

The acquisition of FANB was accounted for using the acquisition method of accounting in accordance with FASB ASC 805, *Business Combinations*. Assets acquired, liabilities assumed and consideration exchanged were recorded at their respective acquisition date fair values. Determining the fair value of assets and liabilities is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as additional information regarding the closing date fair values becomes available. In addition, management assessed and recorded the deferred tax assets resulting from differences in the carrying values of acquired assets and assumed liabilities for financial reporting purposes and their basis for income tax purposes. This estimate also reflects acquired net operating loss carryforwards and other acquired assets with built-in losses that are expected to be settled or otherwise recovered in future periods where the realization of such benefits would be subject to applicable limitations under Section 382 of the Internal Revenue Code of 1986, as amended. Management continues to evaluate fair value adjustments related to loans, other real estate owned, premises, intangibles and deferred tax assets.

The following table presents the assets acquired and liabilities of FANB assumed as of April 8, 2016, and their initial fair value estimates. The fair value adjustments shown in the following table continue to be evaluated by management and may be subject to further adjustment:

		As Recorded by FANB		Fair Value Adjustments			As Recorded by Coastal
Assets							
Cash and cash equivalents	$	4,894,974	$	-		$	4,894,974
Investment securities		2,034,855		-			2,034,855
Other investments		504,786		-			504,786
Loans		81,273,345		(1,515,313)	(a)		79,758,032
Less allowance for loan losses		(621,830)		621,830	(b)		-
Loans, net		80,651,515					79,758,032
Other real estate owned		60,050					60,050
Premises and equipment		9,562,689		(2,963,039)	(c)		6,599,650
Intangible assets		-		1,071,678	(d)		1,071,678
Other assets		13,878,980		946,847	(e)		14,825,827
Total assets	$	111,587,849	$	(1,837,997)		$	109,749,852
Liabilities							
Deposits:							
Noninterest-bearing	$	20,652,396				$	20,652,396
Interest-bearing		77,562,920					77,562,920
Total deposits		98,215,316					98,215,316
Other liabilities		131,796					131,796
Total liabilities		98,347,112					98,347,112
Net identifiable assets acquired over (under) liabilities assumed		13,240,737					11,402,740
Bargain purchase gain		-					(583,824)
Net assets acquired over (under) liabilities assumed	$	13,240,737				$	10,818,916
Consideration:							
Coastal Banking Company common shares issued		885,345					
Purchase price per share of the Company's common stock	$	12.22					
Company common stock issued		10,818,916					
Cash exchanged for shares		-					
Fair value of total consideration transferred		10,818,916					
Less: stock issuance costs		151,084					
Issuance of common stock in acquisition	$	10,667,832					

Explanation of fair value adjustments

(a) Adjustment reflects the fair value adjustments based on the Company's evaluation of the acquired loan portfolio.

(b) Adjustment reflects the elimination of FANB's allowance for loan losses.

(c) Adjustment reflects the fair value adjustment based on the Company's evaluation of the acquired real estate, which is based on recent appraised values.

(d) Adjustment reflects the recording of core deposit intangible on the acquired core deposit accounts.

(e) Adjustment reflects the deferred taxes on the difference in the carrying values of acquired assets and assumed liabilities for financial reporting purposes and their basis for federal income tax purposes and the reversal of FANB valuation allowance established on their deferred tax assets.

Bargain purchase gain of $583,824, which is the excess of the fair value of net assets acquired over the purchase price, was recorded in the FANB acquisition and is the result of expected operational synergies and other factors. Bargain purchase gain is not expected to be included in income for tax purposes.

<u>Note 3 – Regulatory Oversight, Capital Adequacy, Operating Results and Liquidity</u>

Regulatory Oversight

The Company operates under the supervision and monitoring of the Federal Reserve Bank of Richmond while the Bank's primary regulator is the Office of the Comptroller of the Currency. In 2008 the Company issued preferred stock and warrants to purchase common stock to the US Treasury under the Capital Purchase Program within the Troubled Asset Relief Program (TARP). In February 2013, Coastal Banking Company preferred stock was included in a Treasury Department TARP auction, and that transaction settled on March 11, 2013 at which point the original preferred stock was owned by a small group of private investors. On November 15, 2015, the Company redeemed all outstanding preferred stock and paid all preferred dividends accrued through the date of redemption. The redemption and dividend payments were funded with the proceeds of a senior note payable to NexBank, SSB.

For more detailed information on the status and requirements of the regulatory oversight under which we operate is available [click here]

Capital Adequacy

Effective January 1, 2015 (with some changes transitioned into full effectiveness over two to four years), the Bank became subject to new capital requirements adopted by the FDIC. These new requirements create a new required ratio for common equity Tier 1 capital, increase the leverage and Tier 1 capital ratios, change the risk weight of certain assets for purposes of the risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios and change what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses. The Company is exempt from consolidated capital requirements as those requirements do not apply to certain small savings bank holding companies with assets under $1 billion.

Under the new capital regulations, the minimum capital ratios are: (1) common equity Tier 1 capital ratio of 4.5% of risk-weighted assets, (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets, (3) a total capital ratio of 8.0% of risk-weighted assets, and (4) a Tier 1 capital to average assets ratio of 4.0%. Common equity Tier 1 capital generally consists of common stock and retained earnings, subject to applicable regulatory adjustments and deductions.

There are a number of changes in what constitutes regulatory capital, some of which are subject to transition periods. These changes include the phasing-out of certain instruments as qualifying capital. The Bank does not use any of these instruments. Under the new requirements for total capital, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common equity Tier 1 capital will be deducted from capital. The Bank has elected to permanently opt-out of the inclusion of accumulated other comprehensive income in our capital calculations, as permitted by the regulations. This opt-out is expected to reduce the impact of market volatility on our regulatory capital levels.

The new requirements also include changes in the risk-weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (increased from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in non-accrual status; a 20% (increased form 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; a 250% risk weight (increased from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk weights (0% to 600%) for equity exposures.

In addition to the minimum common equity Tier 1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional common equity Tier 1 capital greater than 2.5% to risk weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. This new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.635% of risk-weighted assets and increasing each year until fully implemented in January 2019.

The FDIC's prompt corrective action standards also changed effective January 1, 2015. Under the new standards, in order to be considered well-capitalized, the Bank must have a common equity Tier 1 ratio of 6.5% (new), a Tier 1 ratio of 8.0% (increased from 6.0%), a total risk-based capital ratio of 10.0% (unchanged) and a leverage ratio of 5.0% (unchanged). The Bank meets all these new requirements, including the full capital conservation buffer.

As of June 30, 2016, the Bank was well capitalized under the regulatory framework for prompt corrective action. The following table summarizes the Company's and Bank's capital ratios at June 30, 2016:

	Regulatory Levels To Be Well Capitalized (Applies to Bank)	**CBC National Bank**	**Coastal Banking Company**
Total risk-based (to risk-weighted assets)	10.00%	19.96%	17.32%
Tier 1 risk-based (to risk-weighted assets)	8.00%	18.70%	16.06%
Common Equity Tier 1 (to risk-weighted assets)	6.50%	18.70%	16.06%
Tier 1 leverage (to total average assets)	5.00%	10.64%	9.14%

Operating Results

The Company recorded net income of 2,764,000 for the six months ended June 30, 2016 compared to net income of $2,773,000 for the six months ended June 30, 2016, a 0.3% year over year decrease in first half net income. Core earnings improved $809,000 or 9.75%, driven by the continued growth of the Company's balance sheet. In addition, SBA loan income increased $580,000 or 377% as a result of a year over year increase in the number of SBA loan participation sales during the six months ended June 30, 2016. Other income increased $487,000 as a result of recognizing the bargain purchase gain from the First Avenue National Bank acquisition. The year over year improvements in income were offset by increased operating expenses directly related to the acquisition of First Avenue National Bank as discussed in Note 2. Total non-recurring expenses of $674,000 were recognized during the first half of 2016 in connection with the acquisition. Legal and professional fees increased by $256,000 or 69%, primarily as a result of legal fees expended and reserved for defense costs related to a litigation matter involving labor practices, the outcome of which is not expected to have a material impact on future operating results.

For the quarter ended June 30, 2016 the Company recorded net income of $1,546,000 compared to net income of $1,602,000 during the second quarter of 2015, a 3.5% year over year decrease in second quarter net income. Core earnings from net interest income improved $742,000 or 17%, as a result of the overall growth of the Company's balance sheet. This improvement was offset by the recognition of $674,000 in non-recurring expenses related to the acquisition of First Avenue National Bank as discussed in Note 2.

Liquidity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of our investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control. Our primary liquidity needs involve the funding of mortgage loans available for sale, new portfolio loans, and maturing deposits.

We meet our liquidity needs through scheduled maturities of loans and investments on the asset side and through pricing policies on the liability side for interest-bearing deposit accounts and with advances from approved borrowing facilities with correspondent banks, the Federal Home Loan Bank of Atlanta, and the Federal Reserve Bank discount window.

As of June 30, 2016, the Company had $481.8 million in total borrowing capacity, of which we had utilized $156 million or 32%, leaving remaining available liquidity of $325.8 million. The following tables present available sources of liquidity at June 30, 2016 and December 31, 2015:

	June 30, 2016		
	Total Line of Credit	**Funds Borrowed**	**Funds Available**
Available sources of liquidity			
Federal funds purchased lines of credit	$ 44,000,000	$ —	$ 44,000,000
Available brokered certificates of deposit	41,322,142	12,271,000	29,051,142
Internet deposits – CD Rateline	91,888,206	5,450,000	86,438,206
StoneCastle wholesale MMDA	42,881,163	1,000	42,880,163
CDARS – one way buy deposits	61,258,804	16,276,023	44,982,781
Repurchase agreements secured by investment securities	5,741,000	—	5,741,000
Federal Reserve Borrowing Capacity at Discount Window	31,755,692	—	31,755,692
Federal Home Loan Bank Advance Availability	162,960,687	121,975,000	40,985,687
Total sources of liquidity	$ 481,807,694	$ 155,973,023	$ 325,834,671

	December 31, 2015		
	Total Line of Credit	Funds Borrowed	Funds Available
Available sources of liquidity			
Federal funds purchased lines of credit	$ 37,000,000	$ —	$ 37,000,000
Available brokered certificates of deposit	28,411,635	14,793,320	13,618,315
Internet deposits – CD Rateline	69,398,474	3,726,000	65,672,474
StoneCastle wholesale MMDA	32,385,955	1,000	32,384,955
CDARS – one way buy deposits	46,265,649	2,848,181	43,417,468
Repurchase agreements secured by investment securities	5,682,000	—	5,682,000
Federal Reserve Borrowing Capacity at Discount Window	26,580,002	—	26,580,002
Federal Home Loan Bank Advance Availability	131,563,200	120,500,000	11,063,200
Total sources of liquidity	$ 377,286,915	$ 141,868,501	$ 235,418,414

Additionally, loans available for sale are considered by management as a key source of liquidity as a result of the speed with which these loans are sold and settled for cash. Management expects that, on average, loans originated for sale will be sold and converted to cash within 18 to 20 business days after the loan is originated. The balance of loans available for sale averaged $104.2 million during the first six months of 2016. Accordingly, in the event of a liquidity crisis, we anticipate having the ability to slow or stop loan origination activity to allow the loans available for sale to convert into cash. Another key metric of our liquidity position is the loan-to-total deposit ratio, calculated using loans, net of unearned income, which was 133% at June 30, 2016 and 146% at December 31, 2015. Based on current and expected liquidity needs and sources, management expects the Company to be able to meet all obligations as they become due.

Note 4 –Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended June 30, 2016 and 2015.

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Net income	$ 1,546,140	$ 1,602,342	$ 2,764,084	$ 2,773,094
Preferred stock dividends	—	(223,875)	—	(447,750)
Net income available to common shareholders	$ 1,546,140	$ 1,378,467	$ 2,764,084	$ 2,325,344
Weighted average common shares	3,308,403	2,661,778	3,001,102	2,659,535
Effect of dilutive securities	81,105	60,877	73,629	58,431
Diluted average common shares	3,389,508	2,722,655	3,074,731	2,717,966
Earnings per common share	$ 0.47	$ 0.52	$ 0.92	$ 0.87
Diluted earnings per common share	$ 0.46	$ 0.51	$ 0.90	$ 0.86

Note 5 - Supplemental Segment Information

The Bank has three reportable business segments: community banking, SBA lending, and mortgage banking operations. The Company evaluates performance based on profit and loss from operations before income taxes, not including nonrecurring gains and losses.

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% through an intersegment charge. Management believes that the intersegment interest expense reflected in the SBA Lending and Mortgage Banking segments may be lower than would be paid by these two operations in an arm's length, market rate borrowing relationship, and conversely the intersegment interest income credited to the Community Bank from this intersegment interest allocation may be lower than would otherwise be earned by the Bank in arm's length investments or loans. Except as described above, the Bank accounts for intersegment revenues and expenses as if the revenue/expense transactions were to third parties at current market prices.

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	
Three months ended June 30,	**2016**	**2015**	**2016**	**2015**	**2016**	**2015**
Interest income	$ 3,353	$ 2,195	$ 1,245	$ 754	$ 1,561	$ 2,098
Interest expense	828	585	—	—	—	—
Intersegment interest allocation	1,403	1,262	(498)	(292)	(905)	(970)
Net interest income	3,928	2,872	747	462	656	1,128
Provision for loan losses	252	9	76	—	32	24
Net interest income after provision	3,676	2,863	671	462	624	1,104
Non interest income	829	275	154	72	16,370	16,408
Non interest expense	4,294	2,362	810	537	14,626	15,339
Net income before tax expense	211	776	15	(3)	2,368	2,173
Income tax expense (benefit)	(166)	302	6	(1)	935	846
Net income	$ 377	$ 474	$ 9	$ (2)	$ 1,433	$ 1,327

(In thousands)	Community Banking		SBA Lending Operations		Mortgage Banking Operations	
Six months ended June 30,	**2016**	**2015**	**2016**	**2015**	**2016**	**2015**
Interest income	$ 5,617	$ 4,471	$ 2,320	$ 1,433	$ 2,928	$ 3,604
Interest expense	1,421	1,130	—	—	—	—
Intersegment interest allocation	2,512	2,542	(917)	(587)	(1,595)	(1,955)
Net interest income	6,708	5,883	1,403	846	1,333	1,649
Provision for loan losses	253	147	76	63	64	83
Net interest income after provision	6,455	5,736	1,327	783	1,269	1,566
Non interest income	1,092	540	734	154	28,587	30,637
Non interest expense	6,891	4,459	1,467	1,003	26,297	28,867
Net income before tax expense	656	1,817	594	(66)	3,559	3,336
Income tax expense (benefit)	(11)	704	235	(26)	1,373	1,292
Net income	$ 667	$ 1,113	$ 359	$ (40)	$ 2,186	$ 2,044

The community banking segment provides traditional banking services offered through the Bank's six full service branch locations in Lady's Island and Port Royal, South Carolina; Ocala, The Villages, and Fernandina Beach, Florida. At June 30, 2016 this segment had 92 full time equivalent employees including staff that provides operational and administrative support to the other two reportable segments. Staff levels include 27 full time equivalent employees added during the second quarter of 2016 from the First Avenue National Bank acquisition. The year over year increase in noninterest income for the three and six months ended June 30, 2016 reflects the impact of the nonrecurring bargain purchase gain, while the year over year increase in noninterest expenses were largely reflective of a combination of nonrecurring merger related costs and recurring operating costs from the three new branch locations obtained in the merger. The increase to core earnings from net interest income reflects the expansion of the balance of earning assets, also from the recent bank acquisition.

The Small Business Administration lending segment originates SBA loans throughout the southeastern United States by the Bank's SBA business development officers. At June 30, 2016 the division had 17 full time equivalent employees and conducted all loan funding, sales and servicing activity from the Bank's operations center in Fernandina Beach, Florida. These officers serve markets in Jacksonville, Ft. Myers, Tampa, and Vero Beach, Florida; Greensboro, North Carolina; and Beaufort, South Carolina. The majority of loans originated by the division are processed through the SBA 7(a) loan program. Participations in these loans are typically sold to secondary market investors within 30 days of the loan being funded. However, since the fourth quarter of 2014, the SBA lending segment began to extend the holding time of new loans to accumulate into larger groups of loans for sale rather than selling on a flow basis as the loans were originated. This was done with the expectation of achieving more advantageous pricing with increased block sizes sold in secondary market channels. As a result there were four SBA loan participation sales during the quarter ending June 30, 2016 with a participation balance sold of $1,494,000 and at a weighted average premium of 10.78% from a balance of loans available for participation sale of $1,991,000. The inventory of SBA loans available for participation sale at June 30, 2016 is $28,259,000. During the six months ended June 30, 2015, there were no SBA loan participation sales and the inventory of SBA loans available for participation sale at June 30, 2015 was $10,411,000.

The mortgage banking segment was staffed by 366 full time equivalent employees at June 30, 2016 who originate residential mortgage loans through one of four distinct delivery channels. These channels include (1.) a network of independent mortgage brokers, (2.) a national network of traditional retail mortgage lending branches, (3.) an internet leads based retail loan origination branch, and (4.) retail mortgage lending through the Bank's deposit branch locations. Most of these loans are closed by the Bank and sold to various investors on the secondary market while a limited number of loans are retained in the Bank's loan portfolio. Additionally, during the first six months of 2016, approximately 33% of the loan production was brokered away to other lenders and so were not closed by the Bank. All wholesale and internet retail mortgage banking activity is conducted in the Bank's mortgage banking offices in Atlanta, Georgia, as is the national retail mortgage lending administration function. The national retail lending branches are located in Arizona, Florida, Georgia, Illinois, Indiana, Maryland, Michigan, North Carolina, and Ohio.

Loans on one-to-four family residential mortgages originated by us are sold to various other financial institutions with representations and warranties that are usual and customary for the industry. In addition to these representations and warranties, our loan sale contracts define a condition termed an Early Payment Default ("EPD") in which a borrower fails to make any one of the first four loan payments within 30 days of the due date. In the event of an EPD occurrence, we are required to return the premium paid by the investor for the loan as well as pay certain administrative fees. In the event of a breach of any of the representations and warranties related to a loan sold, we could be liable for damages to the investor up to and including a "make whole" demand that involves, at the investor's option, either reimbursing the investor for actual losses incurred on the loan or repurchasing the loan in full. Our maximum exposure to credit loss in the event of a loan repurchase related to a make whole claim would be the unpaid principal balance of the loan to be repurchased along with any premium paid by the investor when the loan was purchased and other minor collection cost reimbursements.

From the September 2007 inception of the mortgage banking division through June 30, 2016, we have sold over 45,000 residential mortgage loans into the secondary market with a principal balance in excess of $10.4 billion. From this population of sold loans, the Bank has received notification from purchasers of a total of forty-four EPD claims or on average one EPD claim per 1,039 loans sold. Below are the EPD claims by year of sale-vintage:

Year of Sale	# Loans Sold	EPDs	Claims Rate		$ Loans Sold
2016	4,189	—	0.0%	$	995,758,943
2015	7,741	8	0.10%		1,905,768,081
2014	4,892	2	0.04%		1,151,537,418
2013	5,607	3	0.05%		1,301,421,133
2012 & prior	23,293	31	0.13%		5,049,034,014
Total	45,722	44	0.10%	$	10,403,519,589

Beyond the initial payment to the purchasers of $234,000 upon receipt of the EPD claims, the maximum remaining exposure under investor claims of a representation and warranty breach would be the difference between the total loan amount and the liquidated value of the underlying collateral. In the case of our forty-four EPD claims received since the inception of mortgage banking operations, the aggregate loan balance was $8,075,000 and consisted of forty-four single family residences. Original loan-to-value ratios ranged from 65% to 98%, and loans with a loan-to-value ratio over 80% have a mortgage insurance policy in place. If repurchase was required in the future, management believes that the potential amount of loss would not be material and that sufficient reserves exist to fully absorb any loss. Management does not anticipate any material credit risk related to potential EPD claims on loans that have been previously sold and are no longer on the Bank's balance sheet. Because the risk of an EPD claim only exists during the first four payments after a loan is originated, the Bank reports the total of the most recent four months mortgage banking lending volume as off-balance sheet credit risk from EPD claims. As of June 30, 2016, the total off-balance sheet credit risk from EPD claims was $750,738,717.

As discussed above, the representations and warranties in loan sale agreements require that the Bank repurchase loans or indemnify the investors for losses or costs on loans sold under certain limited conditions. Some of these conditions include underwriting errors or omissions, fraud or material misstatements by the borrower in the loan application, or invalid market value on the collateral property due to deficiencies in the appraisal. From the total population of sold loans, in over eight years of operations the Bank has been required to settle nineteen make whole claims or on average one claim per 2,406 loans sold at a total cost of $1,766,000, and has repurchased six loans totaling $1,918,000. Of the six repurchased loans, four have been paid off, and the other two are current and performing in accordance with their loan terms.

Management has recognized the potential risk from costs related to EPD claims and breaches of representations and warranties made in connection with residential loan sales. It is noteworthy that the Bank's loan sale activity began in late 2007 at a time when underwriting requirements had changed and limited documentation conventional (non-government insured) loans were no longer eligible for purchase in the secondary market. Accordingly, the population of conventional loans the Bank has sold was underwritten based on fully documented information. While this will not eliminate all risk of repurchase or indemnification costs, management believes it significantly mitigates that risk as evidenced by the relatively insignificant level of repurchase and indemnification costs incurred to date.

In recognition of risk from potential EPD claims and breaches of representations and warranties, an indemnification reserve has been established and maintained since mortgage banking loan sales began in late 2007 to cover potential costs. Initially we had a limited history of actual costs incurred, so additions to the reserve were made monthly based on a percentage of loan balances sold that month. This approach recognizes that the risk of indemnification costs will rise in relation to the level of loans sold. In August 2013 we evaluated actual loss experience for six years relative to the reserve level and new business volume, and based on that analysis the decision was made to suspend further additions to the reserve balance. As a result, the balance of the indemnification reserve was approximately $2,446,000 at December 31, 2013. We updated this evaluation of actual loss experience in September 2014, including a detailed analysis of investor repurchase demands and claims paid over seven years. Based on that updated analysis, management determined that our existing indemnification reserve level should be reduced by $437,000 in 2014, resulting in a balance of the indemnification reserve of $1,938,000 at December 31, 2014. The trend of limited claims activity continued in 2015 with charges against the indemnification reserve of $30,000 during the year ended December 31, 2015. Despite the modest historical claims experience, management perceived a slightly elevated risk from loans sourced through the national retail group channel (NRG),and so the decision was made to record monthly additions to the reserve beginning in January 2015 based on a percentage of NRG sourced loans that were sold or brokered away to other lenders. The total additions to the reserve for NRG loans sold during 2015 was $54,000. As a result, the balance of the indemnification reserve at December 31, 2015 was $1,962,000. Total additions to the reserve for NRG loans during the six months ended June 30, 2016 were $23,000 while charges against the reserve were $23,000. As a result, the balance of the indemnification reserve at June 30, 2016 remained unchanged at $1,962,000 and based on the Bank's modest historical loss experience and the current level of indemnification claims under review, management believes this level of reserve is adequate for potential exposure in connection with loan sale indemnification or EPD claims. Management will monitor the reserve level relative to loss experience and business volume levels and may continue the suspension of additions to the reserve or alternatively decide that further additions to the reserve may be appropriate. However, we can provide no assurance that our methodology will not change and that the balance of this indemnification reserve will prove sufficient to cover actual costs in the future.

The primary source of direct income generated by the mortgage banking division is the gain on sale of mortgage loans which was $16,412,000 for the quarter ended June 30, 2016 compared to $16,474,000 for the quarter ended June 30, 2015. For the first six months of 2016, the gain was $28,691,000 compared to $30,773,000 for the same period in 2015. The decrease in gain on sale for the first half of 2016 is as a result of lower volume Q1-2016 as compared to Q1-2015 caused by a stabilization of the historically low long term interest which fueled increasing loan demand for both refinance and purchase money loans. At the peak of refinance activity in 2012, 76.4% of units closed by the mortgage division were for the purpose of refinancing an existing loan and 23.6% were for the purpose of purchasing a home. Management has worked to restructure loan product offerings, geographic sales presence, and pricing incentives to increase the focus on purchase money lending. As a result we observed a gradual shift from refinance to purchase money lending with refinance lending falling to 53% of total units funded in 2014. During the first half of 2015, refinance lending increased to 71% of units funded as a result of lower long-term interest rates, reductions in FHA insurance premiums and higher allowable loan to value limits on agency eligible loans. For the six months ended June 30, 2016, a renewed focus on purchase money lending has driven refinance activity back down to 66% of units funded. While mortgage loan volume will always be directly impacted by interest rates, purchase money lending has proven to be more resilient to increasing rate environments than has refinance lending, and so by reducing our reliance on refinance lending we expect to be well positioned to maintain profitable funding levels as long term rates rise from current levels.

The direct noninterest expenses incurred by the division were $14,372,000 for the second quarter of 2016, a decrease of $966,000 over the second quarter 2015 expenses of $15,338,000. The largest contributor to this decrease was in salaries and benefits, which were $11,925,000 for second quarter 2016, compared to $13,073,000 for second quarter 2015, a year over year decrease of 9%. This Q2 year over year decline in mortgage banking compensation expense occurred as a result of slightly reduced lending volume of $49 million or 6%, from $836 million in Q2-2015 to $787 million in Q2-2016.

Beyond the impact of the noninterest income and expense from this division, the Bank earns interest income at the respective note rates on the balance of loans originated by the division from the time the loan is funded until it is sold to a secondary market investor. The average outstanding daily balance of residential mortgage loans available for sale was $117,086,000 for the three months ended June 30, 2016 and $174,299,000 for the three months ended June 30, 2015. The interest income earned on these loans available for sale was $1,121,000 and $1,549,000 during the three months ended June 30, 2016 and 2015, respectively. For the six months ended June 30, the average outstanding daily balance of residential loans available for sale was $104,161,000 in 2016 and $142,088,000 in 2015. The interest income earned on these loans available for sale was $2,035,000 and $2,515,000 during the first half of 2016 and 2015, respectively.

Note 6 - Net Interest Income

The Bank's net interest income is determined by the level of our earning assets, primarily loans outstanding, and the management of our net interest margin. For the quarter ended June 30, 2016, net interest income totaled $5,163,000 as compared to $4,421,000 for the quarter ended June 30, 2015 for an increase of $742,000. On a consecutive quarter basis, net interest income was up by $481,000, or 12%, from the 3,940,000 earned during the quarter ended March 31, 2016.

Total interest income increased by $1,111,000 to $6,160,000 for the three months ended June 30, 2016 compared to $5,049,000 for the three months ended June 30, 2015. On a consecutive quarter basis, total interest income increased by $1,453,000, or 31%, from the $4,707,000 earned during the quarter ended March 31, 2016.

During the final quarter of 2015 the Federal Reserve Bank increased short term interest rates for the first time in nearly a decade. A significant portion of the Bank's portfolio loans carry a variable rate of interest tied to the Prime interest rate, and so the 25 basis point increase to the Prime interest rate from 3.25% to 3.50% had a favorable impact on core earnings of the Company during the first six months of 2016. At June 30, 2016 and June 30, 2015 the Bank held $184,425,000 and $126,359,000 respectively, in loans carrying rates based on the Prime interest rate index.

The positive impact from an increase in the Prime interest rate was partially offset by a reduced balance of residential mortgage loans available for sale during the first six months of 2016, as well as a lower year over year yield on those loans. The average balance of residential mortgage loans held for sale declined from $142,088,000 in the first half of 2015 to $104,161,000 for the first half of 2016, a decrease of $37,927,000, or 27%. Overall average earning assets increased to an average balance of $524,744,000 during the quarter ended June 30, 2016, up by $60,855,000, or 13%, from the average balance during the quarter ended June 30, 2015. One of the largest contributors to the increase in interest income for the first half of 2016 is the interest earned on SBA loans held in the portfolio, which increased $887,000 to $2,320,000 during the first half of 2016, compared to $1,433,000 during the first half of 2015. Total interest and fees earned on portfolio loans increased by $1,096,000 or 23%, to $5,944,000, in the three months ended June 30, 2016 from $4,848,000 in the three months ended June 30, 2015. Interest income from investment securities increased $9,000, or 5%, to $207,000 in the three months ended June 30, 2016 compared to $198,000 earned in the three months ended June 30, 2015. On a consecutive quarter basis, interest income from investments increased $13,000 from $194,000 earned during the quarter ended March 31, 2016.

Interest income not recognized on non-accruing loans during the quarter ended June 30, 2016 was $41,000, an increase of $14,000 from the $27,000 of interest income not recognized during the same quarter in 2015. On a consecutive quarter basis, interest income not recognized on non-accruing loans decreased $32,000 from the $73,000 interest lost during the quarter ended March 31, 2016. During the three month period ended June 30, 2016 there were three non-accruing loans totaling $285,000 returned to accrual status; nine additions to non-accruing loans of $3,498,000; $75,0000 in charge-offs; and $595,000 in principal reductions made for a net increase of $2,541,000 to the balance of loans on nonaccrual.

On November 15, 2015, the Company redeemed all outstanding TARP preferred stock and paid all preferred dividends accrued through the date of redemption. The redemption and dividend payments were funded with the proceeds of a senior note payable to NexBank, SSB. As a result of this refinancing total interest expense increased by $370,000, or 59%, to $998,000 for the three months ended June 30, 2016 compared to $628,000 for the same period in 2015. On a consecutive quarter basis, total interest expense increased by $231,000, or 30%, from $767,000 expensed during the quarter ended March 31, 2016 primarily as a result of a $88,094,000 increase in average interest bearing deposit balances of which $69,516,000 related to the average balances added from the FANB acquisition in Q2-2016.

The net interest margin is a performance metric that reports how successful the Bank's investment decisions have been relative to its funding choices. It is calculated by dividing the annualized net interest income by the balance of the average earning assets for the period. The net interest margin realized on earning assets increased by 13 basis points to 3.95% for the three months ended June 30, 2016 when compared to the 3.82% net interest margin earned during the same three months in 2015. On a consecutive quarter basis, the net interest margin increased by 6 basis points from 3.89% during the quarter ended March 31, 2016.

The net interest rate spread is the difference between the average yield earned by the Bank on loans, investment securities and other earning assets, and the rate paid by the Bank on interest bearing deposits and other borrowings. The net interest rate spread increased by 5 basis point to 3.78% for the three months ended June 30, 2016 compared to the 3.73% net interest rate spread earned during the same three month period in 2015. On a consecutive quarter basis, the net interest rate spread increased by 5 basis points from 3.73% during the quarter ended March 31, 2016.

For the six months ended June 30, 2016, net interest income totaled $9,103,000 as compared to $8,294,000 for the same period in 2015, for an increase of $809,000, or 10%. Total interest income increased $1,358,000, or 14%, to $10,868,000 for the six months ended June 30, 2016 compared to $9,510,000 for the six months ended June 30, 2015. Interest and fees on loans increased by $1,350,000, or 15%, to $10,453,000 in the six months ended June 30, 2016 from $9,103,000 in the six months ended June 30, 2015. As discussed above, during the first half of 2016, the bank's average loan portfolio increased $106,774,000 from the same period reported at June 30, 2015. The FANB acquisition accounted for $37,857,000 of this year over year increase. Interest income on investment securities decreased by $2,000, or 0.50%, to $401,000 in the six months ended June 30, 2016 compared to $403,000 in the six months ended June 30, 2015. Total interest expense increased by $549,000, or 45%, to $1,765,000 for the six months ended June 30, 2016 compared to $1,216,000 for the same period in 2015. The net interest margin and the interest rate spread were 3.92 % and 3.76%, respectively, for the six months ended June 30, 2016. The net interest margin realized on earning assets and the interest rate spread were 3.85% and 3.76%, respectively, for the six months ended June 30, 2015.

<u>Note 7 - Provision and Allowance for Loan Losses</u>

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 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 qualitative factors reflect general declines in collateral values.

To the extent that the recovery of loan balances has become collateral dependent, we obtain appraisals not less than annually, and then we reduce these appraised values for selling and holding costs to determine the liquidated value. Any shortfall between the liquidated value and the loan balance is charged against the allowance for loan losses in the month the related appraisal was received. In the ordinary course of managing and monitoring nonperforming loans, information may come to our attention that indicates the collateral value has declined further from the value established in the most recent appraisal. Such other information may include prices on recent comparable property sales or internet based property valuation estimates. In cases where this other information is deemed reliable, and the impact of a further reduction in collateral value would result in a further loss to the Company, we will record an increase to the allowance to reflect the additional estimated collateral shortfall.

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)	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014
Portfolio loans, gross	$ 393,146	$ 298,262	$ 285,933	$ 274,704	$ 272,115	$ 270,230	$ 272,757	$ 267,393
Loans past due > 30 days and still accruing interest	$ 4,177	$ 1,056	$ 123	$ 2,302	$ 1,752	$ 2	$ 806	$ 455
Loans on nonaccrual	$ 4,478	$ 1,936	$ 2,478	$ 3,484	$ 4,176	$ 4,629	$ 4,330	$ 2,881
(as a % of loans, gross)	1.14%	0.65%	0.87%	1.27%	1.53%	1.71%	1.59%	1.08%
Net loan charge offs (recoveries)	$ (29)	$ 868	$ 16	$ 8	$ 21	$ (76)	$ 72	$ 256
(as a % of loans, gross)	(0.01)%	0.29%	0.01%	0.00%	0.01%	(0.03)%	0.03%	0.10%

Portfolio loans, gross addresses the impact on the provision for loan losses from changes in the size and composition of our loan portfolio. In the past we applied various reserve factors to our portfolio based on the risk-rated categories of loans because we had relatively little charge off activity prior to the quarter ended December 31, 2008. As a result of increasing charge off activity, we now rely more 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 in recent 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. Portfolio loans grew by $95.1 million in the second quarter of 2016. The acquisition of First Avenue National Bank contributed $80.5 million to this increase of which $43.3 million were commercial real estate loans having a higher risk profile.

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 increased to $4,177,000 at June 30, 2016, an increase of $3,121,000 as compared to $1,056,000 at March 31, 2016. Two long standing borrowing relationships were responsible for 97.4% of the current quarter increase in the balance of loans past due greater than 30 days and still accruing interest. As such, the current quarter deterioration in this credit metric reflects ongoing legacy credit challenges rather than indications of possible negative trends from recent portfolio growth. As a leading indicator, this metric suggests that relatively stable loan quality trends may be expected to continue in the current economic and interest rate environment. Management will continue to carefully monitor past due loans and work aggressively to manage loan delinquency levels. While the long term trend in credit quality over the last several years has improved, we can expect that slight volatility will occur as experienced over the last few quarters may continue.

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. Although it is not shown in the table above, the level of loans on nonaccrual peaked at $25,925,000 at June 30, 2009 and then declined by 50% over the following three quarters to $12,992,000 at March 31, 2010. From that March 31, 2010 low point, loans on nonaccrual gradually increased again to peak at $25,399,000 in mid-2011 which was very near the mid-2009 high point. Once again we saw a downward trend; however, after the mid-2011 spike the improvement in nonaccrual balances has generally been sustained. The June 30, 2016 nonaccrual balance of $4,478,000 is an increase of $2,542,000 over nonaccrual loans at March 31, 2016. During the three months ended June 30, 2016 two loans migrated to nonaccrual status, three loans were upgraded to accrual status, and seven were added as part of the acquisition of First Avenue National Bank. One long standing borrower was responsible for 88.2% of the current quarter increase in loans on nonaccrual. While management is generally encouraged by the long term improvement in nonaccrual loans, we remain vigilant in our loan monitoring and loss mitigation efforts.

Net loan charge offs or recoveries reflect our practice of charging recognized losses to the allowance and adding subsequent recoveries back to the allowance. During the three months ended June 30, 2016, we recorded net recoveries of $29,000. This amount represented a decrease of $897,000, or 103%, from the $868,000 in net charge-offs recorded during the prior quarter ended March 31, 2016, and a decrease of $50,000, or 238% from the $21,000 net charge offs during the same quarter in the prior year.

Prior to the fourth fiscal quarter of 2008, we had very little charge off activity and therefore, had limited historical information upon which to base past estimates. Since 2009 charge off activity has been volatile, occasionally significant and difficult to predict with any reliability but we continue to assess the implications of trends in recent charge off activity on potential future losses. The recent volatility in the level of quarterly net loan charge offs or recoveries makes it difficult to identify a specific trend or establish reliable future expectations. As a result, there can be no assurance that charge offs of loans in future periods will not increase or exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period. Thus, there is a risk that substantial additional increases in the allowance for loan losses could be required, which would result in a decrease in our net income and possibly our capital.

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 $360,000 for the three months ended June 30, 2016, as compared to $33,000 for the three months ended June 30, 2015. On a consecutive quarter basis, this provision level was $327,000, or 991%, higher than the $33,000 provision charged to expense during the quarter ended March 31, 2016. The increased level of provision expense for the three months ended June 30, 2016, as related to the prior comparative periods, does not necessarily indicate a general overall decline in loan portfolio credit quality, but rather was driven by a combination of increased levels in directional risk factors of past due loans, nonaccrual loans, and loans classified as substandard.

(In thousands)	**June 30, 2016**	**March 31, 2016**	**December 31, 2015**	**September 30, 2015**	**June 30, 2015**	**March 31, 2015**	**December 31, 2014**	**September 30, 2014**
Provision during quarter ended	$ 360	$ 33	$ 44	$ 57	$ 33	$ 260	$ 266	$ 223
Provision added in excess of net charge-offs/(recoveries)	$ 389	$ (835)	$ 28	$ 49	$ 12	$ 336	$ 194	$ (33)
Allowance for loan losses	$ 4,808	$ 4,419	$ 5,254	$ 5,226	$ 5,177	$ 5,165	$ 4,829	$ 4,635
(as a % of loans, gross)	1.22%	1.48%	1.84%	1.90%	1.90%	1.91%	1.77%	1.73%

The difference between the amount of the provision for loan losses and net loan charge offs will result in expansion or shrinkage to the level of the allowance for loan losses. As shown above, during the three months ended June 30, 2016 the current provision for loan losses of $360,000 was greater than net recoveries against the allowance of $29,000 by $389,000. The result was an increase to the allowance for loan losses by $389,000 to a level of $4,808,000, or 1.22% of gross loans outstanding at June 30, 2016, as compared to $4,419,000, or 1.48% of gross loans outstanding at March 31, 2016.

From a historical perspective, prior to 2008, while the level of loans on nonaccrual was relatively stable, the allowance for loan losses was maintained in the range of 1.2% to 1.3% of the balance of gross loans. As we moved into 2008 and experienced an increase in loans on nonaccrual, it was determined that an increase to the allowance level was appropriate given the projected increased risk of loss, so the allowance was increased to a range of 1.4% to 1.6% during 2008. The weakening of the loan portfolio performance continued into 2009 with actual loss levels that exceeded projections from earlier in 2008, resulting in the decision to increase the allowance level further, to the range of 1.6% to 1.8% in early 2009. With nonaccrual loans reaching a peak in mid-2009, further analysis and projections of potential loan losses in the Bank’s existing portfolio supported a further increase in the allowance level to a range of 2.0% to 2.3% of gross loans outstanding, which was sustained through the end of 2012. Beginning in the final two quarters of 2012 we observed significant improvement in loan portfolio performance that continued into 2014 and throughout 2015 with many key asset quality metrics improving to levels last reported during 2008. Based on these improving trends and current projections of future potential loses, we have gradually reduced our target allowance level to the current range of 1.40% to 1.60% of gross loans outstanding. Management is currently reviewing our target allowance level in light of the addition of loans acquired in the merger with First Avenue National Bank and our assessment of future risk in the loan portfolio. Management believes that the changes in the level of the allowance for loan losses are directionally consistent with the trends observed in the various asset quality metrics discussed above.

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.

Note 8 - Noninterest Income

Noninterest income for the three months ended June 30, 2016 totaled $17,337,000 as compared to $16,739,000 for the three months ended June 30, 2015. Mortgage banking income was $16,412,000 for the quarter ended June 30, 2016 compared to $16,474,000 for the same period during 2015 for an decrease of $62,000 or 0.38% on slightly reduced loan funding levels. This was partially offset by SBA loan income increasing by $82,000 or 114% to $154,000 for the three month period ended June 30, 2016 compared to the $72,000 for the second quarter of 2015. Beginning with the fourth quarter of 2014, the SBA lending segment began to accumulate production in anticipation of more advantageous pricing with increased block sizes to sell in secondary market channels. Despite the SBA participation sales during the first two quarters of 2016, the inventory of SBA loans available for participation sale at June 30, 2016 has grown to $28,259,000 for an increase of $17,848,000 or 171% as compared to $10,411,000 of inventory of SBA loans available for participation sale at June 30, 2015. In addition the SBA loan income was reduced $126,000 during the 3 months ending June 30, 2016 as a result of three early payoffs and one repurchase of loan participation sales. Other noninterest income increased $508,000 during the quarter ending June 30, 2016 as a result of the recognition of the bargain purchase gain from the acquisition of First Avenue National Bank.

Noninterest income for the six months ended June 30, 2016 totaled $30,383,000, as compared to $31,301,000 for the six months ended June 30, 2015. The largest increase was in SBA loan income as a result of the 12 participation loan sales for the first six months of 2016 as compare no loan participation loans sold during the first half of 2015. Mortgage banking income decreased $2,082,000 to $28,691,000 for the first half of 2016, compared to $30,773,000 for the same period of 2015. The decrease in mortgage banking income is primarily the result of a $176,865,000, or 11% decrease, in mortgages produced during the six month period ending June 30, 2016 compared to the same period in 2015.

Note 9 - Noninterest Expense

Total noninterest expense for the three months ended June 30, 2016 was $19,997,000 as compared to $18,377,000 for the same period in 2015. The year-over-year increase in noninterest operating expense of $1,619,000 is due largely to increased expenses as a result of the $674,000 in one-time, non-recurring expenses recognized from the First Avenue National Bank acquisition. Legal and professional expenses increased $196,000 or 77% to $451,000 during the three months ending June 30, 2016 as compared to $255,000 for the quarter ending June 30, 2015 primarily as a result of legal fees expended and reserved for defense costs related to a litigation matter involving labor practices, the outcome of which is not expected to have a material impact on future operating results.

The community banking segment reported a $1,932,000, or 82%, increase in noninterest expenses totaling $4,294,000 for the second quarter of 2016 as compared to $2,362,000 for the same period in 2015 primarily as a result of nonrecurring costs incurred for the acquisition of First Avenue National Bank as well as elevated operating expenses from the three new deposit branch locations added in that acquisition. The SBA division reported a $273,000, or 51%, increase in noninterest expenses totaling $810,000 for the second quarter of 2016 as compared to $537,000 for the same period in 2015. The Mortgage Banking Segment reported a $713,000, or 5%, decrease in noninterest expenses totaling $14,626,000 for the second quarter of 2016 as compared to $15,339,000 for the same period in 2015 as a result in the slightly lower levels of loan volume which reduced commission and administrative expenses. Other real estate expense decreased $23,000 to $89,000 for the second quarter of 2016 compared to $112,000 during the same period of 2015. This improvement is the result of a decline of $12,000 in legal expenses and $11,000 in insurance and taxes related to holding properties.

Total noninterest expense for the six months ended June 30, 2016 increased $466,000, or 1%, to $35,024,000, as compared to $34,558,000 for the same period in 2015. The largest contributor to this increase was in expenses related to net occupancy and equipment costs which increased $522,000, or 30%, to $2,273,000 during the first half of 2016 compared to $1,751,000 during the first half of 2015 from the addition of the three First Avenue National Bank locations. This increase was offset by a reduction in expenses for salaries and benefits which decreased $1,709,000, or 6%, to $26,453,000 during the six months ended June 30, 2016 compared to $28,162,000 during the same period ending June 30, 2015 as a result in lower expenses related to the Mortgage Banking segment from slightly lower levels of production.

Expenses related to other real estate owned increased $2,000 or 2% to $107,000 during the first half of 2016 compared to $105,000 during the first half of 2015. This improvement is the result of a decline of $18,000 in losses on sale, offset by increases of $19,000 in valuation write-downs, and $1,000 in expenses related to holding those properties.

Note 10 – Investment Securities

Investment securities are as follows:

	June 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale				
State and municipal securities	$ 3,120,390	$ 385,769	$ —	$ 3,506,159
Mortgage-backed securities	17,334,265	429,266	(4,863)	17,758,668
	$ 20,454,655	$ 815,035	$ (4,863)	$ 21,264,827
Held to maturity				
Corporate debt securities	$ 100,000	$ —	$ —	$ 100,000
	$ 100,000	$ —	$ —	$ 100,000

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale				
State and municipal securities	$ 3,135,595	$ 318,519	$ (101)	$ 3,454,013
Mortgage-backed securities	16,944,799	231,847	(105,991)	17,070,655
	$ 20,080,394	$ 550,366	$ (106,092)	$ 20,524,668

Note 11 — Loans and allowance for loan losses

The composition of loans is summarized as follows:

	June 30, 2016	December 31, 2015
Commercial and financial	$ 29,760,176	$ 18,795,061
Agricultural	10,000	17,500
Real estate – construction, commercial	27,015,484	20,635,761
Real estate – construction, residential	18,114,302	12,901,736
Real estate – mortgage, commercial	151,533,538	106,651,258
Real estate – mortgage, residential	150,718,406	121,878,211
Real estate – mortgage, farmland	10,718,982	3,845,325
Consumer installment loans	5,274,822	1,207,697
Gross loans	393,145,710	285,932,549
Less: Allowance for loan losses	4,808,392	5,254,407
Net loans	$ 388,337,318	$ 280,678,142

The Bank grants loans and extensions of credit to individuals and a variety of businesses and corporations located in its general trade areas of Beaufort County, South Carolina, Nassau and Marion County, Florida. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate and is dependent upon the real estate market.

Loans exhibiting one or more of the following attributes are placed on a nonaccrual status:

a.) Principal and/or interest is 90 days or more delinquent, unless the obligation is (i) well secured by collateral with a realizable value sufficient to discharge the debt including accrued interest in full, and (ii) in the process of collection, which is reasonably expected to result in repayment of the debt or in its restoration to a current status.

b.) A borrower's financial condition has deteriorated to such an extent, or some condition exists, that makes collection of interest and/or principal in full unlikely in management's opinion.

c.) Foreclosure or legal action has been initiated as a result of default by the borrower on the terms of the debt.

The following is a summary of current, past due and nonaccrual loans:

	June 30, 2016						
(In thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due & Accruing	Nonaccrual	Total Past Due & Nonaccrual	Current Loans	Total Loans
Commercial and financial	$ —	$ —	$ —	$ 86	$ 86	$ 29,674	$ 29,760
Agricultural	—	—	—	—	—	10	10
Real estate – construction, commercial	—	—	—	—	—	27,015	27,015
Real estate – construction, residential	—	—	—	—	—	18,114	18,114
Real estate – mortgage, commercial	2,815	—	—	3,293	6,108	145,426	151,534
Real estate – mortgage, residential	1,357	—	—	1,099	2,456	148,263	150,719
Real estate – mortgage, farmland	—	—	—	—	—	10,719	10,719
Consumer installment loans	5	—	—	—	5	5,270	5,275
	$ 4,177	$ —	$ —	$ 4,478	$ 8,655	$ 384,491	$ 393,146

	December 31, 2015						
(In thousands)	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due & Accruing	Nonaccrual	Total Past Due & Nonaccrual	Current Loans	Total Loans
Commercial and financial	$ —	—	$ —	$ —	$ —	$ 18,795	$ 18,795
Agricultural	—	—	—	—	—	18	18
Real estate – construction, commercial	—	—	—	887	887	19,749	20,636
Real estate – construction, residential	—	—	—	—	—	12,902	12,902
Real estate – mortgage, commercial	—	—	—	1,026	1,026	105,625	106,651
Real estate – mortgage, residential	114	—	—	565	679	121,199	121,878
Real estate – mortgage, farmland	—	—	—	—	—	3,845	3,845
Consumer installment loans	9	—	—	—	9	1,199	1,208
	$ 123	$ —	$ —	$ 2,478	$ 2,601	$ 283,332	$ 285,933

Other Risk Elements in the Loan Portfolio

The following is a summary of other risk elements in the loan portfolio:

	Loans with Interest Only Payments			
(In thousands)	June 30, 2016		December 31, 2015	
Commercial and financial	$ 4,821	8%	$ 3,047	7%
Agricultural	10	—%	18	—%
Real estate – construction, commercial	10,825	17%	7,018	17%
Real estate – construction, residential	12,164	19%	7,461	18%
Real estate – mortgage, commercial	10,420	17%	6,255	15%
Real estate – mortgage, residential	24,305	39%	18,131	43%
Consumer installment loans	97	—%	33	—%
	$ 62,642		$ 41,963	

As shown above, we have a moderate concentration of interest only loans in our portfolio, and such loans are generally regarded as carrying a higher risk profile than fully amortizing loans. It is important to note that none of the interest only loans in our portfolio allow negative amortization, nor do we have any loans with capitalized interest reserves.

Balances within the major loans receivable categories and geographic concentration of the loan portfolio are presented below:

	Geographic Concentration of Loan Portfolio			
	June 30, 2016			
(In thousands)	Florida	Georgia	South Carolina	Other
Commercial and financial	$ 19,292	$ 4,933	$ 2,492	$ 3,044
Agricultural	—	—	10	—
Real estate – construction, commercial	15,053	3,730	5,812	2,422
Real estate – construction, residential	7,778	6,320	3,721	295
Real estate – mortgage, commercial	100,231	14,019	28,643	8,639
Real estate – mortgage, residential	74,399	36,558	27,767	11,993
Real estate – mortgage, farmland	10,476	244	—	—
Consumer installment loans	3,932	312	618	413
	$ 231,161	$ 66,116	$ 69,063	$ 26,806

	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
Agricultural	—	—	18	—
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	552	62
	$ 129,201	$ 66,096	$ 67,936	$ 22,700

We also monitor and evaluate several other loan portfolio characteristics at a total portfolio level rather than by major loan category. These characteristics include:

Junior Liens – Loans secured by liens in subordinate positions tend to have a higher risk profile than loans secured by liens in the first or senior position. At June 30, 2016 the Company held $17,201,000 of loans secured by junior liens, which represented approximately 4.4% of the total net loan portfolio. Net loan charge-offs totaled $60,000 during the six months ended June 30, 2016 for all loans secured by junior liens for an annualized net charge-off rate of 0.70%. At December 31, 2015 the Company held $19,243,000 of loans secured by junior liens which represented approximately 6.7% of the total net loan portfolio.

High Loan to Value Ratios – Typically the Company will not originate a new loan with a loan to value (LTV) ratio in excess of 100%. However, declines in collateral values can result in the case of an existing loan renewal with an LTV ratio in excess of 100% based on the current appraised value of the collateral. In such cases the borrower may be asked to pledge additional collateral or to renew the loan for a lesser amount. If the borrower lacks the ability to pay down the loan or provide additional collateral, but has the ability to continue to service the debt, the loan will be renewed with an LTV ratio in excess of 100%. At June 30, 2016 the loan portfolio included 44 loans with an aggregate balance of $12,392,000, or 3.2% of the net loan portfolio, with LTV ratios in excess of 100%. At December 31, 2015 the loan portfolio included 50 loans with an aggregate balance of $12,972,000, or 4.5% of the net loan portfolio, with LTV ratios in excess of 100%.

Restructured Loans – Historically, the Company has followed a conservative approach by classifying any loan as restructured whenever the terms of a loan were adjusted to the benefit of any borrower in financial distress, regardless of the status of the loan at the time of restructuring. In some cases we have restructured loans for borrowers who were not delinquent, but for various reasons these borrowers were experiencing financial distress that raised a doubt about their continued ability to make payments under current terms. By adjusting the terms of the loan to better fit the borrower’s current financial condition, expectations are that the loan will avoid a future default. In other cases we have restructured loans for borrowers who were in default at the time the loan terms were restructured. The expectation is that by adjusting the terms of such loans, the borrower may begin to make payments again based on the improved loan terms.

The types of changes that are made for troubled borrowers to restructure their obligations include the following:

- Deferral of one or more scheduled loan payments to a future date
- Temporary or permanent reduction of the loan interest rate
- Conversion from principal and interest payment term to an interest only payment term on a temporary basis, or until maturity
- Forgiveness of accrued but uncollected interest
- Extension of loan maturity date
- Reduction in principal due under the loan agreement

The potential financial effects of restructuring troubled debts includes a reduction in the level of interest income collected, a complete loss of interest income, or a loss of some portion of the original loan principal. All troubled debt restructurings are tested for impairment. If a loan is considered to be collateral dependent, the measurement of impairment is based on the fair value of the collateral, net of estimated liquidation costs. If the loan is not considered to be collateral dependent, the present value of expected cash flows is used to determine any amount of impairment. Any impairment is then charged to the allowance for loan and lease losses or designated as a specific reserve, and as such will be considered as a component of the reserve calculation.

The following table provides a summary of all loans that are currently designated as restructured for regulatory purposes.

	June 30, 2016			December 31, 2015		
Troubled debt restructurings	Number of loans	Recorded Investment	Unpaid Principal Balance	Number of loans	Recorded Investment	Unpaid Principal Balance
Real estate – mortgage, commercial	4	$ 540,603	$ 2,135,143	—	$ —	$ —
Real estate – mortgage	4	1,205,039	1,583,416	9	3,741,945	3,866,771
Total troubled debt restructurings	8	$ 1,745,642	$ 3,718,559	9	$ 3,741,945	$ 3,866,771

The following table provides the payment status as of June 30, 2016 and June 30, 2015 of all loans that were restructured in the twelve month periods ending on those respective dates. None of the loans that were restructured in the preceding twelve months as of June 30, 2016 or June 30, 2015 were greater than 30 days past due or on non-accrual status.

	June 30, 2016		June 30, 2015	
	Number of loans	Recorded Investment	Number of loans	Recorded Investment
Restructured loans less than 30 days past due				
Real estate – mortgage, commercial	—	$ —	1	$ 730,932
Total restructured loans less than 30 days past due	—	$ —	1	$ 730,932

Loans classified as Special Mention or Substandard – Management evaluates all loan relationships periodically in order to assess the financial strength of the borrower and the value of any underlying collateral. Loans that are found to have a potential or actual weakness are classified as special mention or substandard and subject to increased monitoring by management. This typically includes frequent contact with the borrower to actively manage the borrowing relationship as needed to rehabilitate or mitigate the weakness identified. A summary of loan credit quality is presented below:

(In thousands)	June 30, 2016			
	Pass	Special Mention	Substandard	Total
Commercial and financial	$ 29,094	$ 394	$ 272	$ 29,760
Agricultural	10	—	—	10
Real estate – construction, commercial	27,015	—	—	27,015
Real estate – construction, residential	18,114	—	—	18,114
Real estate – mortgage, commercial	142,769	3,814	4,951	151,534
Real estate – mortgage, residential	147,693	1,829	1,197	150,719
Real estate – mortgage, farmland	10,719	—	—	10,719
Consumer installment loans	5,235	40	—	5,275
	$ 380,649	$ 6,077	$ 6,420	$ 393,146

(In thousands)	December 31, 2015			
	Pass	Special Mention	Substandard	Total
Commercial and financial	$ 18,022	$ 767	$ 6	$ 18,795
Agricultural	18	—	—	18
Real estate – construction, commercial	19,749	—	887	20,636
Real estate – construction, residential	12,902	—	—	12,902
Real estate – mortgage, commercial	101,274	1,936	3,441	106,651
Real estate – mortgage, residential	120,081	360	1,437	121,878
Real estate – mortgage, farmland	3,845	—	—	3,845
Consumer installment loans	1,207	—	1	1,208
	$ 277,098	$ 3,063	$ 5,772	$ 285,933

Management has established an allowance for loan losses through a provision for loan losses charged to expense on the statement of earnings. Additions to the allowance for loan losses are made periodically to maintain the allowance at an appropriate level based on management's analysis of the potential risk in the loan portfolio. The allowance for loan losses represents an amount, which is believed to be adequate to absorb probable losses on existing loans that may become uncollectible. Management's judgment as to the adequacy of the allowance for loan losses is based upon a number of assumptions about future events, which are believed to be reasonable, but which may or may not prove to be accurate. To the extent that the recovery of loan balances has become collateral dependent, the Bank obtains appraisals not less than annually, and then reduces these appraised values by the amount estimated for selling and holding costs to determine the liquidated value. Any shortfall between the liquidated value and the loan balance is charged against the allowance for loan losses in the month the related appraisal was received. Losses will undoubtedly vary from management estimates, and there is a possibility that charge-offs can reduce this allowance. Management's determination of the allowance for loan losses is based on evaluations of the collectability of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of the overall loan portfolio, economic conditions that may affect the borrower's ability to repay, commercial and residential real estate market trends, the amount and quality of collateral securing the loans, the Bank's historical loan loss experience, and a review of specific problem loans. Management also considers subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity of problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons.

An analysis of the activity in the allowance for loan losses is presented below:

	For the Six Months Ended June 30,	
	2016	2015
Balance, beginning of year	$ 5,254,407	$ 4,828,899
Provision for loan losses	392,933	293,125
Loans charged off	(955,740)	(86,357)
Recoveries of loans previously charged off	116,792	141,496
Balance, end of period	$ 4,808,392	$ 5,177,163

Note 12 — SBA Loan Servicing Rights

Loan Servicing Rights (LSR) are initially recorded when the participation is sold at a value established by an independent LSR valuation company. This initial valuation also provides an expected life for each new LSR added during the quarter. The balance of the LSR is amortized on a straight line basis in proportion to, and over the period of, estimated servicing income as a reduction to SBA loan income. The balance of the LSR asset is evaluated for impairment at the end of each quarter by obtaining a current fair value from an independent third party. For the period ended June 30, 2016, the carrying value of the SBA LSRs was $1,458,000 and the fair value of the SBA LSRs was $1,971,000. As of December 31, 2015, the carrying value of the SBA LSRs was $1,545,000 and the fair value of the SBA LSRs was $1,938,000. As a result of the quarterly independent valuation process, no valuation allowance was required at either period end. The related balance of SBA loans participated and serviced for others was $85,323,000 at June 30, 2016 and $85,830,000 at December 31, 2015.

The fair value of loan servicing rights typically rises as market interest rates increase and declines as market interest rates decrease; however, the extent to which this occurs depends in part on (1) the magnitude of changes in market interest rates, and (2) the differential between the then current market interest rates for mortgage loans and the mortgage interest rates included in the loan-servicing portfolio. Since sales of mortgage servicing rights tend to occur in private transactions and the precise terms and conditions of the sales are typically not readily available, there is a limited market to refer to in determining the fair value of loan servicing rights. As such, like other participants in the SBA loan servicing business, we determine value of loan servicing rights by estimating the present value of the future income stream attained from all of the servicing related cash flows. The value is the sum on the present value of these future income streams, which is impacted by assumptions on prepayment speeds, age and type of the underlying mortgage, and the rate at which these cash flows are discounted. The present value of the portfolio's expected stream of future cash flows is determined though a loan level analysis utilizing assumptions that would be used by other market participants. The valuation incorporates a five step process. Three income elements that include servicing value, remittance value, and additional income are determined as a present value of the respective estimated cash flows from each loan. Finally, the servicing cost, also expressed as a dollar amount per loan, is valued. The net servicing value for each loan is then determined by subtracting the servicing cost from the three income values.

Note 13 — Other Real Estate Owned

A summary of other real estate owned is presented as follows:

	Six Months Ended June 30,	
	2016	2015
Balance, beginning of year	$ 6,115,715	$ 7,322,404
Additions	273,037	481,068
Disposals	(1,172,230)	(708,568)
Valuation write downs and losses on sales	(70,219)	(69,336)
Balance, end of period	$ 5,146,303	$ 7,025,568

Expenses related to other real estate owned include the following:

	Six Months Ended June 30,	
	2016	2015
Net loss on sales of real estate	$ 7,051	$ 25,216
Valuation write downs	63,168	44,120
Operating expenses	36,485	35,225
	$ 106,704	$ 104,561

Other real estate owned represents collateral property taken back from borrowers in partial or full satisfaction of their defaulted debt obligation to the Company. We track our historical experience of loans that ultimately convert to other real estate owned by collateral type and by geographic exposure as shown on the following tables:

(In thousands)	Book Value of Other Real Estate at June 30, 2016 Florida	South Carolina	Total
Residential	$ —	$ —	$ —
Commercial	2,170	982	3,152
Finished lots	—	268	268
Raw land	1,726	—	1,726
	$ 3,896	$ 1,250	$ 5,146

	Number of Parcels at June 30, 2016 Florida	South Carolina	Total
Residential	—	—	—
Commercial	3	8	11
Finished lots	—	7	7
Raw land	5	—	5
	8	15	23

(In thousands)	Book Value of Other Real Estate at December 31, 2015 Florida	South Carolina	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

	Number of Parcels at December 31, 2015 Florida	South Carolina	Total
Residential	1	—	1
Commercial	3	7	10
Finished lots	4	37	41
Raw land	5	1	6
	13	45	58

During the six months ended June 30, 2016 we sold forty other real estate owned properties with a total book value of $1,143,000. The net proceeds from these sales were $1,136,000, which resulted in a net recovery of approximately 80.6% of the original loan amounts and 99.4% of the book value of the other real estate sold. During the six months ended June 30, 2015 we sold seven other real estate owned properties with a total book value of $734,000. The net proceeds from these sales were $709,000, which resulted in a net recovery of approximately 67.9% of the original loan amounts and 96.6% of the book value of the other real estate sold.

The Bank's special asset group is charged with the administration and liquidation of other real estate owned. Our approach has been to manage each property individually in such a way as to maximize our net proceeds upon sale. Management continues to evaluate other methods to liquidate these properties more quickly, but such methods typically result in a much lower recovery relative to the original loan amount. Management attempts to balance the desire to aggressively drive down the level of nonperforming assets with the objective to maximize recovery levels from liquidation of these assets.

Note 14 — Deposits

Total deposits increased by $129,198,000 or 46%, to a total of $413,037,000 at June 30, 2016 from $283,839,000 at December 31, 2015. This increase was driven primarily from the $98,215,000 in total deposits from the First Avenue National Bank acquisition noted above in Note 2. An additional $13,428,000 in brokered deposits with terms of four to thirteen weeks were used to fund the growth in the balance of mortgage loans available for sale and the related loan sales receivable. Noninterest-bearing demand deposits increased $27,538,000 or 63%, while interest-bearing demand deposits increased $48,364,000 or 38%. The Company has continued its use of brokered deposits, which typically carry interest rates that are comparable with rates offered for core retail deposits. Brokered deposits are issued in individual's names and in the names of trustees with balances participated out to others. Core retail deposits are deposits which are gathered in the normal course of business, without the use of a broker. Core reciprocal deposits are gathered in the same manner as core retail deposits, but the funds are participated out to other banks through use of the CDARS reciprocal transactions program. The CDARS program allows depositors to obtain FDIC insurance for deposits up to $50 million by exchanging the portions of their deposits in excess of FDIC insurance limitations with other financial institutions participating in the CDARS program. In return, we receive an equal amount of deposits back from other CDARS participating financial institutions, such that there is no net change in the level of total deposits on our balance sheet.

Balances and percentages within the major deposit categories are as follows:

(In thousands)	June 30, 2016			
	Core Retail Deposits	Core CDAR's Deposits	Brokered Deposits	Total Deposits
Noninterest-bearing demand deposits	$ 71,417	$ —	$ —	$ 71,417
Interest-bearing demand deposits	176,222	—	—	176,222
Savings deposits	14,406	—	—	14,406
Certificates of deposit $100,000 and over	55,093	29,072	16,276	100,441
Other time deposits	7,222	993	42,336	50,551
	$ 324,360	$ 30,065	$ 58,612	$ 413,037

(In thousands)	December 31, 2015			
	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

Note 15 - Other Borrowings

Other Borrowings of $121,975,000 at June 30, 2016 are composed of advances from the Federal Home Loan Bank of Atlanta (FHLB) and represent a $1,475,000 increase from $120,500,000 at December 31, 2015.

FHLB advances outstanding and related terms at June 30, 2016 and December 31, 2015 are shown in the following tables:

		FHLB Advances Outstanding June 30, 2016		
Type advance	Balance	Interest rate	Maturity date	Convertible date
Fixed rate	20,000,000	0.43%	July 5, 2016	
Fixed rate	30,000,000	0.42%	July 15, 2016	
Fixed rate	5,000,000	1.95%	August 9, 2016	
Fixed rate	2,500,000	0.94%	July 28, 2017	
Fixed rate	2,000,000	2.84%	August 9, 2017	
Convertible fixed rate advance	2,000,000	3.69%	September 7, 2017	March 7, 2016
Fixed rate	2,500,000	1.32%	July 30, 2018	
Fixed rate	3,000,000	2.94%	August 9, 2018	
Fixed rate	2,500,000	1.70%	July 24, 2019	
Fixed rate	2,500,000	1.98%	July 24, 2020	
Variable rate overnight advance	49,975,000	0.57%		
Total	$ 121,975,000	0.79%		

		FHLB Advances Outstanding December 31, 2015		
Type advance	Balance	Interest rate	Maturity date	Convertible date
Fixed rate	$ 10,000,000	0.39%	January 15, 2016	
Fixed rate	15,000,000	0.40%	January 21, 2016	
Fixed rate	10,000,000	0.38%	January 29, 2016	
Fixed rate	5,000,000	1.95%	August 9, 2016	
Fixed rate	2,500,000	0.94%	July 28, 2017	
Fixed rate	2,000,000	2.84%	August 9, 2017	
Convertible fixed rate advance	2,000,000	3.69%	September 7, 2017	March 7, 2016
Fixed rate	2,500,000	1.32%	July 30, 2018	
Fixed rate	3,000,000	2.94%	August 9, 2018	
Fixed rate	2,500,000	1.70%	July 24, 2019	
Fixed rate	2,500,000	1.98%	July 24, 2020	
Variable rate overnight advance	63,500,000	0.49%		
Total	$ 120,500,000	0.76%		

Note 16 - Senior Note Payable

On November 15, 2015 the Company redeemed $9.95 million of its outstanding Cumulative Perpetual Preferred Stock, Series A(the "Preferred Stock") with the proceeds from a $10.0 million term loan. The term loan is due November 10, 2020 and has a floating rate equal to LIBOR plus 400 basis points. The current rate is 5.0%. The loan also requires fixed monthly principal payments equal to $83,333. The stated dividend rate on the Preferred Stock was 9.0%. Accordingly, the Company believes the redemption of the Preferred Stock will result in an increase in its net income available to common shareholders.

	June 30, 2016	December 31, 2015
Note payable to NexBank SSB with variable interest rate at 3-month LIBOR plus 4% subject to a 5% floor, with principal plus interest due monthly through maturity at November 2020.	$ 9,416,667	$ 9,916,667
	$ 9,416,667	$ 9,916,667

As of June 30, 2016 and December 31, 2015, the Company was in compliance with the covenants in this agreement.

The senior note payable is secured by 100% of the common stock of the Company's wholly-owned subsidiary, CBC National Bank.

Note 17 - Junior Subordinated Debentures

In May 2004, Coastal Banking Company Statutory Trust I issued $3.0 million of trust preferred securities with a maturity of July 23, 2034. The proceeds from the issuance of the trust preferred securities were used by the Trust to purchase $3,093,000 of the Company's junior subordinated debentures, which pay interest quarterly at a floating rate equal to 3 month LIBOR plus 275 basis points. The Company used the proceeds from the sale of the junior subordinated debentures to strengthen the capital position of the Bank and to accommodate current and future growth. The current regulatory rules allow certain amounts of junior subordinated debentures to be included in the calculation of regulatory capital, and have been included in the Tier I calculation accordingly. The debentures and related accrued interest represent the sole asset of the Trust.

The Company has entered into contractual arrangements which, taken collectively, fully and unconditionally guarantee payment of: (i) accrued and unpaid distributions required to be paid on the trust preferred securities; (ii) the redemption price with respect to any trust preferred securities called for redemption by Trust I, and (iii) payments due upon a voluntary or involuntary dissolution, winding up, or liquidation of the Trust I. The trust preferred securities must be redeemed upon maturity of the debentures on July 23, 2034, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by the Trust I in whole or in part, on or after July 23, 2009. As specified in the indentures, if the debentures are redeemed prior to maturity, the redemption price will be the unpaid principal amount, plus any accrued unpaid interest.

In June 2006, Coastal Banking Company Statutory Trust II issued $4.0 million of trust preferred securities with a maturity of September 30, 2036. The proceeds from the issuance of the trust preferred securities were used by the Trust to purchase $4,124,000 of the Company's junior subordinated debentures, which pay interest quarterly at a floating rate equal to 3 month LIBOR plus 160 basis points. The Company used the proceeds from the sale of the junior subordinated debentures to strengthen the capital position of the Bank and to accommodate current and future growth. The current regulatory rules allow certain amounts of junior subordinated debentures to be included in the calculation of regulatory capital, and have been included in the Tier I calculation accordingly. The debentures and related accrued interest represent the sole asset of the Trust.

The Company has entered into contractual arrangements which, taken collectively, fully and unconditionally guarantee payment of: (i) accrued and unpaid distributions required to be paid on the trust preferred securities; (ii) the redemption price with respect to any trust preferred securities called for redemption by Trust II, and (iii) payments due upon a voluntary or involuntary dissolution, winding up, or liquidation of the Trust II. The trust preferred securities must be redeemed upon maturity of the debentures on September 30, 2036, or upon earlier redemption as provided in the indenture. The Company has the right to redeem the debentures purchased by the Trust II in whole or in part, on or after September 30, 2011. As specified in the indentures, if the debentures are redeemed prior to maturity, the redemption price will be the unpaid principal amount, plus any accrued unpaid interest.

As of June 30, 2016, the Company has paid all interest payments due on all trust preferred securities.

Note 18 – Employee Stock Purchase Plan

On February 27, 2013 the Board of Directors approved the adoption of the Coastal Banking Company Employee Stock Purchase Plan (the "Plan") effective April 1, 2013, and set aside 250,000 shares of common stock for issuance under the Plan. The Plan allows eligible full time employees to direct an after-tax deduction from their pay to be accumulated and disbursed once per quarter to purchase newly issued common stock in the Company at a 5% discount to fair market value on the final day of each calendar quarter. Total shares purchased through the plan were 8,067 shares for the three month period ending June 30, 2016, 16,977 shares for the six month period ended June 30, 2016 and 30,053 shares for the year ending December 31, 2015. The 5% discount to fair market value is considered compensation cost to the Company and it totaled $5,002 for the three month period ended June 30, 2016, $10,348 for the six month period ended June 30, 2016 and $15,233 for the year ended December 31, 2015.

Note 19 – Reclassifications

Certain amounts reported as of December 31, 2015, or the periods ended June 30, 2015, have been reclassified to conform with the presentation of June 30, 2016. These reclassifications had no effect on previously reported net income or shareholders' equity.