



2016 ANNUAL REPORT

CONTENTS

Financial Highlights	1
Letter To Shareholders	2
Shareholders' Meeting	9
Proxy Statement	11
Management's Commentary	23
Consolidated Financial Statements	35
Notes to Consolidated Financial Statements	43
Shareholder Information	88

Coastal Banking Company Inc. is the \$561.4 million-asset bank holding company of CBC National Bank, headquartered in Fernandina Beach, Fla., which provides a full range of consumer and business banking services through full-service banking offices in Fernandina Beach, Ocala, and The Villages, Fla., and Beaufort and Port Royal, S.C. The company's residential mortgage banking division, headquartered in Atlanta, includes traditional retail and wholesale lending, as well as a national retail group that has lending offices in Florida, Georgia, Maryland, Michigan, North Carolina, Illinois, Ohio and Tennessee. The company's SBA lending division originates SBA loans primarily in Jacksonville, Ft. Myers, Tampa and Vero Beach, Fla., Greensboro, N.C., Atlanta, Ga. and Beaufort, S.C. The company's common stock is publicly traded on the OTCQX Best Market under the symbol CBCO. The company was named to the OTCQX® Best 50 in both 2015 and 2016, an annual ranking of the top 50 U.S. and international companies traded on the OTCQX Best Market, based on equal weighting of one-year return and average daily dollar volume growth.

FINANCIAL HIGHLIGHTS

Dollars in thousands, except per share amounts.

Years ended December 31,

2016

2015

Earnings

Net interest income	\$19,494	\$16,652
Provision for loan loss	\$1,450	\$394
Other income	\$22,686	\$17,871
Other expense	\$29,743	\$24,530
Pre-tax income	\$10,986	\$9,599
Taxes	\$4,031	\$3,764
Net income	\$6,956	\$5,835
Preferred stock dividends	-	\$784
Net earnings available to common shareholders	\$6,956	\$5,052
Earnings per share (basic)	\$2.10	\$1.89
Earnings per share (diluted)	\$2.05	\$1.85

Performance Ratios

ROAA	1.29%	1.12%
ROAE	16.07%	13.14%
Net Interest Margin	3.85%	3.89%
Efficiency Ratio	70.52%	71.05%

Capital

Tier 1 leverage capital ratio	10.01%	9.54%
Tier 1 risk-based capital ratio	18.47%	18.60%
Total risk-based capital ratio	19.74%	19.89%
Book value per share	\$14.18	\$12.39
Tangible book value per share	\$13.57	\$11.81

Asset Quality

Other real estate owned	\$5,062	\$6,116
Net Charge-offs (recoveries)	\$714	\$(32)
Net Charge-offs (recoveries) to average loans	0.20%	(0.01)%
Allowance to total loans, net of LHFS	1.47%	1.84%
Nonperforming assets to total assets	1.98%	1.85%

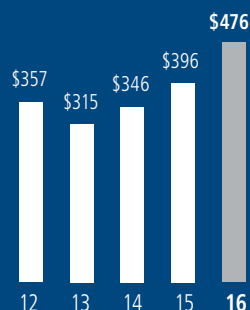
End of Period Balances

Assets	\$561,389	\$464,667
Portfolio Loans	\$408,743	\$285,933
Loans Held for Sale	\$92,009	\$128,182
Deposits	\$417,317	\$283,839
Borrowings	\$63,050	\$120,500
Shareholders' Equity	\$51,715	\$33,259

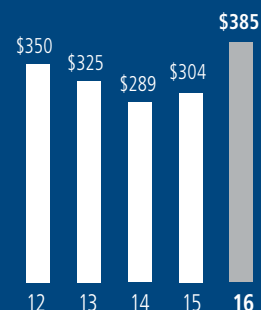
CBCO Common Stock Data

Average Shares	3,308	2,668
Closing Market Price (OTCQX)	\$15.01	\$12.00

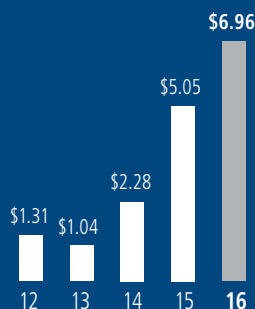
AVERAGE LOANS (IN MILLIONS)



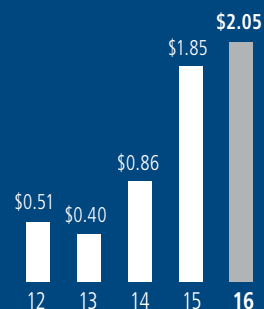
AVERAGE DEPOSITS (IN MILLIONS)



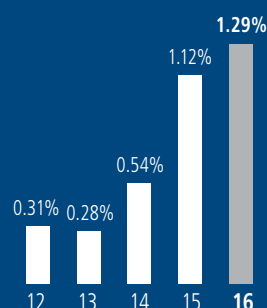
NET INCOME (IN MILLIONS)



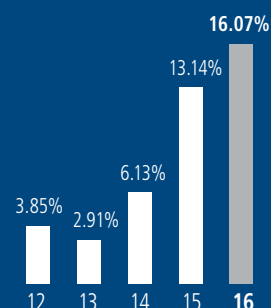
DILUTED EARNINGS PER SHARE



RETURN ON ASSETS



RETURN ON EQUITY (COMMON)



TO OUR SHAREHOLDERS

Dear Shareholder,

Creating shareholder value is a driving force for our Company and the true measure of our success. To accomplish that objective, our Company regularly updates and follows our Strategic Plan to help meet our overarching goals. Without that compass to direct us, and without our capable leaders' steady guidance, we would simply be another banking company plodding along where the economy takes us.

Instead, we plot our own course, we update that course as needed, we ensure that we have the best leaders in the correct positions to help us get where we're going, and we have a definitive destination in mind.

In 2016 we crafted an entirely new Strategic Plan for 2017-2019 to update our prior three-year plan. The new Plan states that our goal is a superior return on equity compared to our peers. Before turning the page to 2017, we also completed our annual budget, did a health-check on the capacity of our leaders and systems, and analyzed our financial reporting, operating and competitive landscape.



“An above-average Return on Equity implies that the net worth of the Company should grow, and the book value of your shares should grow accordingly. We began delivering that net worth growth by mid-year 2015, with above-average, sustainable pre-tax earnings.”

Our goals are driven by shareholder value creation, while being mindful that we exist in a regulated environment. Each year we face challenges that include such operational hurdles as increased cyber security risk, and new compliance rules and regulations, while continuing to address credit, operational, reputational and enterprise risks.

Our Strategic Plan has a principal goal of superior return on equity, but it remains a challenge to achieve that goal, considering the increased costs of compliance, systems enhancements and risk management. When factoring in the myriad challenges we face, our conclusion was that you can overcome these by being staffed with the very best people at all levels of the organization, but most vitally in the key leadership positions.

OUR LEADERS

Several years ago the Board of Directors formed a special committee to consider the opportunities surrounding management succession. After reviewing the candidates' qualifications and conducting interviews, in June 2015 the committee recommended promoting Charles Wagner, who was then Executive Vice President of our Mortgage Division, to President of CBC National Bank. Charles was subsequently elected President of Coastal Banking Company and named to the boards of directors of both, as well.

Yet, that was only the beginning. Management succession is important at every level of a healthy company, as is management depth and cohesion. Our goal was to surround Charles with the very best leaders across the Company. It was important that our executive management team members should be not just business line experts and experienced bankers, but also that they would coalesce around the goals of increasing shareholder value while continuing to run our Company in a prudent, safe and sound manner. We believe that we have a leadership group in place now that is well on the way to accomplishing those goals.

There is no better example of management succession (and depth) than Charles Wagner identifying Brynn Stensrud to follow him as the next leader of our Mortgage Division. Brynn's background was in mortgage risk management, so the credit principles were ingrained. He had worked with Charles in the Mortgage Division for years, and under Charles' mentorship, Brynn had the time to learn origination, sales and compliance. The innate leadership skills were already there. Our Mortgage Division is vital to our business model. Under Brynn's leadership as Executive Vice President of the Mortgage Division, we have continued to operate at the same high level.

Durand Childers, Executive Vice President of the SBA Lending Division, is another great example of our management expertise, experience and strength. Durand has worked in community banks and large regional banks and has been with our Company for 15 years. He has led our SBA Lending Division to be the No. 1 ranked community bank U.S. Small Business Administration lender in the north Florida district in total dollar volume and number of loans (and ranked No. 2 in the state). Durand is one of the foremost SBA lenders in the Southeast.



Charles Wagner

"It was important that our executive management team members should be not just business line experts and experienced bankers, but also that they would coalesce around the goals of increasing shareholder value while continuing to run our Company in a prudent, safe and sound manner"



Durand Childers

Durand created and managed our Special Assets Division during the financial crisis, so he understands risk and problem loan resolution. Understanding that risk management is not risk avoidance provides Durand (and our entire executive management team) the ability to create shareholder value while never losing sight of safe and sound credit principles. We see Durand as one of our important resources in management succession and management continuity planning.

During 2016 we further strengthened our leadership team with the addition of Tom Flournoy as our new Executive Vice President and Chief Financial Officer. We have a challenging business model, so we needed a CFO with both mortgage and SBA accounting experience. We also understood that we were a Company that was in a state of change and we knew that we must recruit a CFO with the leadership skills to collaborate with and complement our existing executives.

We actively recruited Tom because we believed he had the perfect demeanor and professional skills to help guide the Company to the next level. He has worked predominantly in

publicly held community banks; he has extensive business-line accounting experience; and he knows how to work toward consensus in helping us achieve our goals around creating franchise value.

In January we added the missing piece to our executive management team, hiring Mitchell Smith to be our new Executive Vice President and Chief Credit Officer. It's no secret that both organic loan growth and loan growth by acquisition present challenges, and we saw both on our balance sheet in 2016, owing largely to the acquisition of First Avenue National Bank. Mitchell has in-depth experience managing both and fully understands that bank lending is about managing risk, not avoiding it. He has quickly proven himself to be yet another high-performing, cohesive member of our Leadership team.

In sum, this is an extremely solid and talented group. They understand deeply and are committed to creating shareholder value. They are experienced bankers who are steeped in risk management and in the safe and sound operation of our Company. Management succession and management continuity are in very capable hands.



Brynn Stensrud



Tom Flournoy



Mitchell Smith

CREATING VALUE

“Value” is not a nebulous term to us. It derives from numerous operational strategies being executed as planned by the Company’s leadership and exemplary staff across all aspects of the organization, making the company stronger in the process. That proper execution of sound strategic operation, and growing Company strength, rolls up into the creation of value for our shareholders.

I have always been driven by return on your financial investment in Coastal Banking Company. Whether you are an original shareholder from our initial public offering, a community bank investor or one of our new partners from First Avenue National Bank, I know that you have the opportunity to invest in many different companies. However, you chose Coastal, and it is our goal – our commitment – to achieve an above-average return on your investment.

In fact, we made that the centerpiece of our latest three-year Strategic Plan, crafted in 2016. Our 2013 Plan projected an average three-year return on equity of 12% for CBC National Bank. We updated that plan along the way, and although the 2013 Plan acknowledged the anchor of legacy problem assets remaining from the recession, financial performance began to improve.

As a result, the Bank’s average three-year return on tangible equity for 2014-2016 was 12.25%. In fact, the Bank’s annualized return on equity for the fourth quarter of 2016 was in the 93rd percentile nationally. The 2016 Plan states clearly that our principal goal is a continued superior return on equity compared to our peers, along with placing in the top 25% of all peer group benchmarks.

An above-average Return on Equity implies that the net worth of the Company should grow, and the book value of your shares should grow accordingly. We began delivering that net worth growth by mid-year 2015, with above-average, sustainable pre-tax earnings. From

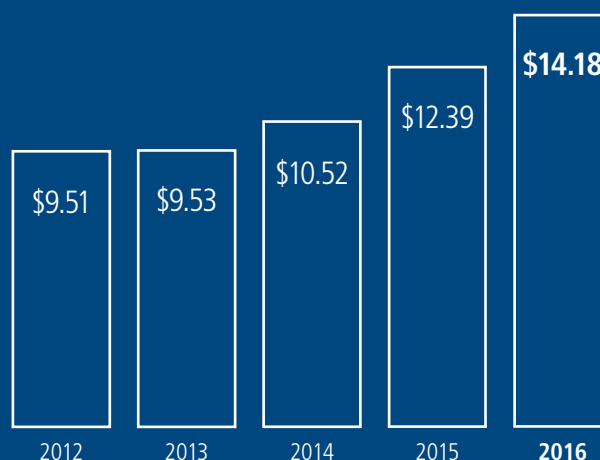
93rd
PERCENTILE
NATIONALLY

Annualized return on
equity for the fourth
quarter of 2016

12.25%
RETURN ON
TANGIBLE EQUITY

The bank’s three-year
return on tangible equity
for 2014-2016

BOOK VALUE PER SHARE [COMMON]



that perspective, we were executing our plan. When we refinanced our Preferred stock in late 2015 with holding company debt, we immediately created additional return on equity. Refinancing the Preferred stock was also a low-risk way to further enhance book value per common share.

Another important strategy executed to enhance shareholder value was our acquisition of First Avenue National Bank, completed in April 2016. The acquisition strengthened our Company in some vitally important ways: It bolstered our balance sheet, added valuable products, services and earnings potential to our Community Bank segment, enhanced management and staff strength, and positioned the Company in the vibrant growth market of Ocala and The Villages, Fla., that ties in well with our existing footprint.

“We believe strongly that if we execute our Strategic Plan and meet our annual budget, our Company will continue to add value, and our stock price will take care of itself.”

STOCK PRICE YEARS ENDED DECEMBER 31,

	2016		2015	
	HIGH	LOW	HIGH	LOW
Q1	\$ 12.45	\$ 11.25	\$ 9.99	\$ 8.80
Q2	\$ 12.99	\$ 12.22	\$ 10.19	\$ 9.00
Q3	\$ 13.45	\$ 12.92	\$ 13.00	\$ 9.60
Q4	\$ 15.05	\$ 13.16	\$ 12.25	\$ 11.60

Moreover, we believe that the acquisition of First Avenue National Bank will provide increased core community bank earnings, creating a more balanced and diversified income stream for the Company – something we have been diligently working toward. The diversified income model, including strong contributions from Mortgage Banking, SBA Lending and Community Banking, creates confidence in our ability to deliver sustainable earnings in the future, and to continue to drive above-average shareholder returns.

We believe strongly that if we execute our Strategic Plan and meet our annual budget, our Company will continue to add value, and our stock price will take care of itself. It is gratifying that analysts and investors are once again paying attention to our financial performance, and that our strong performance is reflected in our increasing stock price.

GIVING BACK TO OUR COMMUNITIES

Although we don't often talk about it as a Company, I have always believed that we have a responsibility to give back to the communities that we call home, and that support us as customers, friends and neighbors.

Giving back, like the creation of value, is a multi-faceted effort. We, of course, make financial contributions to support worthy organizations and activities where we can. But, more importantly, we give back with the countless hours of time we spend working in civic and charitable endeavors. It is important to have a presence in our communities that extends beyond the business we do in offices, in meetings and on boards as representatives of the Company.

We do this most often quietly, donating our financial and human resources from Alpharetta to Beaufort, from Fernandina Beach to Ocala and The Villages. I am amazed at, and proud of, the contributions our employees make in our communities to help those less fortunate than us, and to support those who support us.

Doing so is, in short, the right thing to do. It also is, in its own very meaningful way that's not captured on any balance sheet, adding value to our Company.

In closing, thank you for being a shareholder of Coastal Banking Company. We understand that you have alternative opportunities for investments and you chose Coastal. Our goal is to continue creating value for your investment.

Sincerely,



Michael G. Sanchez
Chairman & CEO
Coastal Banking Company Inc. and CBC National Bank

COASTAL BANKING COMPANY, INC.

**36 Sea Island Parkway
Beaufort, South Carolina 29907
(843) 522-1228**

April 21, 2017

Dear Shareholder:

You are cordially invited to attend our 2017 Annual Meeting of Shareholders on Wednesday, May 24, 2017 at 10:00 a.m. at the Hilton Garden Inn, 1500 Queen Street, Beaufort, South Carolina 29902. We sincerely hope that you will be able to attend the meeting and look forward to seeing you.

The attached Notice of the Annual Meeting and Proxy Statement describes the formal business to be transacted at the meeting. We will also report on our operations during the past year and during the first quarter of fiscal year 2017, as well as our plans for the future.

A copy of our Annual Report, which contains information on our operations and financial performance as well as our audited financial statements, is also included with this Proxy Statement.

Please take this opportunity to become involved in the affairs of Coastal. For your convenience, you may vote your shares online by visiting our website <http://www.coastalbanking.com> and clicking on *Shareholder Proxy*. You will need the control number printed on the enclosed proxy card to cast your online vote. Whether or not you expect to be present at the meeting, please visit us online to vote your shares or mark, date and sign the enclosed proxy card and return it to us in the envelope provided as soon as possible. Voting by proxy, online or otherwise, WILL NOT deprive you of your right to attend the meeting and vote your shares in person. If you attend the meeting and wish to do so, you may withdraw your proxy and vote your own shares.



Michael G. Sanchez
Chairman and Chief Executive Officer



COASTAL BANKING COMPANY, INC.

36 Sea Island Parkway
Beaufort, South Carolina 29907
(843) 522-1228

**NOTICE OF THE ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD WEDNESDAY, MAY 24, 2017**

The Annual Meeting of Shareholders of Coastal Banking Company, Inc. ("Coastal" or the "Company") will be held on Wednesday, May 24, 2017 at 10:00 a.m. at the Hilton Garden Inn, 1500 Queen Street, Beaufort, South Carolina 29902, for the following purposes:

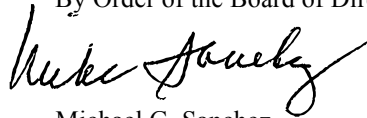
- (1) to elect five (5) persons to serve as Class III Directors for a three-year term expiring in 2020;
- (2) to ratify the appointment of Mauldin & Jenkins, Certified Public Accountants, LLC, as the independent registered public accounting firm for the Company for the fiscal year ending December 31, 2017; and
- (3) to transact any other business as may properly come before the meeting or any adjournments of the meeting.

The Board of Directors has set the close of business on April 11, 2017 as the record date for determining the shareholders who are entitled to notice of and to vote at the meeting.

We hope that you will be able to attend the meeting. We ask, however, whether or not you plan to attend the meeting, that you promptly vote your shares. For your convenience, you may vote online by visiting us at <http://www.coastalbanking.com> and clicking on *Shareholder Proxy*. You will need the control number printed on the enclosed proxy card to cast your online vote. If you choose to mark, date, sign and return the enclosed proxy card to us, please do so as soon as possible using the envelope provided. Promptly casting your vote by proxy via our website, or otherwise, will help ensure the greatest number of shareholders are present, whether in person or by proxy.

If you attend the meeting, you may revoke your proxy at the meeting and vote your shares in person. You may revoke your proxy at any time before the proxy is exercised.

By Order of the Board of Directors,



Michael G. Sanchez
Chairman and Chief Executive Officer

April 21, 2017

**IMPORTANT NOTICE REGARDING THE AVAILABILITY OF PROXY
MATERIALS FOR THE ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD ON MAY 24, 2017**

Visit our website <http://www.coastalbanking.com> and click on *Shareholder Proxy* to access online voting and Coastal Banking Company, Inc.'s Proxy Statement and Annual Report

COASTAL BANKING COMPANY, INC.
36 Sea Island Parkway
Beaufort, South Carolina 29907
(843) 522-1228

PROXY STATEMENT FOR 2017 ANNUAL MEETING

INTRODUCTION

Time and Place of the Meeting

Our Board of Directors is furnishing this Proxy Statement in connection with its solicitation of proxies for use at the Annual Meeting of Shareholders to be held on Wednesday, May 24, 2017 at 10:00 a.m. at the Hilton Garden Inn, 1500 Queen Street, Beaufort, South Carolina 29902, and at any adjournments of the meeting.

Record Date and Mailing Date

The close of business April 11, 2017 is the record date for the determination of shareholders entitled to notice of and to vote at the meeting. We first mailed this Proxy Statement and the accompanying proxy card to shareholders on or about April 21, 2017.

Number of Shares of Common Stock Outstanding

As of the close of business on the record date, Coastal had authorized 10,000,000 shares of common stock, \$.01 par value, of which 3,673,518 shares were issued and outstanding. Each issued and outstanding share of common stock is entitled to one vote on all matters presented at the meeting.

VOTING AT THE ANNUAL MEETING

Proposals to be Considered

Shareholders will be asked to elect five (5) persons to serve as Class III Directors for a three-year term expiring in 2020. These director nominees, as well as the continuing directors, are described beginning on page 4. ***The Board of Directors recommends shareholders vote FOR each of the Class III nominees.***

Shareholders will also be asked to ratify the appointment of Mauldin & Jenkins, Certified Public Accountants, LLC (“Mauldin & Jenkins”) to serve as the independent registered public accounting firm for Coastal for the year ending December 31, 2017. ***The Board of Directors recommends a vote FOR the ratification of the appointment of Mauldin & Jenkins as the Company’s independent registered public accounting firm for 2017.***

Procedures for Voting by Proxy

If you properly vote your shares by proxy, either online or by returning a signed proxy by mail, and do not revoke your proxy, the persons appointed as proxies will vote your shares according to the instructions you have specified on the proxy card. If you vote by online proxy or sign and return your proxy card but do not specify how the persons appointed as proxies are to vote your shares, your proxy will be voted **FOR** the election of the director nominees, **FOR** the ratification of the appointment of Mauldin & Jenkins, and in the best judgment of the persons appointed as proxies as to all other matters properly brought before the meeting. If any nominee for election to the Board of Directors named in this Proxy Statement becomes unavailable for election for any reason, the proxy will be voted for a substitute nominee selected by the Board of Directors.

You can revoke your proxy at any time before it is voted by delivering a written revocation of the proxy or a duly executed proxy bearing a later date to Thomas J. Flournoy, Chief Financial Officer, at 1891 South 14th Street, Fernandina Beach, Florida 32034 by the close of business on the day prior to the shareholders meeting or by attending the meeting and voting in person.

Requirements for Shareholder Approval

A quorum will be present at the meeting if a majority of the outstanding shares of common stock is represented in person or by valid proxy. We will count abstentions and broker non-votes, which are described below, in determining whether a quorum exists. Only those votes actually cast for each proposal, however, will be counted for purposes of determining whether a proposal received sufficient votes to pass.

For the election of directors, a director nominee must receive more votes than any other competing nominee for the particular seat on the Board of Directors to be elected. As a result, if you withhold your vote as to one or more nominees, it will have no effect on the outcome of the election unless you cast that vote for a competing nominee. At the present time, we do not know of any competing nominees.

To be approved, the ratification of the appointment of Mauldin & Jenkins requires the affirmative vote of a majority of the shareholders present in person or by proxy and entitled to vote at the meeting. Abstentions and broker non-votes will be counted in determining the minimum number of votes required for approval and will, therefore, have the effect of negative votes.

Any other matters that may properly come before the Annual Meeting require the affirmative vote of a majority of shares of common stock present in person or by proxy and entitled to vote on the matter. Abstentions and broker non-votes will be counted in determining the minimum number of votes required for approval and will, therefore, have the effect of negative votes.

Abstentions. A shareholder who is present in person or by proxy at the Annual Meeting and who abstains from voting on any or all proposals will be included in the number of shareholders present at the Annual Meeting for the purpose of determining the presence of a quorum. Abstentions do not count as votes in favor of or against a given matter.

Broker Non-Votes. Brokers who hold shares for the accounts of their clients may vote these shares either as directed by their clients or in their own discretion if permitted by the exchange or other organization of which they are members. All NYSE and NASDAQ member brokers are prohibited from exercising discretionary voting in all director elections and advisory resolutions on executive compensation unless the broker has instructions from the beneficial shareholder on how to vote. Proxies that contain a broker vote on one or more proposals but no vote on others are referred to as “broker non-

votes” with respect to the proposal(s) not voted upon. Broker non-votes are included in determining the presence of a quorum. A broker non-vote, however, does not count as a vote in favor of or against a particular proposal for which the broker has no discretionary voting authority, including uncontested director elections.

SOLICITATION OF PROXIES

Coastal will pay for all costs associated with this proxy solicitation. Our directors, officers and employees may, without additional compensation, solicit proxies by personal interview, telephone, fax or otherwise. We will direct brokerage firms or other custodians, nominees or fiduciaries to forward our proxy solicitation material to the beneficial owners of common stock held of record by these institutions and will reimburse them for the reasonable out-of-pocket expenses they incur in connection with this process.

PROPOSAL I: ELECTION OF DIRECTORS

The Board of Directors consists of 13 members and is divided into three classes, with four members in Class I, four members in Class II, and five members in Class III. The directors in each class serve staggered terms of three years each. The term of each class expires at the Annual Meeting in the years indicated below and upon the election and qualification of the director's successor. Each of our directors is also a director of our wholly owned subsidiary, CBC National Bank.

Set forth below is information about each of our director nominees and continuing directors. The Board of Directors selected the director nominees based on the recommendation of the Corporate Governance and Nominating Committee. The Class III Director Nominees are each standing for re-election for a three-year term expiring in 2020.

The Board unanimously recommends shareholders vote FOR each of these nominees.

Class III Director Nominees (*Term Expiring 2020*)

John Q. Adams II, 53, Class III Director, is one of two directors appointed to the Board of Directors in 2016 upon consummation of the April 2016 merger of First Avenue National Bank ("First Avenue") with and into CBC National Bank. Mr. Adams was a founding director of First Avenue and served as its chairman for four years. He also chaired the First Avenue Audit, Loan and Executive Committees and served on the Asset-Liability Committee (ALCO) from First Avenue's inception through the merger. Mr. Adams is a licensed certified public accountant practicing in Florida and is the owner/principal of the public accounting firm of Adams & Company, P.A. In 1994 he graduated with a master's degree in accountancy from the University of Central Florida and completed the CPA exam. He is a longtime member of the American Institute of Certified Public Accountants and the Florida Institute of Certified Public Accountants. Mr. Adams has a long history of community leadership, serving on several boards, including The Arnette House and the Marion County Family YMCA, and achieved the rank of Eagle Scout. We believe Mr. Adams's business experience and previous service on the First Avenue board well qualify him to serve on the Board.

Robert B. Pinkerton, 75, Class III Director, has served as a director of Coastal since 1999. He has been president and chief executive officer of Athena Corporation, a manufacturer and fabricator of custom products for the construction industry, since 1990. Prior to that, he was president and chief executive officer of Blackstone Corporation (now part of Valeo), a multinational original equipment manufacturer of automotive engine cooling systems. Mr. Pinkerton is a principal in Village Renaissance, Inc., a developer in Beaufort and Port Royal, South Carolina. He holds a law degree, two engineering degrees, and is a graduate of the SCBA Bank Directors College. He served as chairman of the City of Beaufort Redevelopment Commission 2004-2010, is treasurer of St. Mark's Episcopal Church, is on the board of directors of the Episcopal Forum of South Carolina, and is a trustee of the Diocese of the Episcopal Church in South Carolina. We believe Mr. Pinkerton's long and varied career, including his service as president and chief executive officer of a large manufacturing company, well qualifies him to serve on the Board.

Charles K. Wagner, 46, Class III Director, has been President of Coastal Banking Company since August 24, 2016. He was named President of CBC National Bank and elected to the Board of Directors on June 8, 2015. Prior to that he served as Executive Vice President, Mortgage Division, for CBC National Bank (2011-2015) and as Senior Vice President of Mortgage Banking for CBC National Bank (2007-2011). Before joining Coastal, he was the manager of mortgage banking at First Horizon National Corporation. He served as executive director of American Mortgage Express Corporation from February 2004 through June 2007. Mr. Wagner earned a bachelor's degree from the University of

Georgia. He has 20 years of experience in the financial services industry. We believe Mr. Wagner's extensive executive banking experience well qualifies him to serve on the Board.

Edward E. Wilson, 65, Class III Director, has served as a director since our merger with First Capital Bank Holding Corporation on October 1, 2005. He served as a director of First Capital Bank Holding Corporation from 1998 until the merger. Mr. Wilson is a licensed insurance agent. He is part-owner and has served as an officer of several Florida insurance agencies comprising Morrow Insurance Group, Inc., including agencies located in Madison, Florida (secretary and treasurer since 1985), Fernandina Beach, Florida (president since 1987), and Yulee, Florida (president since 1998). Mr. Wilson also participates in real estate investments. We believe Mr. Wilson's extensive experience in the field of insurance well qualifies him to serve on the Board.

Marshall E. Wood, 70, Class III Director, was elected to the Board of Directors in May 2007. He served as a director of First Capital Bank Holding Corporation from 1998 until its merger with Coastal on October 1, 2005. Mr. Wood served as a director of Barnett Bank from 1981 to 1997 and its successor, Nations Bank (Jacksonville, Florida), until May 1998. He graduated from the University of Georgia in 1968 with a degree in business administration and from the University of Tennessee with a Juris Doctor degree in 1972. He is engaged in the practice of law in Fernandina Beach, Florida. We believe Mr. Wood's previous long and varied career, including his service as a director of a NYSE-listed financial institution, well qualifies him to serve on the Board.

Class I Continuing Directors (Term Expiring 2018)

Christina H. Bryan, 71, Class I Director, has served as a director since our merger with First Capital Bank Holding Corporation on October 1, 2005. She served as a director of First Capital Bank Holding Corporation from 1998 until the merger. She is chairman of the board of Baptist Medical Center-Nassau, trustee of the YMCA of Florida's First Coast, and past president of Gator Boosters for the University of Florida. Ms. Bryan is treasurer of United Methodist Women and serves on the Capital Campaign Committee of Memorial United Methodist Church. We believe Ms. Bryan's long and varied career and her breadth of civic involvement well qualify her to serve on the Board.

James W. Holden, Jr., 57, Class I Director, has served as a director of Coastal since 1999. He is a licensed veterinarian in South Carolina, North Carolina and Georgia, and has been practicing veterinary medicine in Beaufort, South Carolina since 1986. He received his degree in veterinary medicine from the University of Georgia in 1983 and a degree in pre-veterinary medicine from Clemson University in 1979. He is a member of the Rotary Club of Beaufort where he has served as director, president, vice president, and secretary. Dr. Holden served on the board of directors of South Carolina Select Laboratories, LLC, a reference laboratory serving primarily rural physicians and hospitals across the state of South Carolina, from 2007 to 2013 and is past chairman of the board of directors of Lowcountry Estuarium, a non-profit marine science educational organization. He is a 2003 graduate of the SCBA Bank Directors College. We believe Dr. Holden's business experience and his knowledge of our market areas well qualify him to serve on the Board.

James C. Key, 77, Class I Director, has served as a director of Coastal since 1999. He is the managing partner of Shenandoah Group, LLP, a firm providing governance, risk management, and compliance (GRC) solutions for a wide variety of clients in business, government, education and multilaterals since 1997. Mr. Key served as director-internal audit for North America and Asia Pacific at IBM Corporation in Armonk, New York, until he retired in 1997. He is a certified internal auditor and holds a certification in risk management assurance. Additionally, Mr. Key has been active in The Institute of Internal Auditors since 1991. He graduated from Syracuse University with a degree in liberal studies and has completed graduate work at the Maxwell School of Citizenship and Public Affairs, Syracuse University. Mr. Key is immediate past president of the Southeast District of the Unitarian

Universalist Association (UUA) of Congregations in Charlotte, North Carolina and has chaired the audit committee of the board of trustees of the National UUA organization. He was elected to a single six-year term as moderator and chief governance officer of the National UUA in 2013. In that role he chairs the board of trustees, presides over annual meetings, and meets with congregations across the country. We believe Mr. Key's extensive career in risk management and compliance, in addition to his extensive audit experience, well qualifies him to serve on the Board.

Michael G. Sanchez, 67, Class I Director and Chairman of the Board, has served as Chief Executive Officer of Coastal Banking Company since August 27, 2007. Mr. Sanchez served as President of Coastal Banking Company from the merger with First Capital Bank Holding Corporation on October 1, 2005 until August 27, 2007 and has served as a director of Coastal Banking Company since October 1, 2005. He served as director, president, and chief executive officer of First Capital Bank Holding Corporation from 1998 until the merger. Mr. Sanchez has over 40 years of experience in the banking industry. We believe Mr. Sanchez's long banking career well qualifies him to serve on the Board.

Class II Continuing Directors (*Term Expiring 2019*)

Kenneth C. Ausley, 48, Class II Director, is one of two directors appointed to the Board of Directors in 2016 upon consummation of the merger of First Avenue with and into CBC National Bank. Mr. Ausley was a founding director of First Avenue and served as its chairman from 2009-2011. He served on multiple First Avenue committees, including the Executive Committee, Directors Loan Committee, Nominating and Corporate Governance Committee and the Strategic, Enterprise Risk Management and Compliance Committee. He graduated from Florida State University in 1990 with a degree in history and is the CEO of Ausley Construction Company, Inc., a commercial construction firm headquartered in Ocala, Florida. Mr. Ausley is also the current chairman of the Ocala/Marion County Chamber and Economic Partnership and serves as a board member on the City of Ocala's 2035 Vision Leadership Group and the Marion County Value Adjustment Board. He is also the co-founder and former chairman of the board of Ambleside School of Ocala, Inc., a non-profit, private K-8 school, as well as the former chairman and current board member of the Ocala/Marion County Children's Advocacy Center. We believe Mr. Ausley's business experience and previous service on the First Avenue board well qualify him to serve on the Board.

Suellen Rodeffer Garner, 60, Class II Director, has served as a director since our merger with First Capital Bank Holding Corporation on October 1, 2005. She served as a director of First Capital Bank Holding Corporation from 1998 until the merger. Ms. Garner served as a director of Barnett Bank from 1990 to 1998. In addition, Ms. Garner is a licensed orthodontist and has been in practice for 32 years. We believe Ms. Garner's previous service as director of a NYSE-listed financial institution well qualifies her to serve on the Board.

Mark B. Heles, 67, Class II Director, is a founding director who served on the Coastal Banking Company Board from May 1999 until October 2005, after which he continued as a director on the Lowcountry National Bank Board. He was re-elected to and has served on the Coastal Banking Company Board since May 2008. He has served on multiple committees and currently serves on the Executive Compensation and Management Resources and the Directors Loan Committee. In 1976 he graduated from the University of South Carolina with a degree in business administration/finance. He is the former president and founder of TempO Personnel Services, Inc., a full-service staffing agency with offices in Beaufort and Hilton Head Island, South Carolina, which he sold in 2002. Mr. Heles is a graduate of the South Carolina Bankers Association (SCBA) Bank Directors College. He is a former president of the Hilton Head Island Rotary Club and past director for the Greater Beaufort Chamber of Commerce. He currently serves as president of H&H Quality Properties, LLC a commercial and residential real estate holding company. We believe Mr. Heles's executive and management experience well qualifies him to serve on the Board.

Ladson F. Howell, 73, Class II Director and Vice-Chairman of the Board, has served as a director of Coastal since 1999. He is an attorney licensed to practice law in South Carolina and practiced with Howell, Gibson & Hughes, PA, a law firm located in Beaufort, South Carolina, from 1968 until he retired in January 2000. Mr. Howell received his law degree from the University of South Carolina Law School in 1968 and a degree in journalism from the University of South Carolina in 1965. He is a former president of the Beaufort County Bar Association and a current member of the South Carolina State Bar Association. He currently serves as chairman of the finance committee for Carteret Street United Methodist Church. We believe Mr. Howell's experience as an attorney and his civic involvement in the Beaufort, South Carolina community well qualify him to serve on the Board.

EXECUTIVE OFFICERS

The following table shows for each executive officer of Coastal: (a) his name, (b) his age at December 31, 2016; (c) how long he has been an officer of Coastal; and (d) his positions with Coastal and CBC National Bank:

<u>Name (Age)</u>	<u>Officer Since</u>	<u>Position with Coastal Banking Company and CBC National Bank</u>
Michael G. Sanchez (67)	1998	Chairman and CEO of Coastal and CBC National Bank
Charles K. Wagner (46)	2007	President of Coastal and CBC National Bank
Thomas J. Flournoy (61)	2016	Executive Vice President, Chief Financial Officer of Coastal and CBC National Bank
W. Durand Childers (47)	2002	Executive Vice President, SBA Lending Division, CBC National Bank
Brynn L. Stensrud (48)	2008	Executive Vice President, Mortgage Division, CBC National Bank
Mitchell Smith (63)	2017	Executive Vice President, Chief Credit Officer, CBC National Bank

Biographical information for Messrs. Sanchez and Wagner can be found under the headings “**Class I Continuing Directors (Term Expiring 2018)**” and “**Class III Director Nominees (Term Expiring 2020)**,” respectively.

Thomas J. Flournoy, 61, has served as Executive Vice President, Chief Financial Officer of Coastal Banking Company and CBC National Bank since August 8, 2016. For the 15 years prior to joining Coastal, Mr. Flournoy served as CFO or COO of five community banks in Georgia, Indiana and Kentucky. From 2009-2015 he served as CFO of highly-recognized First Bank of Georgia in Augusta. He has played a significant role in the growth and ultimate sale of two community banks significantly beneficial to the shareholder base. Mr. Flournoy has extensive leadership experience in the areas of finance/accounting, SEC reporting, audit and risk, bank operations and information technology teams. Mr. Flournoy earned a bachelor's degree from Ball State University and is a graduate of the BAI School for Bank Administration. He is a certified public accountant and has over 35 years of experience in the financial services industry.

W. Durand Childers, 47, has served as Executive Vice President, SBA Lending Division, for CBC National Bank since August 2013 and as Senior Vice President for CBC National Bank since July 2002. Prior to joining the Bank, he was president, CEO and chairman of the board of directors of First National Bank, Tarpon Springs, Florida. Mr. Childers earned a bachelor's degree from the University of Georgia and is a graduate of both The Tennessee Banking School, Vanderbilt University and the Graduate School of Banking, Louisiana State University. Mr. Childers currently serves as the treasurer and executive trustee for the Fernandina Beach High School Foundation as well as a board member of the Nassau County Economic Development Board. He has 24 years of experience in the financial services industry.

Brynn L. Stensrud, 48, became Executive Vice President of the Mortgage Division in 2015. He has served as Senior Vice President of the Mortgage Division for CBC National Bank since 2011 and Credit Risk and Operations Leader since 2008. Prior to joining the Bank, he was senior vice president of SouthStar Funding. Mr. Stensrud earned a bachelor's degree from Louisiana State University, an MBA from Georgia State University, and received accreditation from Georgia Banking School. He has 23 years of experience in the financial services industry.

Mitchell Smith, 63, became Executive Vice President, Chief Credit Officer of CBC National Bank on January 1, 2017. Prior to joining the Bank, he was executive vice president and chief credit officer for HeritageBank of the South in Albany, Georgia. Mr. Smith has extensive experience in all aspects of lending and credit quality and has a highly successful track record of developing and leading teams. He managed the due diligence process for the acquisition of over 20 community banks while with HeritageBank of the South. He earned a bachelor's degree from Valdosta State College and is a graduate of the Graduate School of Banking of the South. He has 39 years of experience in the financial services industry.

**PROPOSAL II:
RATIFICATION OF THE APPOINTMENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Audit Committee has selected, and the Board has approved, Mauldin & Jenkins, Certified Public Accountants, LLC, an independent registered public accounting firm, to serve as the independent registered public accounting firm for the Company for the year ending December 31, 2017, subject to ratification by the shareholders. Mauldin & Jenkins also served as the independent auditors for the Company for the year ended December 31, 2016. Although shareholder ratification of our independent auditors is not required by our Bylaws or otherwise, we are submitting the selection of Mauldin & Jenkins to shareholders for ratification to permit shareholders to participate in this important corporate decision. If Mauldin & Jenkins declines to act or otherwise becomes incapable of acting, or if appointment is otherwise discontinued, the Audit Committee will appoint another independent registered public accounting firm. A representative of Mauldin & Jenkins is expected to be present at the Annual Meeting and will be given an opportunity to make a statement on behalf of the firm or to respond to appropriate questions from shareholders.

The ratification of Mauldin & Jenkins as independent auditors of the Company for the fiscal year ending December 31, 2017 requires the approval by the affirmative vote of a majority of the shareholders present in person or by proxy and entitled to vote at the meeting.

**THE BOARD UNANIMOUSLY RECOMMENDS THAT SHAREHOLDERS
VOTE FOR THE RATIFICATION OF THE APPOINTMENT
OF MAULDIN & JENKINS AS COASTAL BANKING COMPANY'S
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM
FOR THE YEAR ENDING DECEMBER 31, 2017.**

RELATIONSHIPS AND RELATED TRANSACTIONS

We have banking and other transactions in the ordinary course of business with our directors and officers and the bank and their affiliates. It is our policy that these transactions are on substantially the same terms (including price, or interest rates and collateral) as those prevailing at the time for comparable transactions with unrelated parties. We do not expect these transactions to involve more than the normal risk of collectability nor present other unfavorable features to the Company or CBC National Bank. Loans to individual directors and officers must also comply with CBC National Bank's lending policies and statutory lending limits, and directors with a personal interest in any loan application are excluded from the consideration of that loan application. The Company intends for all of its transactions with its affiliates to be on terms no less favorable to the Company than could be obtained from an unaffiliated third party and to be approved by a majority of disinterested directors.

SHAREHOLDER PROPOSALS AND SHAREHOLDER COMMUNICATIONS

Any shareholder proposal to be made at an Annual Meeting must comply with Coastal's Bylaws. Proposals must be delivered to the Secretary of the Company no less than 30 nor more than 60 days prior to the date of the 2017 Annual Meeting date; provided, however, that if less than 31 days' notice of the meeting is given to shareholders, the notice must be delivered within ten (10) days following the day on which notice of the meeting was mailed to shareholders. Pursuant to our Bylaws, the notice must set forth for each proposal:

- (1) a description of the business desired to be brought before the Annual Meeting (including the specific proposal(s) to be presented) and the reasons for conducting such business at the Annual Meeting;
- (2) the name and record address of the shareholder proposing such business;
- (3) the class and number of shares of the Company that are owned of record, and the class and number of shares of the Company that are held beneficially, but not held of record, by the shareholder as of the record date for the meeting if such date has been made publicly available, or as of a date within ten (10) days of the effective date of the notice by the shareholder if the record date has not been made publicly available; and
- (4) any interest of the shareholder in such business being proposed.

If a shareholder attempts to bring business before the Annual Meeting without complying with these provisions, the chairman of the meeting may declare that the matter was not properly brought before the meeting and the business will not be transacted; provided, however, that the chairman of the meeting, for good cause shown and with proper regard for the orderly conduct of business, may waive the Bylaw notice provisions. Proxies solicited by the management of the Company will confer discretionary authority upon the management of the Company to vote upon any shareholder proposal contained in a shareholder notice received by the Company after the Bylaw notice deadline.

Additionally, in accordance with our Bylaws, a shareholder may nominate persons for election as directors in opposition of the Company's nominees. Shareholders who wish to make a director nomination must deliver nominations in writing to the Secretary of the Company no later than 90 days in advance of the Annual Meeting (typically held in May) or seven days after Notice of a Special Meeting is given to shareholders. Each notice must set forth:

- the name and address of the shareholder who intends to make the nomination and of the person or persons to be nominated;
- a representation that the shareholder is a holder of record of stock of the Company entitled to vote at such meeting and intends to appear in person or by proxy at the meeting to nominate the person or persons specified in the notice;
- a description of all arrangements or understandings between the shareholder and each nominee and any other person or persons (naming such person or persons) pursuant to which the nomination or nominations are to be made by the shareholder;
- such other information regarding each nominee proposed by such shareholder as would be required to be included in a proxy statement filed pursuant to the proxy rules of the Securities and Exchange Commission had the nominee been nominated or intended to be nominated by the Board of Directors; and

- the consent of each nominee to serve as a director of the Company, if so elected.

The chairman of the meeting may refuse to acknowledge the nomination of any person not made in compliance with the foregoing procedure. Additionally, any shareholder nominee will be required to adhere to any required regulatory notice or approval prior to the date of the meeting.

Shareholder Communications

Shareholders wishing to communicate with the Board of Directors or with a particular director may do so in writing addressed to the Board, or to the particular director, and by sending it to the Secretary of the Company at the Company's principal office at 36 Sea Island Parkway, Beaufort, South Carolina 29907. The Secretary will promptly forward such communications to the applicable director or to the Chairman of the Board for consideration at the next scheduled meeting.

OTHER MATTERS

The Board of Directors of Coastal knows of no other matters that may be brought before the meeting. If, however, any matters other than the election of directors or the ratification of the appointment of our independent auditors should properly come before the meeting, votes will be cast pursuant to the proxies in accordance with the best judgment of the proxyholders.

If you cannot be present in person at the meeting, please visit us online at <http://www.coastalbanking.com> and click on *Shareholder Proxy* to access online voting. You will need the control number printed on the enclosed proxy card to cast your online vote. If you choose to complete, sign, date and return the enclosed proxy to us, please do so promptly using the postage-paid envelope provided.

April 21, 2017

MANAGEMENT'S COMMENTARY

Introduction

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

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

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

Forward-Looking Statements

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

Results of Operations

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

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

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

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

Overview

Net income for 2016 was \$6,956,000 or \$2.05 per diluted common share, compared to net income of \$5,052,000, or \$1.85 per diluted common share in 2015. The 2015 results are net of preferred dividends of \$784,000 paid through November 15, 2015 when all preferred shares outstanding were redeemed and replaced by a \$10 million holding company borrowing. Net income per basic common share was \$2.10 for 2016, compared to \$1.89 for 2015.

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

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

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

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

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

Supplemental Segment Information

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

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

Mortgage Banking Operations

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

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

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

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

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

SBA Lending

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

Community Banking

At the end of 2015, the Bank had 3 branches in Fernandina Beach, Florida, and Beaufort and Port Royal, South Carolina. With the acquisition of First Avenue Bank, 3 additional branches were added in April, 2016 in the Ocala, Florida area. The acquisition significantly increased the magnitude and importance of this segment to the Company. The primary source of income generated by this division is interest and fees on loans, service charges and other income from typical retail banking

sources. Net income for Community Banking increased from \$98,000 in 2015 to \$1,399,000 for 2016. Approximately \$428,000 of the increase in net income is attributable, however, to one-time, non-recurring net gains from the FANB acquisition. These net gains consist of the bargain purchase gain, fixed asset write-downs and one-time merger expenses. Additionally, the increased interest expense allocation percentage discussed above benefitted Community Banking in 2016. Net interest income increased 63.1%, noninterest income increased 158.6% and noninterest expense increased 46.2% from 2015 to 2016 as a result of the changes above. However, for 2016 and 2015, all non-allocated administrative income and expense of the Bank remain included in Community Banking in arriving at its segment net income.

Net Interest Income

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

Average Balances and Interest Rates

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

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

Interest Rate Sensitivity and Asset Liability Management

Interest rate sensitivity measures the timing and magnitude of the repricing of assets compared with the repricing of liabilities and is an important part of asset/liability management of a financial institution. The objective of interest rate sensitivity

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

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

At December 31, 2016 Maturing or Repricing in:

(In Thousands)	3 Months or Less	4 Months to 12 Months	1 to 5 Years	Over 5 Years	Total
Mortgage-Backed Securities	\$ 711,294	\$ 2,822,047	\$ 6,109,376	\$ 3,247,988	\$ 12,890,705
Fed Funds Sold	387,123			0	387,123
Other Investments	3,784,170	700,165	4,106,560	5,503,992	14,094,887
Total Investments	\$ 4,882,587	\$ 3,522,212	\$ 10,215,936	\$ 8,751,980	\$ 27,372,715
Commercial Loans	\$ 80,656,499	\$ 2,280,942	\$ 3,998,963	\$ 4,168,893	\$ 91,105,297
Real Estate Loans	194,196,756	66,290,587	65,237,654	28,654,302	354,379,299
Installment Loans	27,585,255	8,223,141	10,101,011	9,358,563	55,267,970
Total Loans	\$ 302,438,510	\$ 76,794,670	\$ 79,337,628	\$ 42,181,758	\$ 500,752,566
Total Interest-Bearing Earning Assets	\$ 307,321,097	\$ 80,316,882	\$ 89,553,564	\$ 50,933,738	\$ 528,125,281
Certificates of Deposit	\$ 28,469,141	\$ 75,286,604	\$ 46,227,631	\$ 0	\$ 149,983,376
Transaction Accounts	72,218,074	6,862,122	36,706,044	58,325,938	\$ 174,112,178
Senior Debentures	7,217,000				7,217,000
Junior Subordinated Debentures	8,916,667				8,916,667
FHLB Advances	46,060,005	6,500,000	10,500,000		63,060,005
Total Interest-Bearing Liabilities	\$ 162,880,887	\$ 88,648,726	\$ 93,433,675	\$ 58,325,938	\$ 403,289,226
Interest Sensitive Assets	\$ 307,321,097	\$ 80,316,882	\$ 89,553,564	\$ 50,933,738	\$ 528,125,281
Interest Sensitive Liabilities	\$ 162,880,887	\$ 88,648,726	\$ 93,433,675	\$ 58,325,938	\$ 403,289,226
Gap	\$ 144,440,210	\$ -8,331,844	\$ -3,880,111	\$ -7,392,200	\$ 124,836,055
Cumulative Gap	\$ 144,440,210	\$ 136,108,366	\$ 132,228,255	\$ 124,836,055	
Gap Ratio	1.89	0.91	0.96	0.87	1.31
Cumulative Gap Ratio	1.89	1.54	1.38	1.31	
Cumulative Gap as % of EA	27.3%	25.8%	25.0%	23.6%	

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

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

Provision and Allowance for Loan Losses

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

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

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

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

"Loans past due greater than 30 days and still accruing interest" has proven to be a useful leading indicator of directional trends in future loan losses. As the level of this metric rises, expectations are for a comparable increase in loans moving into a nonaccrual status and ultimately foreclosure resulting in increased losses. This pattern has been observed in the past where increases in loans past due greater than 30 days and still accruing are followed in future quarters with the same directional changes in the level of loans on nonaccrual. The level of loans past due greater than 30 days and still accruing interest totaled \$3,191,000 at December 31, 2016, an increase of \$2,396,000 from the prior quarter end, and \$3,068,000 higher than the \$123,000 level at December 31, 2015. While the long term trend in credit quality over the last several years has improved,

we continue to experience ups and downs throughout the process and so management will continue to carefully monitor past due loans and work aggressively to manage loan delinquency levels.

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

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

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

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

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

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

Noninterest Income

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

Service charges on deposit accounts increased by 17.7% to \$247,000 for the year ended December 31, 2016 due to the addition of three branches and related deposits acquired in the FANB acquisition. Other service charges, commissions and fees increased 35.4% to \$614,000 primarily for the same reason.

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

Noninterest Expense

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

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

Income Taxes

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

Financial Condition

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

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

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

Investment Securities

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

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

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

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

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

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

Loans

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

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

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

Other Real Estate Owned (OREO)

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

Book Value of Other Real Estate Owned at December 31, 2016				
(In thousands)	Florida	South Carolina	Other	Total
Residential	\$ -	\$ -	\$ -	\$ -
Commercial	1,721	844	749	3,314
Finished lots	-	32	-	32
Raw land	1,716	-	-	1,716
	<u>\$ 3,437</u>	<u>\$ 876</u>	<u>\$ 749</u>	<u>\$ 5,062</u>

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

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

Deposits

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

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

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

Other Borrowings and Liquidity

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

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

(In Thousands)

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

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

CONSOLIDATED FINANCIAL STATEMENTS



INDEPENDENT AUDITOR'S REPORT

**To the Board of Directors
and Stockholders of
Coastal Banking Company**

We have audited the accompanying consolidated financial statements of **Coastal Banking Company and Subsidiaries**, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Coastal Banking Company as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads "Mauldin & Jenkins, LLC".

Albany, Georgia
March 30, 2017

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

	December 31,	
	2016	2015
Assets		
Cash and due from banks	\$ 5,730,468	\$ 3,058,112
Interest-bearing deposits in banks	2,225,536	1,772,456
Federal funds sold	387,123	82,642
Securities available for sale, at fair value	19,667,769	20,524,668
Restricted equity securities, at cost	4,992,287	6,781,900
Loans held for sale, at fair value	92,009,241	128,181,623
Loans, net of unearned income	408,743,325	285,932,549
Less allowance for loan losses	5,990,733	5,254,407
Loans, net	402,752,592	280,678,142
Premises and equipment, net	13,604,166	7,174,034
Cash surrender value of life insurance	2,362,805	2,521,887
SBA loan servicing rights	1,403,431	1,544,682
Intangible assets	813,716	—
Other real estate owned	5,061,661	6,115,715
Other assets	10,377,931	6,231,111
Total assets	<u>\$ 561,388,726</u>	<u>\$ 464,666,972</u>
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest-bearing	\$ 77,603,027	\$ 42,156,742
Interest-bearing	174,112,178	118,889,345
Savings	15,618,336	5,179,736
Time	149,983,376	117,613,561
Total deposits	417,316,917	283,839,384
FHLB and other borrowings	63,050,000	120,500,000
Senior note payable	8,916,667	9,916,667
Junior subordinated debentures	7,217,000	7,217,000
Other liabilities	13,172,850	9,935,021
Total liabilities	509,673,434	431,408,072
Commitments and contingencies (Note 16)		
Shareholders' Equity:		
Preferred stock, par value \$.01; 10,000,000 shares authorized	—	—
Common stock, par value \$.01; 10,000,000 shares authorized; 3,647,489 shares issued and outstanding at December 31, 2016; 2,684,478 shares issued and outstanding at December 31, 2015	36,475	26,845
Additional paid-in capital	53,354,382	41,764,823
Accumulated deficit	(1,870,203)	(8,825,989)
Accumulated other comprehensive income	194,638	293,221
Total shareholders' equity	51,715,292	33,258,900
Total liabilities and shareholders' equity	<u>\$ 561,388,726</u>	<u>\$ 464,666,972</u>

See accompanying notes to consolidated financial statements.

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES

Consolidated Statements of Income

	For the Years Ended December 31,	
	2016	2015
Interest income:		
Interest and fees on loans	\$ 22,709,121	\$ 18,362,518
Interest on taxable securities	689,833	675,536
Interest on nontaxable securities	115,514	113,770
Interest on deposits in other banks	14,771	8,361
Interest on federal funds sold	12,764	188
Total interest income	23,542,003	19,160,373
Interest expense:		
Interest on deposits	2,422,894	1,603,573
Interest on senior note payable	480,556	255,623
Interest on FHLB, other borrowings and junior subordinated debentures	1,144,973	649,144
Total interest expense	4,048,423	2,508,340
Net interest income	19,493,580	16,652,033
Provision for loan losses	1,450,061	393,863
Net interest income after provision for loan losses	18,043,519	16,258,170
Noninterest income:		
Service charges on deposit accounts	246,667	209,486
Other service charges, commissions and fees	613,671	453,294
SBA loan income	1,962,023	1,414,020
Mortgage banking income	18,225,244	15,686,148
Gain on sales of securities available for sale	18,373	—
Income from investment in cash value life insurance	83,584	84,594
Other income	1,536,287	23,166
Total other income	22,685,849	17,870,708
Noninterest expenses:		
Salaries and employee benefits	17,373,369	14,971,769
Occupancy and equipment expense	3,147,188	2,204,884
Advertising fees	653,609	287,310
Audit fees	769,158	552,606
Data processing fees	1,969,355	1,329,447
Director fees	403,550	301,550
FDIC insurance expense	239,506	327,462
Legal and other professional fees	1,023,046	1,462,880
Mortgage loan expense	703,285	888,390
OCC examination fees	162,385	103,812
Other real estate owned expenses	616,676	741,311
Other operating	2,681,878	1,358,608
Total other expenses	29,743,005	24,530,029
Income before income taxes	10,986,363	9,598,849
Income tax expense	4,030,577	3,763,628
Net income	\$ 6,955,786	\$ 5,835,221
Preferred stock dividends	—	783,563
Net earnings available to common shareholders	\$ 6,955,786	\$ 5,051,658
Basic earnings per share available to common shareholders	\$ 2.10	\$ 1.89
Diluted earnings per share available to common shareholders	\$ 2.05	\$ 1.85

See accompanying notes to consolidated financial statements.

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income

	For the Years Ended December 31,	
	2016	2015
Net income	\$ 6,955,786	\$ 5,835,221
Other comprehensive loss, net of tax benefit:		
Net unrealized holding losses from securities available for sale arising during period, net of tax benefit of \$44,538 and \$36,396	(86,457)	(70,651)
Reclassification adjustment for gains of securities included in net income, net of tax of \$6,247 and \$—	(12,126)	—
Total other comprehensive loss	(98,583)	(70,651)
Comprehensive income	<u>\$ 6,857,203</u>	<u>\$ 5,764,570</u>

See accompanying notes to consolidated financial statements.

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity
For the Years Ended December 31, 2016 and 2015

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount				
Balance, December 31, 2014	9,950	\$ 9,950,000	2,654,225	\$ 26,542	\$ 41,400,835	\$ (13,877,647)	\$ 363,872	\$ 37,863,602
Net income	—	—	—	—	—	5,835,221	—	5,835,221
Proceeds from exercise of stock options	—	—	200	2	678	—	—	680
Proceeds from employee stock purchase program	—	—	30,053	301	312,176	—	—	312,477
Preferred stock dividend	—	—	—	—	—	(783,563)	—	(783,563)
Preferred stock redemption	(9,950)	(9,950,000)	—	—	—	—	—	(9,950,000)
Stock-based compensation expense	—	—	—	—	51,134	—	—	51,134
Other comprehensive loss	—	—	—	—	—	—	(70,651)	(70,651)
Balance, December 31, 2015	—	—	2,684,478	26,845	41,764,823	(8,825,989)	293,221	33,258,900
Net income	—	—	—	—	—	6,955,786	—	6,955,786
Issuance of common stock, net of stock issuance costs	—	—	885,345	8,853	10,658,979	—	—	10,667,832
Proceeds from exercise of stock options	—	—	43,381	434	389,755	—	—	390,189
Proceeds from employee stock purchase program	—	—	34,285	343	416,140	—	—	416,483
Stock-based compensation expense	—	—	—	—	124,685	—	—	124,685
Other comprehensive loss	—	—	—	—	—	—	(98,583)	(98,583)
Balance, December 31, 2016	—	\$ —	3,647,489	\$ 36,475	\$ 53,354,382	\$ (1,870,203)	\$ 194,638	\$ 51,715,292

See accompanying notes to consolidated financial statements.

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows

	For the Years Ended December 31,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 6,955,786	\$ 5,835,221
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation, amortization and accretion	1,044,340	694,247
Loss on sales of fixed assets	103,492	1,476
Stock-based compensation expense	124,685	51,134
Provision for loan losses	1,450,061	393,863
Gain on sales of securities available for sale	(18,373)	—
Provision for deferred taxes	(12,433)	(598,456)
Write downs of other real estate owned	544,131	607,334
(Gain) loss on sales of other real estate owned	2,582	(15,877)
Bargain purchase gain	(1,243,824)	—
Increase in cash value life insurance	(83,584)	(119,174)
Originations of mortgage loans held for sale	(2,985,912,562)	(2,776,265,526)
Proceeds from sales of mortgage loans held for sale	3,040,310,207	2,758,913,534
Net (increase) decrease in interest receivable	(426,379)	14,827
Net increase in interest payable	6,099	25,145
SBA loan income	(1,962,023)	(1,414,020)
Mortgage banking income	(18,225,224)	(15,686,148)
Net other operating activities	4,302,280	3,971,326
Net cash provided by (used in) operating activities	46,959,261	(23,591,094)
Cash flows from investing activities:		
Net increase in interest-bearing deposits in banks	(453,080)	(409,174)
Net (increase) decrease in federal funds sold	(304,481)	5,325
Proceeds from maturities of securities available for sale	3,141,268	3,881,768
Proceeds from sales of securities available for sale	15,278,589	—
Purchase of securities available for sale	(4,185,373)	—
Net change in restricted equity securities	2,294,399	(1,389,400)
Net increase in loans	(43,691,761)	(13,715,376)
Proceeds from redemption of bank owned life insurance	242,666	—
Purchase of premises and equipment	(464,583)	(309,431)
Proceeds from sales of other real estate owned	1,492,673	1,186,374
Net cash received from acquisition	4,894,974	—
Net cash used in investing activities	(21,754,709)	(10,749,914)
Cash flows from financing activities:		
Net increase (decrease) in deposits	35,262,217	(1,824,052)
Proceeds from other borrowings	1,099,400,000	663,850,000
Repayment of other borrowings	(1,156,850,000)	(626,850,000)
Dividends paid on preferred stock	—	(783,563)
Proceeds from senior note payable	—	10,000,000
Repayment of senior note payable	(1,000,000)	(83,333)
Redemption of preferred stock	—	(9,950,000)
Proceeds from employee stock purchase plan	416,483	312,477
Proceeds from exercise of stock options	390,189	680
Common stock issuance costs	(151,085)	—
Net cash provided by (used in) financing activities	(22,532,196)	34,672,209
Net increase in cash and due from banks	2,672,356	331,201
Cash and due from banks at beginning of year	3,058,112	2,726,911
Cash and due from banks at end of year	\$ 5,730,468	\$ 3,058,112

See accompanying notes to consolidated financial statements.

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows

	For the Years Ended December 31,	
	2016	2015
Supplemental disclosures of cash flow information:		
Cash paid during the year for interest	\$ 4,047,268	\$ 2,483,195
Cash paid during the year for income taxes	\$ 5,000,564	\$ 3,828,635
Noncash transactions:		
Principal balances of loans transferred to other real estate owned	\$ 925,283	\$ 871,142
Sales of other real estate owned through internally financed loans	\$ —	\$ 300,000

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

COASTAL BANKING COMPANY, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Basis of Presentation and Nature of Operations

Coastal Banking Company, Inc. (the “Company”) is organized under the laws of the State of South Carolina for the purpose of operating as a bank holding company for CBC National Bank (the “Bank”). The Bank commenced business on May 10, 2000 as Lowcountry National Bank. The Company acquired First National Bank of Nassau County, which began its operations in 1999, through its merger with First Capital Bank Holding Corporation on October 1, 2005. On August 10, 2008, Lowcountry National Bank and First National Bank of Nassau County merged into one charter. Immediately after the merger, the name of the surviving bank was changed to CBC National Bank and the main office relocated to 1891 South 14th Street, Fernandina Beach, Nassau County, Florida. During 2016, the Company acquired First Avenue National Bank and merged it into CBC National Bank and expanded its footprint to Ocala, Marion County, Florida. The Bank provides full commercial and consumer banking services to customers throughout Beaufort County, South Carolina and Nassau and Marion Counties, Florida, and is subject to regulation by the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC”). The Company is subject to regulation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”).

The Bank also has a residential mortgage banking division headquartered in Atlanta, Georgia. The mortgage banking division operates thirteen retail residential loan production offices located in nine states within Arizona, Florida, Georgia, Illinois, Indiana, Maryland, Michigan, North Carolina and Ohio. The Company also has an investment in Coastal Banking Company Statutory Trust I (“Trust I”) and Coastal Banking Company Statutory Trust II (“Trust II”). Both trusts are special purpose subsidiaries organized for the sole purpose of issuing trust preferred securities.

The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany transactions have been eliminated in consolidation. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America and to general practices in the banking industry.

Accounting Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of other real estate owned and deferred taxes, other-than-temporary impairments of securities, and the fair value of financial instruments.

The Company has evaluated all transactions, events, and circumstances for consideration or disclosure through March 30, 2017, the date these financial statements were available to be issued, and has reflected or disclosed those items within the consolidated financial statements and related footnotes as deemed appropriate.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Accounting Estimates (Continued)

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Cash, Due from Banks and Cash Flows

For purposes of reporting cash flows, cash and due from banks includes cash on hand, cash items in process of collection and amounts due from banks. Cash flows from loans, federal funds sold, deposits, interest-bearing deposits in banks and restricted equity securities are reported net.

The Bank is required to maintain reserve balances in cash or on deposit with correspondent banks and the Federal Reserve Bank. The total of those reserve requirements was approximately \$1,431,000 at December 31, 2016 and \$762,000 at December 31, 2015.

Securities

The Company classifies its securities as available for sale or held to maturity. Held to maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All securities not included in held to maturity are classified as available for sale.

Available for sale securities are recorded at fair value. Held to maturity securities are recorded at cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on securities available for sale, net of the related tax effect, are excluded from earnings and are reported as a separate component of shareholders' equity until realized.

In estimating other-than-temporary impairment losses, management considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

A decline in the market value of securities below cost that is deemed other than temporary is charged to earnings and establishes a new cost basis for the security.

Premiums and discounts are amortized or accreted over the life of the related securities as adjustments to the yield. Realized gains and losses for securities classified as available for sale and held to maturity are recorded on trade date, are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

The Company evaluates investment securities for other-than-temporary impairment using relevant accounting guidance specifying that (a) if the Company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss has occurred in the security. If management does not intend to sell the security and it is more likely than not that they will not have to sell the security before recovery of the cost basis, management will recognize the credit component of another-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Restricted Equity Securities

The Company is required to maintain an investment in capital stock of the Federal Home Loan Bank of Atlanta ("FHLB") and the Federal Reserve Bank of Atlanta ("FRB"). The stock is generally pledged as collateral against any borrowings from these institutions. Based on redemption provisions of these entities, the stock has no quoted market value and is carried at cost. At their discretion, these entities may declare dividends on the stock. Management reviews for impairment based on the ultimate recoverability of the cost basis in these stocks. At December 31, 2016, the balance of FHLB stock was \$3,200,900 and the balance of FRB stock was \$1,605,900. At December 31, 2015, the balance of FHLB stock was \$5,501,000 and the balance of FRB stock was \$1,281,000. The Company had investments in other restricted equity securities of \$185,487 at December 31, 2016.

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at fair value under the fair value option accounting guidance for financial instruments. Gains and losses on loan sales (sales proceeds minus carrying value) are recorded in noninterest income. All residential loans are sold servicing released so there is no servicing income recognized on those loans. Interest income is generally recognized on those loans held for sale until the loan sale is fully completed and the loan is transferred. Interest income on loans held for sale is reflected along with portfolio loans in interest and fees on loans in the consolidated statement of income. In accordance with trade date accounting guidance, the sale of residential mortgage loans is recognized at the time that all conditions precedent to the sale have been met and all material risks and rewards of loan ownership have passed from the Company to the investor purchasing the loans. This typically occurs when the physical loan documents are delivered to the investor. Upon delivery of loan documents, the Company records the gain or loss on sale of the loans and recognizes the receivable from the investor for the proceeds of sale. At December 31, 2016, unpaid principal balances for loans held for sale totaled approximately \$92,286,000 and the fair market value of those loans was approximately \$92,009,000. At December 31, 2015, unpaid principal balances for loans held for sale totaled approximately \$128,233,000 and the fair market value of those loans was approximately \$128,182,000.

The Company also originates SBA loans, which in some cases are sold on the secondary market. Once the decision is made to sell, adjustments to reflect fair value and realized gains and losses upon ultimate sale of the loans are classified as noninterest income in the consolidated statements of income.

Loans and Allowance for Loan Losses

Loans are stated at the principal amount outstanding, net of deferred loan origination fees and costs and the allowance for loan losses. Interest on loans is calculated by using the interest rates and terms as stipulated in the loan notes and based upon the principal amount outstanding. Loan origination and commitment fees and direct loan origination costs are deferred and amortized over the contractual or expected economic life of the related loan or commitments as an adjustment of the related loan yields.

A loan is considered impaired when, based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, at the loan's observable market price, or at the fair value of the collateral of the loan if the loan is collateral dependent.

To the extent that the recovery of loan balances has become collateral dependent, we obtain appraisals and then we reduce these appraised values for estimated 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 non-performing 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.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Loans and Allowance for Loan Losses (Continued)

Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts that the borrower's financial condition is such that collection of interest is doubtful. When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely. The allowance represents an amount, which, in management's judgment, will be adequate to absorb probable losses on existing loans that may become uncollectible.

Management's judgment in determining the adequacy of the allowance is based on evaluations of the collectability of loans. These evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, historical losses, high loan concentrations, trends in past dues and non accrual loans, loan risk ratings, economic conditions, market conditions and other internal and external factors that influence each portfolio segment and review of specific impaired loans. The combination of these results are compared monthly to the recorded allowance for loan losses for reasonableness and material differences are adjusted by increasing or decreasing the provision for loan losses. Management uses an external loan review program to challenge and corroborate the internal loan grading system and provide additional analysis in determining the adequacy of the allowance and the future provisions for estimated loan losses.

Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on judgments different than those of management.

Troubled Debt Restructurings

The Company designates loan modifications as troubled debt restructurings ("TDRs") when for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. TDRs can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. In circumstances where the TDR involves charging off a portion of the loan balance, the Company typically classifies these restructurings as nonaccrual.

In connection with restructurings, the decision to maintain a loan that has been restructured on accrual status is based on a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation includes consideration of the borrower's current capacity to pay, which among other things may include a review of the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations, a debt to income analysis, and an evaluation of secondary sources of payment from the borrower and any guarantors. This evaluation also includes an evaluation of the borrower's current willingness to pay, which may include a review of past payment history, an evaluation of the borrower's willingness to provide information on a timely basis, and consideration of offers from the borrower to provide additional collateral or guarantor support. The credit evaluation also reflects consideration of the borrower's future capacity and willingness to pay, which may include evaluation of cash flow projections, consideration of the adequacy of collateral to cover all principal and interest, and trends indicating improving profitability and collectability of receivables.

Restructured nonaccrual loans may be returned to accrual status based on a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation must include consideration of the borrower's sustained historical repayment for a reasonable period, generally a minimum of six months, prior to the date on which the loan is returned to accrual status.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Non-performing Assets

Loans are placed in a non accrual status when, in the opinion of management, the collection of additional interest is questionable. Thereafter, no interest is taken into income unless received in cash or until such time as the borrower demonstrates the ability to pay principal and interest.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Costs incurred for maintenance and repairs that do not extend the useful life of the asset are expensed as incurred.

Depreciation expense totaled approximately \$531,000 and \$371,000 for the years ended December 31, 2016 and December 31, 2015, respectively, and is computed using the straight-line method over the following estimated useful lives:

Building and improvements	10 - 40 years
Furniture and equipment	3 - 10 years

SBA Loan Servicing Rights

SBA Loan Servicing Rights (“LSRs”) consist of the portion of Small Business Administration (SBA) loans participated to other institutions and serviced by the Company.

LSRs are carried at original fair value, as determined by an independent evaluation, less accumulated amortization. Amortization is recorded over the expected life of the loan. The LSR asset is evaluated for impairment at the end of each quarter, by obtaining a revised fair value from an independent third party. The related balance of SBA loans participated and serviced for others was approximately \$89,210,000 at December 31, 2016, and \$85,830,000 at December 31, 2015.

Intangible Assets

Intangible assets consist of core deposit premiums acquired in connection with business combinations. The core deposit premium is initially recognized based on a valuation performed as of the consummation date. The core deposit premium is amortized over the average remaining life of the acquired customer deposits, or approximately 6 years. Amortization periods are reviewed annually in connection with the annual impairment testing. The intangible assets were evaluated for impairment during the fourth quarter and based on that evaluation it was determined that there was no impairment at December 31, 2016.

Other real estate owned

Other real estate owned acquired through or in lieu of loan foreclosure are held for sale and are initially recorded at fair value less estimated selling costs. Any write-down to fair value at the time of transfer to other real estate owned is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated costs to sell. Costs of improvements are capitalized, to the extent that these costs don’t increase the total carrying amount above the improved fair value less estimated selling costs. Costs relating to holding other real estate owned and subsequent adjustments to the value are expensed. The carrying amount of other real estate owned at December 31, 2016 and 2015 was approximately \$5,062,000 and \$6,116,000 respectively.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Derivatives

Derivatives are recognized as assets and liabilities on the consolidated balance sheet and measured at fair value. For exchange-traded contracts, fair value is based on quotable market prices. For nonexchange traded contracts, fair value is based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant management judgment or estimation.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges of assets and liabilities are classified in the cash flow statement in the same category as the cash flows of the items being hedged.

Derivative Loan Commitments: Mortgage loan commitments that relate to the origination of a mortgage that will be held for sale upon funding are considered derivative instruments under the derivatives and hedging accounting guidance (FASB ASC 815, *Derivatives and Hedging*). Loan commitments that are derivatives are recognized at fair value on the consolidated balance sheet in other assets and other liabilities with changes in their fair values recorded in noninterest income.

Forward Loan Sale Commitments: The Company carefully evaluates all loan sales agreements to determine whether they meet the definition of a derivative under the derivatives and hedging accounting guidance (FASB ASC 815) as facts and circumstances may differ significantly. If agreements qualify, to protect against the price risk inherent in derivative loan commitments, the Company uses both “mandatory delivery” and “best efforts” forward loan sale commitments to mitigate the risk of potential decreases in the values of loans that would result from the exercise of the derivative loan commitments. Mandatory delivery contracts which include both bulk sales and assignment of trade structures are accounted for as derivative instruments. Accordingly, forward loan sale commitments are recognized at fair value on the consolidated balance sheet in other assets and liabilities with changes in their fair values recorded in other noninterest income.

The Company estimates the fair value of its forward loan sales commitments using a methodology similar to that used for derivative loan commitments.

Income Taxes

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management’s judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Stock Compensation Plans

Stock compensation accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. Compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards and stock grants.

Earnings Per Share

The Company is required to report earnings per common share with and without the dilutive effects of potential common stock issuances from instruments such as options, convertible securities and warrants on the face of the statements of operations. Basic earnings per common share are based on the weighted average number of common shares outstanding during the period, which was 3,307,965 shares in 2016 and 2,667,940 shares in 2015, while the effects of potential common shares outstanding during the period are included in diluted earnings per share. Additionally, the Company must reconcile the amounts used in the computation of both "basic earnings per share" and "diluted earnings per share". At December 31, 2016, potential common shares of 24,119 were not included in the calculation of diluted earnings per share because the exercise of such shares would be anti-dilutive. At December 31, 2015, potential common shares of 11,619 were not included in the calculation of diluted earnings per share because the exercise of such shares would be anti-dilutive. Earnings per common share amounts are as follows:

	For the Years Ended December 31,	
	2016	2015
Net income	\$ 6,955,786	\$ 5,835,221
Preferred stock dividends	-	(783,563)
Net income available to common shareholders	\$ 6,955,786	\$ 5,051,658
Weighted average common shares	3,307,965	2,667,940
Effect of dilutive securities	80,647	60,336
Diluted average common shares	3,388,612	2,728,276
Earnings per common share	\$ 2.10	\$ 1.89
Diluted earnings per common share	\$ 2.05	\$ 1.85

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company - put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Fair Value of Financial Instruments

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 19. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Advertising Costs

Advertising costs are expensed as incurred.

Risks and Uncertainties

In the normal course of its business, the Company encounters two significant types of risk: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different bases, than its interest-earning assets. Credit risk is the risk of default on the Company's loan portfolio that results from borrowers' inability or unwillingness to make contractually required payments, or that a counterparty to a financial contract or commitment fails to perform in accordance with the contract or commitment terms. Market risk reflects changes in the value of collateral underlying loans receivable, the valuation of real estate held by the Company, and the valuation of loans held for sale and mortgage-backed securities available for sale.

The Company is subject to the regulations of various government agencies. These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances, and operating restrictions, resulting from the regulators' judgments based on information available to them at the time of their examination.

Concentrations of Credit Risk

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily through our full-service offices in Beaufort County, South Carolina and in and around Duval and Nassau Counties in Florida. The Company's loan portfolio is not concentrated in loans to any single borrower or in a relatively small number of borrowers.

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risk that could arise from potential concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g. principal deferral period, loans with initial interest-only payments, etc.), and loans with high loan-to-value ratios. Additionally, there are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. For example, the Company makes variable-rate loans and fixed-rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e. balloon-payment loans). These loans are underwritten and monitored to manage the associated risks.

The Company's investment portfolio consists principally of obligations of the United States, its agencies or its corporations and general obligation municipal securities. In the opinion of management, there is no concentration of credit risk in this investment portfolio. The Company places its deposits and correspondent accounts with and sells its federal funds to high quality institutions. Management believes credit risk associated with correspondent accounts is not significant.

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

Reclassification of Certain Items

Certain items in the consolidated financial statements as of and for the year ended December 31, 2015 have been reclassified, with no effect on total assets or net income, to be consistent with the classifications adopted for the year ended December 31, 2016.

Note 2. Investment Securities

Investment securities are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016				
<i>Available for sale</i>				
State and municipal securities	\$ 4,460,550	\$ 223,517	\$ (49,967)	\$ 4,634,100
Corporate debt obligations	956,119	14,711	—	970,830
Mortgage-backed securities - residential	13,929,469	181,681	(48,311)	14,062,839
	<u>\$ 19,346,138</u>	<u>\$ 419,909</u>	<u>\$ (98,278)</u>	<u>\$ 19,667,769</u>
December 31, 2015				
<i>Available for sale</i>				
State and municipal securities	\$ 3,135,595	\$ 318,519	\$ (101)	\$ 3,454,013
Mortgage-backed securities - residential	16,944,799	231,847	(105,991)	17,070,655
	<u>\$ 20,080,394</u>	<u>\$ 550,366</u>	<u>\$ (106,092)</u>	<u>\$ 20,524,668</u>

The following table shows gross unrealized losses and fair value of securities, aggregated by category and length of time that securities have been in a continuous unrealized loss position. There were no corporate securities in a loss position at December 31, 2016.

Investment securities available for sale:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016						
State and municipal securities	\$ 982,314	\$ (49,967)	\$ —	\$ —	\$ 982,314	\$ (49,967)
Mortgage-backed securities - residential	4,083,026	(46,870)	428,485	(1,442)	4,511,511	(48,311)
Total	<u>\$ 5,065,340</u>	<u>\$ (96,837)</u>	<u>\$ 428,485</u>	<u>\$ (1,442)</u>	<u>\$ 5,493,825</u>	<u>\$ (98,278)</u>
December 31, 2015						
State and municipal securities	\$ 50,827	\$ (101)	\$ —	\$ —	\$ 50,827	\$ (101)
Mortgage-backed securities - residential	5,961,080	(91,702)	607,552	(14,288)	6,568,632	(105,991)
Total	<u>\$ 6,011,907</u>	<u>\$ (91,803)</u>	<u>\$ 607,552</u>	<u>\$ (14,288)</u>	<u>\$ 6,619,459</u>	<u>\$ (106,092)</u>

Notes to Consolidated Financial Statements

Note 2. Investment Securities (Continued)

State and municipal securities. The unrealized loss on three investment in state and municipal securities was caused by interest rate increases. The contractual terms of the investment does not permit the issuer to settle the security at a price less than the amortized cost basis of the investment. Because the Company does not intend to sell the investment and it is not more likely than not that the Company will be required to sell the investment before recovery of their amortized cost basis, which may be maturity, the Company does not consider the investment to be other-than-temporarily impaired at December 31, 2016.

Mortgage-backed securities - residential: The unrealized losses on the Company's investment in six mortgage-backed residential securities were caused by interest rate increases. The Company purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

The amortized cost and estimated fair value of investment securities at December 31, 2016 and 2015, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2016		December 31, 2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<i>Available for sale</i>				
Due in one year or less	\$ —	\$ —	\$ —	\$ —
Due from one year to five years	—	—	—	—
Due from five to ten years	3,291,501	3,350,508	3,135,595	3,454,013
Due after ten years	2,125,168	2,254,422	—	—
Mortgage-backed securities – residential	13,929,469	14,062,839	16,944,799	17,070,655
	<u>\$ 19,346,138</u>	<u>\$ 19,667,769</u>	<u>\$ 20,080,394</u>	<u>\$ 20,524,668</u>

Securities were pledged to secure public deposits and Federal Home Loan Bank borrowings with an approximate carrying amount of \$11,735,000 and \$13,227,000 as of December 31, 2016 and 2015, respectively. Pledged securities may not be sold without first pledging replacement securities and obtaining consent of the party to whom the securities are pledged.

Gains and losses on sales of securities available for sale consist of the following:

	For the Years Ended December 31,	
	2016	2015
Gross gains on sales of securities	\$ 18,373	\$ —
Gross losses on sales of securities	—	—
Net realized gains on sales of securities available for sale	<u>\$ 18,373</u>	<u>\$ —</u>

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses

The composition of loans is summarized as follows:

	December 31,	
	2016	2015
Commercial and financial	\$ 29,301,374	\$ 18,795,061
Agricultural	2,995	17,500
Real estate – construction, commercial	27,335,553	20,635,761
Real estate – construction, residential	18,949,839	12,901,736
Real estate – mortgage, commercial	162,329,189	106,651,258
Real estate – mortgage, residential	154,884,420	121,878,211
Real estate – mortgage, farmland	10,592,571	3,845,325
Consumer installment loans	5,347,384	1,207,697
Gross loans, net of unearned income	408,743,325	285,932,549
Less: Allowance for loan losses	5,990,733	5,254,407
Net loans	\$ 402,752,592	\$ 280,678,142

The Company 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, and Marion and Nassau Counties, Florida. Although the Company 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.

A loan is considered impaired, in accordance with the impairment accounting guidance (FASB ASC 310-10-35-16), when, based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans as defined by GAAP are summarized as follows:

	December 31, 2016				
(In thousands)	Recorded Investment	Unpaid Principal Balance	Recorded Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Real estate - construction	\$ 681	\$ 1,120	\$ —	\$ 764	\$ 40
Real estate - mortgage	3,887	4,484	—	4,514	239
Commercial, financial, and agricultural	236	236	—	241	53
With an allowance recorded:					
Real estate – construction	\$ 140	\$ 140	\$ 68	\$ 140	\$ 2
Real estate - mortgage	6,182	6,328	675	6,670	193
Commercial, financial, and agricultural	590	590	542	442	47
Total impaired loans:					
Real estate - construction	\$ 821	\$ 1,260	\$ 68	\$ 904	\$ 42
Real estate - mortgage	10,069	10,812	675	11,184	432
Commercial, financial, and agricultural	826	826	542	683	100

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

(In thousands)	December 31, 2015				
	Recorded Investment	Unpaid Principal Balance	Recorded Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Real estate - construction	\$ 139	\$ 500	\$ —	\$ 191	\$ —
Real estate - mortgage	411	411	—	417	35
With an allowance recorded:					
Real estate - construction	\$ 747	\$ 747	\$ 572	\$ 748	\$ 4
Real estate - mortgage	4,997	5,035	891	6,247	211
Total impaired loans:					
Real estate - construction	\$ 886	\$ 1,247	\$ 572	\$ 939	\$ 4
Real estate - mortgage	5,408	5,446	891	6,664	246

As of December 31, 2015, there are six restructured loans with a recorded investment of \$2,610,000 included in the impaired loans table above, as required by GAAP, that management has not internally classified as impaired. These loans are performing in accordance with their restructured terms such that we expect to recover all loan principal and interest, however, these loans meet the GAAP definition of a TDR.

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:

(In thousands)	December 31, 2016						
	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	\$ 7	\$ 3	—	\$ 654	\$ 664	\$ 28,637	\$ 29,301
Agricultural	—	—	—	—	—	3	3
Real estate – construction, commercial	58	—	—	179	237	27,099	27,336
Real estate – construction, residential	—	—	—	—	—	18,950	18,950
Real estate – mortgage, commercial	979	—	—	2,747	3,726	158,603	162,329
Real estate – mortgage, residential	1,340	—	—	2,491	3,831	151,053	154,884
Real estate – mortgage, farmland	—	—	—	—	—	10,593	10,593
Consumer installment loans	—	12	—	—	12	5,335	5,347
	<u>\$ 2,384</u>	<u>\$ 15</u>	<u>—</u>	<u>\$ 6,071</u>	<u>\$ 8,470</u>	<u>\$ 400,273</u>	<u>\$ 408,743</u>

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

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
	Past Due	Past Due	Past Due & Accruing	Nonaccrual	Nonaccrual	Loans	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

Management evaluates all loan relationships periodically in order to assess the financial strength of the borrower and the value of any underlying collateral. Based on the results of these evaluations, management will assign internal loan classifications to designate the relative strength of the credit. The internal grades used are Pass, Special Mention, and Substandard. Within the Pass classification, there are sub grades that range from High to Acceptable, all of which indicate that the loan is expected to continue to perform in accordance with its terms. Loans with potential weaknesses that deserve management's close attention are classified as Special Mention. If the potential weakness in a Special Mention loan was to go uncorrected, it could result in deteriorating prospects for continued loan performance at some future date; however, the loan is not currently adversely classified. The Substandard classification is assigned to loans that are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. These loans have a well-defined weakness that jeopardizes the payment of the debt or the liquidation of the collateral securing the debt, and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Loans classified as Special Mention or Substandard are 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, or potential weakness, identified. At December 31, 2016, the Company had \$10,936,000 in loans that were internally classified as Special Mention or Substandard, of which \$3,888,000, or 36%, were either current or less than 30 days past due. At December 31, 2015, the Company had \$8,835,000 in loans that were internally classified as Special Mention or Substandard, of which \$6,357,000, or 72%, were either current or less than 30 days past due.

A summary of loan credit quality is presented below:

(In thousands)	December 31, 2016			
	Pass	Special Mention	Substandard	Total
Commercial and financial	\$ 28,680	\$ 31	\$ 590	\$ 29,301
Agricultural	3	—	—	3
Real estate – construction, commercial	27,157	—	179	27,336
Real estate – construction, residential	18,950	—	—	18,950
Real estate – mortgage, commercial	155,783	2,693	3,853	162,329
Real estate – mortgage, residential	151,295	1,098	2,491	154,884
Real estate – mortgage, farmland	10,593	—	—	10,593
Consumer installment loans	5,345	2	—	5,347
	\$ 397,806	\$ 3,824	\$ 7,113	\$ 408,743

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

(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
	<u>\$ 277,098</u>	<u>\$ 3,063</u>	<u>\$ 5,772</u>	<u>\$ 285,933</u>

Risk Elements in the Loan Portfolio

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

(In thousands)	Loans with Interest Only Payments			
	December 31, 2016		December 31, 2015	
Commercial and financial	\$ 6,798	10%	\$ 3,047	7%
Agricultural	3	—%	18	—%
Real estate – construction, commercial	12,140	18%	7,018	17%
Real estate – construction, residential	13,227	20%	7,461	18%
Real estate – mortgage, commercial	4,562	7%	6,255	15%
Real estate – mortgage, residential	28,517	43%	18,131	43%
Real estate – mortgage, farmland	1,174	2%		
Consumer installment loans	43	—%	33	—%
	<u>\$ 66,464</u>		<u>\$ 41,963</u>	

As shown above, the Company has a moderate concentration of interest only loans in the 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 the portfolio allow negative amortization, nor does the Company have any loans with capitalized interest reserves.

Management also monitors and evaluates 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 December 31, 2016, the Company held approximately \$20,380,000 of loans secured by junior liens, which represents approximately 4.99% of the total gross portfolio of loans. At December 31, 2015, the Company held approximately \$19,243,000 of loans secured by junior liens, which represents approximately 6.7% of the total gross portfolio of loans.

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 December 31, 2016, the loan portfolio included 44 loans with an aggregate balance of approximately \$11,532,000, or 2.8% of the gross loan portfolio, with LTV ratios in excess of 100%. At December 31, 2015, the loan portfolio included 44 loans with an aggregate balance of approximately \$12,972,000, or 4.5% of the gross loan portfolio, with LTV ratios in excess of 100%.

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

Troubled Debt Restructurings

At December 31, 2016 and 2015, impaired loans included loans that were classified as Troubled Debt Restructurings “TDRs”. The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

In assessing whether or not a borrower is experiencing financial difficulties, the Company considers information currently available regarding the financial condition of the borrower. This information includes, but is not limited to, whether (i) the debtor is currently in payment default on any of its debt; (ii) a payment default is probable in the foreseeable future without the modification; (iii) the debtor has declared or is in the process of declaring bankruptcy and (iv) the debtor's projected cash flow is sufficient to satisfy contractual payments due under the original terms of the loan without a modification.

The Company considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by the Company include the debtor's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan. The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt, (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (iii) a temporary period of interest-only payments, and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan. As of December 31, 2016 and 2015, management had \$5,088,670 and \$6,293,440, respectively, in loans considered restructured that are not already on nonaccrual. Of the nonaccrual loans at December 31, 2016 and 2015, \$722,257 and \$792,888, respectively, met the criteria for restructured. A loan is placed back on accrual status when both principal and interest are current and it is probable that management will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

The following tables provide the payment status and impact on the allowance for loan losses as of December 31, 2016 and December 31, 2015 of all loans that were restructured in the twelve month periods ending on those respective dates.

	Troubled-Debt Restructurings		
	Number of loans	Recorded Investment	Impact on the Allowance for Loan Losses
December 31, 2016:			
Restructured loans less than 30 days past due			
Commercial, financial and agricultural	1	\$ 235,940	\$ —
Total restructured loans less than 30 days past due	1	\$ 235,940	\$ —
Restructured loans 30 days or more past due	—	\$ —	\$ —
Total restructured loans 30 days or more past due	—	\$ —	\$ —
Restructured loans on nonaccrual	—	\$ —	\$ —
Total restructured loans on nonaccrual	—	\$ —	\$ —

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

Troubled Debt Restructurings (Continued)

	Troubled-Debt Restructurings		
	Number of loans	Recorded Investment	Impact on the Allowance for Loan Losses
December 31, 2015:			
Restructured loans less than 30 days past due			
Real estate – mortgage	1	\$ 140,079	\$ —
Total restructured loans less than 30 days past due	1	\$ 140,079	\$ —
Restructured loans 30 days or more past due	—	\$ —	\$ —
Total restructured loans 30 days or more past due	—	\$ —	\$ —
Restructured loans on nonaccrual	—	\$ —	\$ —
Total restructured loans on nonaccrual	—	\$ —	\$ —

Loans modified in a troubled-debt restructuring (the “TDR”) are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. The allowance for loan losses may be increased, adjustments may be made in the allocation of the allowance for loan losses, or partial charge-offs may be taken to further write-down the carrying value of the loan. During the years ending December 31, 2016 and December 31, 2015, there were no such defaults of TDR loans. The Company has no commitments to lend additional funds to any of the related debtors whose terms have been modified in a TDR.

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 Company obtains appraisals, 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 Company’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 Years Ended December 31,	
	2016	2015
Balance, beginning of year	\$ 5,254,407	\$ 4,828,899
Provision for loan losses	1,450,061	393,863
Loans charged off	(1,070,811)	(200,760)
Recoveries of loans previously charged off	357,076	232,405
Balance, end of year	\$ 5,990,733	\$ 5,254,407

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

The following tables provide additional information concerning changes to the allowance for loan losses within major loan categories:

For the year ended December 31, 2016						
(In thousands)	Commercial, Financial & Agricultural	Real Estate - Construction	Real Estate - Mortgage	Consumer	Unallocated	Total
Allowance balance, beginning of year	\$ 993	\$ 750	\$ 1,775	\$ 17	\$ 1,719	\$ 5,254
Loans charged off	(96)	(571)	(400)	(3)	—	(1,070)
Recoveries	56	133	164	4	—	357
Provision for loan losses	359	253	880	3	(45)	1,450
Allowance balance, end of period	1,312	565	2,419	21	1,674	5,991
Allowance for loans individually evaluated for impairment	431	340	514	—	—	1,285
Allowance for loans collectively evaluated for impairment	881	225	1,905	21	1,674	4,706
Total allowance for loan losses	1,312	565	2,419	21	—	5,991
Loans individually evaluated for impairment	852	1,650	9,079	135	—	11,716
Loans collectively evaluated for impairment	28,452	44,636	318,727	5,212	—	397,027
Total loans	\$ 29,304	\$ 46,286	\$ 327,806	\$ 5,347	\$ —	\$ 408,743

For the year ended December 31, 2015						
(In thousands)	Commercial, Financial & Agricultural	Real Estate - Construction	Real Estate - Mortgage	Consumer	Unallocated	Total
Allowance balance, beginning of year	\$ 655	\$ 488	\$ 2,913	\$ 46	\$ 727	\$ 4,829
Loans charged off	(71)	(30)	(99)	(1)	—	(201)
Recoveries	53	1	126	52	—	232
Provision for loan losses	356	291	(1,165)	(80)	992	394
Allowance balance, end of period	993	750	1,775	17	1,719	5,254
Allowance for loans individually evaluated for impairment	390	209	518	—	—	1,117
Allowance for loans collectively evaluated for impairment	603	541	1,257	17	1,719	4,137
Total allowance for loan losses	993	750	1,775	17	1,719	5,254
Loans individually evaluated for impairment	511	396	2,565	—	—	3,472
Loans collectively evaluated for impairment	18,284	33,142	229,809	1,226	—	282,461
Total loans	\$ 18,795	\$ 33,538	\$ 232,374	\$ 1,226	\$ —	\$ 285,933

Notes to Consolidated Financial Statements

Note 3. Loans and Allowance for Loan Losses (Continued)

Troubled Debt Restructurings (Continued)

In the ordinary course of business, the Company has granted loans to certain directors, executive officers and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. Changes in related-party loans are summarized as follows:

	For the Years Ended December 31,	
	2016	2015
Balance, beginning of year	\$ 3,426,092	\$ 3,047,472
Advances	556,692	517,270
Repayments	(660,313)	(138,650)
Change in status	1,092,016	—
Balance, end of year	\$ 4,414,487	\$ 3,426,092

Note 4. Premises and Equipment

Premises and equipment are summarized as follows:

	December 31,	
	2016	2015
Land	\$ 5,201,765	\$ 3,631,015
Building	9,502,780	4,712,599
Furniture and equipment	5,096,024	3,622,354
	19,800,569	11,965,968
Less accumulated depreciation	(6,196,403)	(4,791,934)
	\$ 13,604,166	\$ 7,174,034

Depreciation expense totaled approximately \$532,000 for the year ended December 31, 2016 and \$371,000 for the year ended December 31, 2015.

The Company has operating leases for rental space for certain of its retail residential mortgage loan production offices. Each of these leases is cancelable at any time, or transferable upon disassociation with the Company.

The Company has four non-cancelable operating leases for both mortgage and SBA loan production offices as well as a land lease for its full service branch in Marion County, Florida.

Notes to Consolidated Financial Statements

Note 4. Premises and Equipment (Continued)

At December 31, 2016, future minimum lease payments under the non-cancelable operating leases with initial or remaining terms of one year or more are as follows:

2017	\$ 601,251
2018	601,523
2019	444,602
2020	151,672
2021	137,712
Thereafter	1,980,724
	<u>\$ 3,917,484</u>

Total rental expense amounted to approximately \$1,436,000 and \$1,180,000 for the years ended December 31, 2016 and 2015, respectively, under both cancelable and non-cancelable operating leases.

Note 5. Other Real Estate Owned

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

	Years Ended December 31,	
	2016	2015
Balance, beginning of year	<u>\$ 6,115,715</u>	<u>\$ 7,322,404</u>
Additions	985,332	871,142
Disposals	(1,492,673)	(1,486,374)
Net gain (loss) on sales of real estate	(2,582)	15,877
Valuation write-downs	(544,131)	(607,334)
Balance, end of year	<u>\$ 5,061,661</u>	<u>\$ 6,115,715</u>

Expenses related to other real estate owned include the following:

	Years Ended December 31,	
	2016	2015
Net (gain) loss on sales of real estate	<u>\$ 2,582</u>	<u>\$ (15,877)</u>
Valuation write-downs	544,131	607,334
Operating expenses	69,963	149,854
Total expenses related to other real estate owned	<u>\$ 616,676</u>	<u>\$ 741,311</u>

Residential real estate properties included in other real estate owned totaled approximately \$210,000 and \$595,000 at December 31, 2016 and 2015, respectively. There were no residential real estate properties in process of foreclosure at December 31, 2016 or 2015.

The Company'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 non-performing assets with the objective to maximize recovery levels from liquidation of these assets.

Notes to Consolidated Financial Statements

Note 6. SBA Loan Servicing Rights

Following is a summary of information related to SBA loan servicing rights:

	December 31,	
	2016	2015
<i>Loan servicing rights</i>		
Balance at beginning of period	\$ 1,544,682	\$ 1,658,706
Additions	303,146	219,695
Amortization	(444,397)	(333,719)
Net carrying amount	<u>\$ 1,403,431</u>	<u>\$ 1,544,682</u>

Loan Servicing Rights (LSR) are initially booked at an estimated original fair value during the current quarter. At quarter end, the estimated original fair value is determined by an independent evaluation at loan level detail, less accumulated amortization with any resulting adjustment to SBA loan income. Amortization is recorded over the expected life of the loan as a component of SBA loan income. Under the amortization method, loan servicing rights are amortized in proportion to, and over the period of, estimated servicing income. In the event a loan pays off prior to the expected life, the full remaining balance of the related LSR is charged off. 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 December 31, 2016, the carrying value of the SBA LSRs was approximately \$1,403,000 and the fair value of the SBA LSRs was \$1,951,000. For the period ended December 31, 2015, the carrying value of the SBA LSRs was approximately \$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 approximately \$89,210,000 at December 31, 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 through 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.

Notes to Consolidated Financial Statements

Note 7. Intangible Assets

Intangible Assets

During 2016, the Company acquired the assets and assumed the liabilities of First Avenue National Bank, Ocala, Florida in a business combination. The following is a summary of information related to the intangible assets acquired:

	As of December 31, 2016	
	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:		
Core deposit intangible	\$ 1,071,678	\$ 257,962

The aggregate amortization expense was \$257,962 for the year ended December 31, 2016. There was no core deposit intangible recorded as of December 31, 2015.

The estimated amortization expense for each of the next five years is as follows:

2017	\$ 290,192
2018	220,451
2019	159,832
2020	100,566
2021	42,675
	\$ 813,716

Notes to Consolidated Financial Statements

Note 8. Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2016 and 2015 was approximately \$33,895,000 and \$12,271,000, respectively. The Company held approximately \$50,576,000 and \$47,430,000 in brokered deposits included in time deposits as of December 31, 2016 and 2015, respectively.

The scheduled maturities of time deposits at December 31, 2016 are as follows:

2017	\$ 103,755,754
2018	14,264,764
2019	6,235,171
2020	6,877,007
2021	18,850,680
	<u>\$ 149,983,376</u>

At December 31, 2016 and 2015, overdraft demand deposits reclassified to loans totaled \$13,451 and \$30,274, respectively.

Note 9. Employee Benefit Plans

The Company sponsors the Coastal Banking Company, Inc. 401(k) Profit Sharing Plan & Trust (the "Plan") for the benefit of all eligible employees. All full-time and part-time employees are eligible to participate in the Plan provided they have met the eligibility requirements. Contributions may begin after 30 days of employment. Part-time employees must work a minimum of 1,000 hours per year to be eligible. The Plan allows a participant to defer a portion of his or her compensation and provides that the Company will match a portion of the deferred compensation. Company matched contributions are vested over a five year period. The Company contributes to the Plan annually. Contributions made to the Plan in 2016 and 2015 totaled \$781,926 and \$611,860, respectively.

On February 27, 2013 the Board of Directors approved the adoption of the Coastal Banking Company Employee Stock Purchase Plan (the "Stock Purchase Plan") effective April 1, 2013, and set aside 250,000 shares of common stock for issuance under the Stock Purchase Plan. The Stock Purchase 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 Stock Purchase Plan were 34,285 shares for the year ended December 31, 2016 and 30,053 shares for the year ended December 31, 2015. The 5% discount to fair market value is considered compensation cost to the Company and it totaled \$21,597 for the year ended December 31, 2016, and \$15,233 for the year ended December 31, 2015. At December 31, 2016, there were 156,966 shares left available for issuance under this Plan.

Note 10. Deferred Compensation Plans

The Company adopted a deferred compensation arrangement in 2004 that provides a defined benefit payable to executive officers upon retirement or reaching a specific age. This benefit is held in trust and, therefore, the Company does not carry a liability related to the plan. The Company made annual contributions to the plan of approximately \$61,800 and \$58,000 in 2016 and 2015, respectively.

Notes to Consolidated Financial Statements

Note 11. Other Borrowings

Other borrowings consist of the following FHLB advances.

Type advance	Balance	FHLB Advances Outstanding December 31, 2016	
		Interest rate	Maturity date
Fixed rate	\$ 10,000,000	0.49%	January 5, 2017
Fixed rate	20,000,000	0.63%	January 27, 2017
Fixed rate	2,500,000	0.94%	July 28, 2017
Fixed rate	2,000,000	0.92%	August 9, 2017
Fixed rate	2,000,000	0.98%	September 7, 2017
Fixed rate	2,500,000	1.32%	July 30, 2018
Fixed rate hybrid	3,000,000	1.42%	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	16,050,000	0.80%	December 14, 2017
	<u>\$ 63,050,000</u>	<u>0.84%</u>	

Type advance	Balance	FHLB Advances Outstanding December 31, 2015		
		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 hybrid	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	<u>\$ 120,500,000</u>	<u>0.76%</u>		

The Company maintains relationships with correspondent banks that can provide funds on short notice, if needed. Presently, the Company has arrangements with six commercial banks for short term unsecured advances of overnight borrowings of up to \$44,000,000, in addition to up to \$13,265,000 available from day light overdraft program. The Company also has reverse repurchase accommodations with a term of up to one month for a maximum advance of \$25,000,000 limited by the amount of eligible securities pledged, which was approximately \$2,641,000 at December 31, 2016. The reverse repurchase agreements are committed borrowing facilities granted by other commercial banks and are secured by securities in the Company's investment portfolio.

At December 31, 2016, the Company has pledged approximately \$152,811,000 of its portfolio loans and loans available for sale to the FHLB and can borrow up to \$89,761,000 on such collateral. The Company has also pledged \$69,958,000 of its portfolio loans to the Federal Reserve Bank of Atlanta at December 31, 2016 and can borrow up to \$33,983,000 on such collateral at the Discount Window. At December 31, 2015, the Company has pledged approximately \$163,326,000 of its portfolio loans and loans available for sale to the FHLB and can borrow up to \$131,563,000 on such collateral. The Company has also pledged \$49,090,000 of its portfolio loans to the Federal Reserve Bank of Atlanta at December 31, 2015 and can borrow up to \$26,580,000 on such collateral at the Discount Window.

Notes to Consolidated Financial Statements

Note 12. Income Taxes

The components of income tax expense is as follows:

	For the Years Ended December 31,	
	2016	2015
Currently payable	\$ 4,043,010	\$ 4,362,084
Deferred tax benefit	(12,433)	(598,456)
Income tax expense	\$ 4,030,577	\$ 3,763,628

The Company's income tax expense differs from the amounts computed by applying the federal income tax statutory rates to income before income taxes. A reconciliation of the differences is as follows:

	For the Years Ended December 31,	
	2016	2015
Tax at federal income tax rate	\$ 3,735,363	\$ 3,263,609
Increase (decrease) resulting from:		
Tax exempt interest	(39,275)	(38,682)
Other	334,489	538,701
Income tax expense	\$ 4,030,577	\$ 3,763,628

Net deferred tax assets are included in other assets. The components of deferred income taxes are as follows:

	December 31,	
	2016	2015
Deferred income tax assets:		
Loan loss reserves	\$ 835,185	643,490
Depreciation and amortization	959,249	—
Other real estate owned	413,942	494,280
Indemnification reserve	676,028	666,947
Net operating loss carryforward	1,109,936	—
Other	(58,834)	300,779
Total deferred tax assets	3,935,506	2,105,496
Deferred income tax liabilities:		
Deferred loan costs	209,876	593,909
Depreciation and amortization	—	151,481
Intangible assets	276,663	7,836
Unrealized gain on securities available for sale	127,044	151,053
Total deferred tax liabilities	613,583	904,279
Net deferred tax asset	\$ 3,321,923	\$ 1,201,217

At December 31, 2016, the Company had federal and state net operating loss carryforwards of approximately \$3,475,000 which expire at various dates from 2028 to 2035. The federal net operating loss carryforwards are subject to limitations pursuant to Internal Revenue Code Section 382 and are expected to be recovered over the next 11 years. The state net operating loss carryforwards are subject to similar limitations and are expected to be recovered over the next 11 years. Deferred tax assets are recognized for net operating losses because the benefit is more likely than not to be realized.

The federal income tax returns of the Company for 2015, 2014, and 2013 are subject to examination by the IRS, generally for three years after they were filed.

Notes to Consolidated Financial Statements

Note 13. Senior Note Payable

	For the years ended December 31,	
	2016	2015
Note payable to NexBank SSB with variable interest rate at 3-month LIBOR plus 4% subject to a 5% floor, with principal and interest due monthly through maturity at November 2020. Interest rate at December 31, 2016 was 5.00%	\$ 8,916,667	\$ 9,916,667
	<u>\$ 8,916,667</u>	<u>\$ 9,916,667</u>

As of December 31, 2016, the Company and its subsidiary were in compliance with the covenants in this agreement.

The senior note payable is secured by 100% of the common stock of CBC National Bank.

The contractual maturities of the senior note payable are as follows:

2017	\$ 1,000,000
2018	1,000,000
2019	1,000,000
2020	1,000,000
2021	1,000,000
Thereafter	3,916,667
	<u>\$ 8,916,667</u>

Note 14. Junior Subordinated Debentures

In May 2004, Coastal Banking Company Statutory Trust I (the "Trust I") (a non-consolidated subsidiary) issued \$3,000,000 of floating rate trust preferred securities with a maturity of July 23, 2034. The Company received from the Trust I the \$3,000,000 proceeds from the issuance of securities and the \$93,000 initial proceeds from the capital investment in the Trust I, and accordingly has shown the funds due to the Trust I as \$3,093,000 junior subordinated debentures.

All of the common securities of the Trust I are owned by the Company. The proceeds from the issuance of the trust preferred securities were used by the Trust I to purchase \$3,093,000 of junior subordinated debentures of the Company, which carry a floating rate equal to the 3-month LIBOR plus 2.75%. At December 31, 2016, this rate was 3.63%. The proceeds received by the Company from the sale of the junior subordinated debentures were used 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 assets of the Trust I.

The trust preferred securities accrue and pay distributions quarterly, equal to 3-month LIBOR plus 2.75% per annum of the stated liquidation value of \$1,000 per capital security. 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 the 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 indenture, if the debentures are redeemed prior to maturity, the redemption price will be the unpaid principal amount, plus any accrued unpaid interest.

Notes to Consolidated Financial Statements

Note 14. Junior Subordinated Debentures (Continued)

In June 2006, Coastal Banking Company Statutory Trust II (the “Trust II”) (a non-consolidated subsidiary) issued \$4,000,000 of fixed to floating rate trust preferred securities with a maturity of September 30, 2036. The Company received from the Trust II the \$4,000,000 proceeds from the issuance of securities and the \$124,000 initial proceeds from the capital investment in the Trust II, and accordingly has shown the funds due to the Trust II as \$4,124,000 junior subordinated debentures.

All of the common securities of the Trust II are owned by the Company. The proceeds from the issuance of the trust preferred securities were used by the Trust II to purchase \$4,124,000 of junior subordinated debentures of the Company, which carried a fixed rate of 7.18% until September 30, 2011 and a floating rate equal to the 3-month LIBOR plus 1.60%, adjusted quarterly thereafter. At December 31, 2016, this rate was 2.60%. The proceeds received by the Company from the sale of the junior subordinated debentures were used 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 assets of the Trust II.

The trust preferred securities accrue and pay distributions quarterly, equal to 3-month LIBOR plus 1.60% per annum of the stated liquidation value of \$1,000 per capital security. 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 the 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 indenture, if the debentures are redeemed prior to maturity, the redemption price will be the unpaid principal amount, plus any accrued unpaid interest.

Note 15. Stock Based Compensation

The Company’s 2016 Incentive Stock Option Plan (“2016 Plan”) reserved 200,000 shares of common stock for the granting of options to officers and employees. Option prices reflect the fair market value of the Company’s common stock on the dates the options are granted. The options may be exercised over a period of ten years in accordance with vesting schedules determined by the Board of Directors. There were 55,000 shares still available for grant under the 2016 Plan at December 31, 2016. The Company also has a 2000 Incentive Stock Option Plan that no longer has any shares available for grant but does have some options still outstanding.

The Company acquired First Avenue National Bank (“First Avenue”) during the year ended 2016. The Company converted 283,958 outstanding First Avenue options at the conversion ratio of 0.4848 into 137,652 Company options related to officers and directors of First Avenue. First Avenue’s plan was terminated after conversion and therefore no additional options are available for grant under the First Avenue plan at December 31, 2016.

Notes to Consolidated Financial Statements

Note 15. Stock Based Compensation (Continued)

The fair value of each stock option award is estimated on the date of grant using a Black-Scholes-Merton valuation model that uses the weighted-average assumptions noted in the following table. Expected volatilities are based on Company specific data. The Company considers historical data and peer group data to estimate option exercises and employee terminations within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is based on the short-cut method and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the average of the U.S. Treasury yield curve in effect at the time of grant.

The fair value of options granted was determined using the following weighted-average assumptions as of grant date.

	2016
Expected volatility	41.28%
Expected dividends	0.00%
Expected term (in years)	7.00
Risk-free rate	1.30%

A summary of option activity under the Plan and changes during the years then ended is presented below:

	December 31, 2016			December 31, 2015		
		Weighted-Average Exercise Price	Aggregate Intrinsic Value		Weighted-Average Exercise Price	Aggregate Intrinsic Value
	Shares			Shares		
Outstanding at beginning of year	140,214	\$ 6.70	\$ 825,220	161,964	\$ 6.65	\$ 424,269
Granted	282,652	12.70	—	—	—	—
Forfeited	(16,834)	9.20	—	(21,550)	5.86	—
Exercised	(43,381)	8.99	—	(200)	3.40	—
Expired	(20,762)	18.30	—	—	—	—
Outstanding at end of year	<u>341,889</u>	<u>\$ 10.54</u>	<u>\$ 1,063,224</u>	<u>140,214</u>	<u>\$ 6.70</u>	<u>\$ 825,220</u>
Exercisable at end of year	<u>176,789</u>	<u>\$ 8.95</u>	<u>\$ 875,094</u>	<u>104,014</u>	<u>\$ 6.46</u>	<u>\$ 657,820</u>

Additional information related to stock options as of December 31:

	2016
Weighted-average fair value of options granted	\$ 5.70
Intrinsic value of options exercised	\$ 228,000

Notes to Consolidated Financial Statements

Note 15. Stock Based Compensation (Continued)

At December 31, 2016, there was \$786,711 in unrecognized compensation cost related to share-based compensation arrangements to be recognized over the next 4.50 years.

Options Outstanding			Options Exercisable		
Number Outstanding	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Number Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years
500	5.15	\$ 3.00	400	\$ 3.00	5.15
49,220	3.40	3.40	49,220	3.40	3.40
50,000	6.16	7.40	30,000	7.40	6.16
85,550	7.25	11.35	85,550	11.35	7.25
132,500	9.50	12.90	—	—	—
12,500	9.50	13.15	—	—	—
11,619	0.49	19.05	11,619	19.05	0.49
341,889	7.26		176,789		5.55

NOTE 16. Commitments and Contingent Liabilities

Loan Commitments

We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments consist of commitments to extend credit, standby letters of credit and loans sold with representations and warranties. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are written conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. Our exposure to credit loss in the event of non-performance by the other party to the instrument is represented by the contractual notional amount of the instrument.

Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. We use the same credit policies in making commitments to extend credit as we do for on-balance sheet instruments. Collateral held for commitments to extend credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

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 in which the borrower fails to make any one of the first four loan payments within 30 days of the due date as an Early Payment Default (“EPD”). 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.

Notes to Consolidated Financial Statements

NOTE 16. Commitments and Contingent Liabilities (Continued)

Loan Commitments (Continued)

From the September 2007 inception of the mortgage banking division through December 31, 2016, we have sold over 50,000 residential mortgage loans into the secondary market with a principal balance of just over \$11.4 billion. From this population of sold loans, the Company has received notification from purchasers of a total of forty-four EPD claims or an average of one EPD claim per 1,141 loans sold. Below are the EPD claims experience by year of sale-vintage:

<u>Year of Sale</u>	<u># Loans Sold</u>	<u>Loans Sold</u>	<u>EPDs</u>	<u>Claims Rate</u>
2016	8,709	\$ 2,068,990,937	5	0.06%
2015	7,741	1,904,602,055	3	0.04%
2014	4,892	1,151,537,418	2	0.04%
2013	5,607	1,301,421,133	3	0.05%
2012 and prior	23,293	5,049,034,014	31	0.13%
Total	50,242	\$ 11,475,585,557	44	0.09%

Beyond the initial payment to the purchasers of approximately \$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 44 single family residences. Original loan-to-value ratios ranged from 65% to 100%, 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 Company's balance sheet. Because the risk of an EPD claim only exists during the first four payments after a loan is originated, the Company reports the total of the most recent four months mortgage banking lending volume as off-balance sheet credit risk from EPD claims. As of December 31, 2016, the total off-balance sheet credit risk from EPD claims was approximately \$710,063,000.

As discussed above, the representations and warranties in loan sale agreements require that the Company 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 nine years of operations the Company has been required to settle nineteen make whole claims or on average one claim per 2,644 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. During the period from 2009 through 2012 the industry experienced a high level of loan "put backs" to lenders on the basis of representation and warranty breaches. It is noteworthy that the Company'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.

Notes to Consolidated Financial Statements

NOTE 16. Commitments and Contingent Liabilities (Continued)

Loan Commitments (Continued)

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 lower 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. In light of the slightly elevated risk and claims from loans sourced through the national retail group channel (NRG), management made the decision to make monthly additions to the reserve beginning in January 2015 based on a percentage of NRG sourced loans that were sold. The total additions to the reserve for NRG loans sold during 2016 and 2015 was \$27,000 and \$54,000, respectively. As a result, the balance of the indemnification reserve at December 31, 2016 was \$1,988,318 and based on the Company'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 Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit, standby letters of credit and loans sold with representations and warranties is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. In most cases, the Company requires collateral to support financial instruments with credit risk.

The following table summarizes our off-balance-sheet financial instruments whose contract amounts represent credit risk as of December 31, 2016 and 2015:

	December 31,	
	2016	2015
Commitments to extend credit	\$ 50,196,000	\$ 44,027,000
Standby letters of credit	\$ 538,000	\$ 278,000
Loans sold with representations and warranties	\$ 710,063,000	\$ 509,068,000

Contingencies

The Company has, from time to time, various lawsuits and claims arising from the conduct of its business. Such items are not expected to have any material adverse effect on the financial position or results of operations of the Company.

Notes to Consolidated Financial Statements

Note 17. Concentrations of Credit

The Company makes commercial, residential, construction, agricultural, agribusiness and consumer loans to customers in South Carolina, Florida, and Georgia. The ability of the Company's customers to honor the terms of their loan contracts is dependent on the business economy in the geographical area served by the Company.

Ninety-two percent of the Company's loans are secured by real estate in the Company's primary market area. Accordingly, the ultimate collectability of a majority of the Company's loan portfolio is susceptible to changes in real estate conditions in the Company's primary market area.

Note 18. Shareholders' Equity and Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Federal and state banking agencies have adopted regulations that substantially amend the capital regulations currently applicable. The regulations implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

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 limits 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.

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 requirements for total capital, Tier 2 capital is not limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights and intangible assets, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of common equity Tier 1 capital are 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 reduces the impact of market volatility on our regulatory capital levels.

In addition to the minimum common equity Tier 1, Tier 1 and total capital ratios, the Bank has 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. The capital conservation buffer requirement was phased in beginning in January 2016 at 0.635% of risk-weighted assets and increases each year until fully implemented in January 2019.

Notes to Consolidated Financial Statements

Note 18. Shareholders' Equity and Regulatory Matters (Continued)

The FDIC's prompt corrective action standards also changed effective January 1, 2015. Under the 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 requirements, including the full capital conservation buffer.

As of December 31, 2016, the Bank was well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2016, that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios as of December 31, 2016 and 2015, are presented in the following table:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2016:						
Total Capital to Risk Weighted Assets						
CBC National Bank	\$ 68,775,000	22.13%	\$ 24,857,000	8.00%	\$ 31,071,000	10.00%
Tier I Capital to Risk Weighted Assets						
CBC National Bank	\$ 64,834,000	20.87%	\$ 18,643,000	6.00%	\$ 24,857,000	8.00%
Common Equity Tier 1 Capital to Risk Weighted Assets						
CBC National Bank	\$ 64,834,000	20.87%	\$ 13,982,000	4.50%	\$ 20,196,000	6.50%
Tier I Capital to Average Assets						
CBC National Bank	\$ 64,834,000	11.34%	\$ 22,873,000	4.00%	\$ 28,591,000	5.00%
As of December 31, 2015:						
Total Capital to Risk Weighted Assets						
CBC National Bank	\$ 52,300,000	23.24%	\$ 18,005,000	8.00%	\$ 22,506,000	10.00%
Tier I Capital to Risk Weighted Assets						
CBC National Bank	\$ 49,432,000	21.96%	\$ 13,503,000	6.00%	\$ 18,005,000	8.00%
Common Equity Tier 1 Capital to Risk Weighted Assets						
CBC National Bank	\$ 49,432,000	21.96%	\$ 10,128,000	4.50%	\$ 14,629,000	6.50%
Tier I Capital to Average Assets						
CBC National Bank	\$ 49,432,000	11.75%	\$ 16,829,000	4.00%	\$ 21,036,000	5.00%

Notes to Consolidated Financial Statements

Note 18. Shareholders' Equity and Regulatory Matters (Continued)

On December 5, 2008, Coastal issued and sold 9,950 preferred shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "TARP preferred stock") to the United States Department of the Treasury (the "Treasury") as part of the Capital Purchase Program ("CPP"). The Treasury was also granted a Warrant to purchase 205,579 shares of the Company's common stock at \$7.26 per share. On April 10, 2013, the Company repurchased and cancelled 60,000 of these common stock warrants at a price of \$1.65 per share. On June 12, 2013, the Company repurchased and cancelled the remaining 145,579 common stock warrants at a price of \$1.55 per share. The TARP preferred stock was sold by the Treasury through an action to private investors on March 11, 2013 at which point the Company was no longer subject to TARP related operating restrictions.

The preferred stock as originally issued carried an annual 5% cumulative dividend rate which resulted in a quarterly dividend payment of \$12.50 per share, payable on February 15, May 15, August 15 and November 15. On February 16, 2014, the annual dividend rate increased to 9% payable quarterly on the same dates, increasing the quarterly dividend payments to \$22.50 per share. 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 (see Note 13).

Note 19. Fair Value

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic (FASB ASC 820), the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between willing market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between willing market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds and exchange traded equities. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset-backed and other securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis (Continued)

The table below presents the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2016, aggregated by the level in the fair value hierarchy within which those measurements fall.

	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
State and municipal securities	\$ 4,634,100	\$ —	\$ 4,634,100	\$ —
Corporate debt obligations	970,830	—	970,830	—
Mortgage-backed securities – residential	14,062,839	—	14,062,839	—
Loans held for sale	92,009,241	—	92,009,241	—
Derivative asset positions	1,229,133	—	1,229,133	—
Total fair value of assets measured on a recurring basis	\$ 112,906,143	\$ —	\$ 112,906,143	\$ —
Liabilities:				
Derivative liability positions	\$ (1,138,705)	\$ —	\$ (1,138,705)	\$ —
Total fair value of liabilities measured on a recurring basis	\$ (1,137,705)	\$ —	\$ (1,137,705)	\$ —

The table below presents the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2015, aggregated by the level in the fair value hierarchy within which those measurements fall.

	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
State and municipal securities	\$ 3,454,013	\$ —	\$ 3,454,013	\$ —
Mortgage-backed securities – residential	17,070,655	—	17,070,655	—
Loans held for sale	128,181,662	—	128,181,662	—
Derivative asset positions	259,854	—	259,854	—
Total fair value of assets measured on a recurring basis	\$ 148,966,184	\$ —	\$ 148,966,184	\$ —
Liabilities:				
Derivative liability positions	\$ 285,294	\$ —	\$ 285,294	\$ —
Total fair value of liabilities measured on a recurring basis	\$ 285,294	\$ —	\$ 285,294	\$ —

The Company had no Level 3 assets measured at fair value on a recurring basis at December 31, 2016 and 2015.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Impaired Loans

Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less estimated selling costs if the loan is collateral dependent.

The fair value of impaired loans were primarily measured based on the value of the collateral securing these loans. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for estimated costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Other Real Estate Owned

Other real estate owned, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at fair value less estimated costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less estimated costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, a loss is recognized in noninterest expense.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis (Continued)

The table below presents the Company's assets for which a nonrecurring change in fair value has been recorded during the year ended December 31, 2016, aggregated by the level in the fair value hierarchy within which those measurements fall.

	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total losses for the Year Ended December 31, 2016
Assets:					
Impaired loans	\$ 3,958,388	\$ —	\$ —	\$ 3,958,388	\$ (1,045,419)
Other real estate owned	2,256,430	—	—	2,256,430	(457,140)
Total fair value of assets measured on a nonrecurring basis	\$ 6,214,818	\$ —	\$ —	\$ 6,214,818	\$ (1,502,599)

The table below presents the Company's assets for which a nonrecurring change in fair value has been recorded during the year ended December 31, 2015, aggregated by the level in the fair value hierarchy within which those measurements fall.

	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total losses for the Year Ended December 31, 2015
Assets:					
Impaired loans	\$ 411,970	\$ —	\$ —	\$ 411,970	\$ (811,407)
Other real estate owned	3,751,266	—	—	3,751,266	(607,334)
Total fair value of assets measured on a nonrecurring basis	\$ 4,163,236	\$ —	\$ —	\$ 4,163,236	\$ (1,418,741)

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis (Continued)

For Level 3 assets measured at fair value on a nonrecurring basis as of December 31, 2016 and 2015, the significant unobservable inputs used in the fair value measurements are presented below.

	Carrying Amount	Valuation Technique	Significant Unobservable Input
December 31, 2016:			
Nonrecurring:			
Impaired loans	\$ 3,958,388	Appraisal	Appraisal discounts (5-15%)
Other real estate owned	\$ 2,256,430	Appraisal	Appraisal discounts (5-15%)
	Carrying Amount	Valuation Technique	Significant Unobservable Input
December 31, 2015:			
Nonrecurring:			
Impaired loans	\$ 411,970	Appraisal	Appraisal discounts (5-15%)
Other real estate owned	\$ 3,751,266	Appraisal	Appraisal discounts (5-15%)

Fair Value of Financial Instruments

The fair value of a financial instrument is the current amount that would be exchanged between willing parties in an orderly transaction. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered as representative of the liquidation value of the Company, but rather represent a good-faith estimate of the increase or decrease in value of financial instruments held by the Company since purchase, origination, or issuance.

The following methods and assumptions were used in this analysis in estimating the fair value of financial instruments:

- **Cash, due from banks, interest-bearing deposits in banks and federal funds sold:** The carrying amount of cash, due from banks, interest-bearing deposits in banks and federal funds sold approximates fair value.
- **Securities:** The fair values of securities available for sale are determined by an independent securities accounting service provider using quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. The carrying amount of restricted equity securities with no readily determinable fair value approximates fair value.
- **Loans:** The carrying amount of variable-rate loans that reprice frequently and have no significant change in credit risk approximates fair value. The fair value of fixed-rate loans is estimated based on discounted contractual cash flows, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The fair value of impaired loans is estimated based on discounted contractual cash flows or underlying collateral values, where applicable.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Fair Value of Financial Instruments (Continued)

- **Loans Held for Sale:** Residential mortgage loans are originated for sale as whole loans in the secondary market. These loans are carried at fair value, with changes in the fair value of these loans recognized in mortgage banking noninterest income. Direct loan origination costs and fees are deferred at origination, and then recognized in the gain or loss on loan sales when the loans are sold. Gains and losses on loan sales (sales proceeds minus the carrying value of the loan sold) are recorded as noninterest income.
- **SBA Loan Servicing Rights:** Fair value is based upon market prices for comparable loan servicing contracts, when available, or alternatively, is based upon an independent valuation model that calculates the present value of the estimated future net servicing income.
- **Derivative Asset and Liability Positions:** The fair value of derivative asset and liability positions is based on available quoted market prices.
- **Deposits:** The carrying amount of demand deposits, savings deposits and variable-rate certificates of deposits approximates fair value. The fair value of fixed-rate certificates of deposit is estimated based on discounted contractual cash flows using interest rates currently being offered for certificates of similar maturities.
- **FHLB, Other Borrowings and Senior Note Payable:** The carrying amount of variable rate borrowings and federal funds purchased approximates fair value. The fair value of fixed rate borrowings is estimated based on discounted contractual cash flows using the current incremental borrowing rates for similar type borrowing arrangements.
- **Junior Subordinated Debentures:** The fair value of the Company's trust preferred securities is based on discounted contractual cash flows using the current incremental borrowing rates for similar type borrowing arrangements.
- **Accrued Interest:** The carrying amount of accrued interest approximates fair value.
- **Off-Balance-Sheet Instruments:** The carrying amount of commitments to extend credit and standby letters of credit approximates fair value. The carrying amount of the off-balance-sheet financial instruments is based on fees charged to enter into such agreements.

Notes to Consolidated Financial Statements

Note 19. Fair Value (Continued)

Fair Value of Financial Instruments (Continued)

The carrying amount and estimated fair value of the Company's financial instruments are as follows:

	December 31,			
	2016		2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash, due from banks, and interest-bearing deposits in banks	\$ 7,956,004	\$ 7,956,004	\$ 4,830,568	\$ 4,830,568
Federal funds sold	387,123	387,123	82,642	82,642
Securities available for sale	19,667,769	19,667,769	20,524,668	20,524,668
Restricted equity securities	4,992,287	4,992,287	6,781,900	6,781,900
Loans held for sale	92,009,241	92,009,241	128,181,623	128,181,623
Loans, net	402,752,592	390,401,123	280,678,142	272,417,309
SBA loan servicing rights	1,403,431	1,951,087	1,544,682	1,937,924
Derivative asset positions	1,229,133	1,229,133	259,854	259,854
Accrued interest receivable	1,242,702	1,242,702	816,324	816,324
Financial liabilities:				
Deposits	417,316,917	419,396,335	283,839,384	284,676,608
Other borrowings	63,050,000	63,239,442	120,500,000	121,364,104
Senior note payable	8,916,667	8,916,667	9,916,667	9,916,667
Junior subordinated debentures	7,217,000	7,217,000	7,217,000	7,217,000
Derivative liability positions	1,138,705	1,138,705	285,294	285,294
Accrued interest payable	198,019	198,019	196,863	196,863

Note 20. Derivative Financial Instruments

Mortgage banking derivatives used in the ordinary course of business consist of best efforts and mandatory forward sales contracts and interest rate lock commitments on residential mortgage loan applications. Forward sales contracts represent future commitments to deliver loans at a specified price and by a specified date and are used to manage interest rate risk on loan commitments and mortgage loans held for sale. Rate lock commitments represent commitments to fund loans at a specific rate and by a specified expiration date. These derivatives involve underlying items, such as interest rates, and are designed to mitigate risk. Substantially all of these instruments expire within 60 days from the date of issuance. Notional amounts are amounts on which calculations and payments are based, but which do not represent credit exposure, as credit exposure is limited to the amounts required to be received or paid.

Notes to Consolidated Financial Statements

Note 20. Derivative Financial Instruments (Continued)

The following tables include the notional amounts and realized gain (loss) for mortgage banking derivatives recognized in mortgage banking income for the periods ending December 31, 2016 and December 31, 2015:

Derivatives not designated as hedging instruments (in thousands)	December 31, 2016	December 31, 2015
Mandatory forward sales contracts		
Notional amount	\$ 147,347	\$ 133,211
Gain (loss) on change in market value of mandatory forward sales contracts	\$ 417	\$ (61)
Derivative asset balance included in other assets	\$ 833	\$ 130
Derivative liability balance included in other liabilities	\$ 416	\$ 191
Best efforts forward sales contracts		
Notional amount	\$ 2,202	\$ 2,889
Gain on change in market value of best efforts forward sales contracts	\$ 15	\$ 2
Derivative asset balance included in other assets	\$ 16	\$ —
Derivative liability balance included in other liabilities	\$ 1	\$ 2
Rate lock loan commitments		
Notional amount	\$ 160,320	\$ 103,783
Gain (loss) on change in market value of rate lock commitments	\$ (341)	\$ 33
Derivative asset balance included in other assets	\$ 380	\$ 126
Derivative liability balance included in other liabilities	\$ 721	\$ 93

Forward sales contracts also contain an element of risk in that the counterparties may be unable to meet the terms of such agreements. In the event the parties to deliver commitments are unable to fulfill their obligations, the Company could potentially incur significant additional costs by replacing the positions at then current market rates. The Company manages its risk of exposure by limiting counterparties to those banks and institutions deemed appropriate by management and the Board of Directors. The Company does not expect any counterparty to default on their obligations and therefore, the Company does not expect to incur any cost related to counter-party default.

The Company is exposed to interest rate risk on loans held for sale and rate lock loan commitments. As market interest rates increase or decrease, the fair value of mortgage loans held for sale and rate lock commitments will decrease or increase accordingly. To offset this interest rate risk, the Company enters into derivatives such as forward contracts to sell loans. The fair value of these forward sales contracts will change as market interest rates change, and the change in the value of these instruments is expected to largely, though not entirely, offset the change in fair value of loans held for sale and rate lock commitments. The objective of this activity is to minimize the exposure to losses on rate lock commitments and loans held for sale due to market interest rate fluctuations. The net effect of derivatives on earnings will depend on risk management activities and a variety of other factors, including market interest rate volatility, the amount of rate lock commitments that close, the ability to fill the forward contracts before expiration, and the time period required to close and sell loans.

Notes to Consolidated Financial Statements

Note 21. Condensed Financial Information of Coastal Banking Company (Parent Company Only)

Condensed Balance Sheets

	December 31,	
	2016	2015
Assets		
Cash and due from banks	\$ 688,213	\$ 301,219
Investment in Coastal Banking Company Statutory Trust I & II	217,000	217,000
Investment in subsidiary bank	66,323,526	49,725,524
Other assets	1,159,513	600,958
Total assets	<u>\$ 68,388,252</u>	<u>\$ 50,844,701</u>
Liabilities		
Senior note payable	\$ 8,916,667	\$ 9,916,667
Junior subordinated debentures	7,217,000	7,217,000
Other liabilities	539,293	452,134
Total liabilities	<u>16,672,960</u>	<u>17,585,801</u>
Shareholders' Equity		
Shareholder common equity	51,715,292	33,258,900
Shareholders' equity	<u>51,715,292</u>	<u>33,258,900</u>
Total liabilities and shareholders' equity	<u>\$ 68,388,252</u>	<u>\$ 50,844,701</u>

Condensed Statements of Income

	For the Years Ended December 31,	
	2016	2015
Income		
Interest income	\$ 6,057	\$ 5,236
Dividend income from subsidiary	2,000,000	1,300,000
Total income	<u>2,006,057</u>	<u>1,305,236</u>
Expenses		
Interest expense	681,997	255,623
Other operating expenses	847,910	672,037
Total expenses	<u>1,529,907</u>	<u>927,660</u>
Income before income tax benefits and equity in undistributed earnings of subsidiary	476,150	377,576
Income tax benefits	<u>(601,945)</u>	<u>(312,736)</u>
Income before equity in undistributed earnings of subsidiary	1,078,095	690,312
Equity in undistributed earnings of subsidiary	<u>5,877,691</u>	<u>5,144,909</u>
Net income	<u>\$ 6,955,786</u>	<u>\$ 5,835,221</u>

Notes to Consolidated Financial Statements

Note 21. Condensed Financial Information of Coastal Banking Company (Parent Company Only) (Continued)

Condensed Statements of Cash Flows

	For the Years Ended December 31,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 6,955,786	\$ 5,835,221
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed income of Subsidiary	(5,877,691)	(5,144,909)
Stock-based compensation expense	124,685	51,134
Change in other assets and liabilities	(471,373)	(10,543)
Net cash provided by operating activities	<u>731,407</u>	<u>730,903</u>
Cash flows from financing activities:		
Net change in senior note payable	(1,000,000)	9,916,667
Redemption of preferred stock	—	(9,950,000)
Proceeds from employee stock purchase plan	416,483	312,477
Proceeds from exercise of stock options	390,189	680
Common stock issuance costs	(151,085)	—
Dividends paid on preferred stock	—	(783,563)
Net cash used in financing activities	<u>(344,413)</u>	<u>(503,739)</u>
Net increase in cash and due from banks	386,994	227,164
Cash and due from banks at beginning of year	301,219	74,055
Cash and due from banks at end of year	<u>\$ 688,213</u>	<u>\$ 301,219</u>

Note 22. Acquisition Activity

Acquisition Accounting

U.S. GAAP requires the use of fair value accounting in determining the carrying values of certain assets and liabilities acquired in business combinations and accordingly the Company recorded assets purchased and liabilities assumed in the First Avenue acquisition at their fair values. The fair value of the loan portfolios acquired in these transactions was recorded and is being accounted for under the principles prescribed by ASC 310. Topic 310-30 applies to a loan with evidence of deterioration of credit quality since origination, acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. Topic 310-30 prohibits carrying over or creating an allowance for loan losses upon initial recognition for loans that fall under its scope.

Because the Company recorded the loans acquired in connection with the First Avenue acquisition at fair value, the Company recorded no allowance for loan losses related to the acquired loans on the acquisition date, given that the fair value of the loans acquired incorporates assumptions regarding credit risk.

Acquisitions are accounted for under the purchase method of accounting. Purchased assets and assumed liabilities are recorded at their estimated fair values as of the purchase date. Any identifiable intangible assets are also recorded at fair value. When the fair value of the assets purchased exceed the fair value of liabilities assumed, a "bargain purchase gain" results. If the consideration given exceeds the fair value of the net assets received, goodwill is recognized. Fair values are subject to refinement for up to one year after the closing date of an acquisition as information relative to closing date fair values becomes available.

Notes to Consolidated Financial Statements

Note 22. Acquisition Activity (Continued)

First Avenue National Bank

After the close of business on April 8, 2016, Coastal Banking Company acquired 100% of the outstanding shares of First Avenue National Bank in a stock-for-stock whole-bank purchase. Upon acquisition, First Avenue was merged with and into CBC National Bank. Under the terms of the acquisition, approximately 250 common shareholders received 0.4848 a share of the Company's common stock in exchange for each share of First Avenue common stock resulting in total consideration of \$10,818,916. This acquisition expands the footprint of the Company to Ocala, Florida and Marion County. Acquisition related costs of \$712,492 are included in other operating expenses in the Company's income statement for the year ended December 31, 2016. The fair value of the common shares issued as part of the consideration paid for First Avenue was determined upon basis of the closing price of the Company's common shares on the acquisition date and resulted in an after tax bargain purchase gain of \$1,243,824 which is included in other income in the Company's income statement for the year ended December 31, 2016.

The fair values of the assets acquired and liabilities assumed in conjunction with the acquisition as of the closing date are detailed in the following table:

	As Recorded by First Avenue	Fair Value and Other Adjustments	As Recorded by the Company
Assets			
Cash and due from banks	\$ 4,894,974	\$ —	\$ 4,894,974
Securities available to sale	2,034,855	—	2,034,855
Restricted equity securities	504,786	—	504,786
Loans	81,273,346	(515,313) ^(a)	80,758,033
Premises and equipment	9,562,689	(2,963,039) ^(b)	6,599,650
Other real estate owned	60,050	—	60,050
Core deposit intangible	—	1,071,678 ^(c)	1,071,678
Deferred tax assets	1,477,417	606,847 ^(d)	2,084,264
Other assets	12,401,563	—	12,401,563
Total assets	<u>\$ 112,209,680</u>	<u>\$ (1,799,827)</u>	<u>\$ 110,409,853</u>
Liabilities			
Noninterest-bearing deposits	\$ 21,236,797	\$ —	\$ 21,236,797
Interest-bearing deposits	76,978,519	—	76,978,519
Other liabilities	131,797	—	131,797
Total liabilities	<u>\$ 98,347,113</u>	<u>\$ —</u>	<u>\$ 98,347,113</u>
Net identifiable assets acquired over (under) liabilities assumed	13,862,567	(1,799,827)	12,062,740
Consideration paid	—	(10,818,916)	(10,818,916)
Net assets acquired over liabilities assumed	<u>\$ 13,862,567</u>	<u>\$ (12,618,743)</u>	<u>\$ 1,243,824</u>

Explanations

- (a) The adjustment represents \$(735,292) in adjustments due to the interest rate differential noted as part of the valuation process and deferred loan fees of \$219,979.
- (b) The adjustment represents the fair value adjustment for the premises and equipment purchased as calculated as part of the third party valuation process.
- (c) The adjustment represents the consideration paid for the value of the core deposit base assumed in the acquisition. The core deposit asset was recorded as an identifiable intangible asset and will be amortized on an accelerated basis over the average life of the deposit base, estimated to be seven years.
- (d) The adjustment is for deferred tax effect of the above purchase accounting adjustments.

SHAREHOLDER INFORMATION

Stock Information

The Common Stock of Coastal Banking Company, Inc. is not listed on any exchange, however the stock is quoted on the OTCQX® Marketplace under the symbol "CBCO." There were approximately 762 shareholders of record on December 31, 2016. The following table sets forth the high and low bid prices as quoted on the OTCQX® during the periods indicated. The quotations reflect inter-dealer prices, without retail mark-up, mark-down, or commissions, and may not represent actual transactions.

	Years Ended December 31,			
	2016		2015	
	High	Low	High	Low
First quarter	\$ 12.45	\$ 11.25	\$ 9.99	\$ 8.80
Second quarter	\$ 12.99	\$ 12.22	\$ 10.19	\$ 9.00
Third quarter	\$ 13.45	\$ 12.92	\$ 13.00	\$ 9.60
Fourth quarter	\$ 15.05	\$ 13.16	\$ 12.25	\$ 11.60

To date, the Company has not yet declared or paid a cash dividend on common stock. The ability of the Company to pay cash dividends is dependent upon receiving cash dividends from the Bank. However, federal banking regulations restrict the amount of cash dividends that can be paid to the Company by the Bank. All of our outstanding shares of common stock are entitled to share equally in dividends from funds legally available when, and if, declared by the Board of Directors. Any future determination relating to our dividend policy will be made at the discretion of the Board of Directors.

Copies of the Company's Annual Report for the fiscal year ended December 31, 2016 will be furnished at no charge to shareholders upon written request to: Thomas J. Flournoy, EVP & Chief Financial Officer, CBC National Bank, 1891 South 14th Street, Fernandina Beach, FL 32034

This Annual Report serves as the Annual Financial Disclosure Statement furnished pursuant to Part 350 of the Federal Deposit Insurance Corporation's Rules and Regulations. This Statement has not been reviewed or confirmed for accuracy or relevance by the Office of the Comptroller of the Currency.

BOARD OF DIRECTORS

John Q. Adams II

Adams & Company, P.A., C.P.A.

Kenneth C. Ausley

CEO, Ausley Construction Company, Inc.

Christina H. Bryan

Retired Business Owner

Suellen Rodeffer Garner

Orthodontist; Co-Owner Suellen

Rodeffer and David Tod Garner D.D.S., P.A.

Mark B. Heles

President of H&H Quality Properties, LLC

James W. Holden, Jr., DVM,**Secretary**

Owner, Veterinary Wellness Care, LLC

Ladson F. Howell, Vice Chairman

Retired Attorney,

Howell, Gibson & Hughes, P.A.

James C. Key

Partner, Shenandoah Group, LLP

Robert B. Pinkerton

President & CEO, Athena Corporation

Michael G. Sanchez, Chairman

Chairman & CEO, Coastal Banking
Company Inc. and CBC National Bank

Charles K. Wagner

President of Coastal Banking
Company Inc. and CBC National Bank

Edward E. Wilson

Owner of Morrow Insurance Group, Inc.

Marshall E. Wood

Attorney, Wood & Smith, P.A.

COMMITTEES

Audit

James C. Key, Chairman

John Q. Adams II

Christina H. Bryan

Marshall E. Wood

Director Loan

Robert B. Pinkerton, Chairman

Kenneth C. Ausley

Mark B. Heles

Ladson F. Howell

Edward E. Wilson

Marshall E. Wood

**Corporate Governance
and Nominating**

James W. Holden, Jr., DVM, Chairman

Kenneth C. Ausley

Suellen R. Garner

Ladson F. Howell

James C. Key

**Executive Compensation
and Management Resources**

Edward E. Wilson, Chairman

John Q. Adams II

Christina H. Bryan

Suellen R. Garner

Mark B. Heles

CONTACT INFORMATION

Corporate Office

36 Sea Island Parkway

Beaufort, South Carolina 29907

(843) 522-1228 Fax (843) 524-4510

Stock Transfer Department

Continental Stock Transfer & Trust

17 Battery Place, 8th Floor

New York NY 10004

Phone (212) 509-4000

General Counsel

Bryan Cave, LLP

1201 West Peachtree St., NW 14th Floor

Atlanta, Georgia 30309

Independent Public Accounting Firm

Mauldin & Jenkins

2303 Dawson Road

Post Office Box 71549

Albany, Georgia 31708



WWW.COASTALBANKING.COM