
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2018
OR

TRANSITION REPORT
PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.
Commission File Number: 001-38280

CBTX, INC.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

20-8339782
(I.R.S. employer
identification no.)

9 Greenway Plaza, Suite 110
Houston, Texas 77046
(Address of principal executive offices)

(713) 210-7600
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically, every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of October 26, 2018, there were 25,961,584 shares of the registrant's common stock, par value \$0.01 per share outstanding, including 230,080 shares of unvested restricted stock.

CBTX, INC.

	Page
<u>PART I — FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements – (Unaudited)</u>	1
<u>Condensed Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u>	1
<u>Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2018 and 2017</u>	2
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2018 and 2017</u>	3
<u>Condensed Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2018 and 2017</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2018 and 2017</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
<u>Cautionary Note Regarding Forward-looking Statements</u>	33
<u>Overview</u>	34
<u>Results of Operations</u>	35
<u>Financial Condition</u>	42
<u>Liquidity and Capital Resources</u>	50
<u>Interest Rate Sensitivity and Market Risk</u>	54
<u>Impact of Inflation</u>	55
<u>Non-GAAP Financial Measures</u>	55
<u>Critical Accounting Policies</u>	56
<u>Recently Issued Accounting Pronouncements</u>	58
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures about Market Risk</u>	58
<u>Item 4.</u>	
<u>Controls and Procedures</u>	58
<u>PART II — OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	58
<u>Item 1A.</u>	
<u>Risk Factors</u>	59
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 3.</u>	
<u>Defaults Upon Senior Securities</u>	59
<u>Item 4.</u>	
<u>Mine Safety Disclosures</u>	59
<u>Item 5.</u>	
<u>Other Information</u>	59
<u>Item 6.</u>	
<u>Exhibits</u>	60
<u>SIGNATURES</u>	61

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

CBTX, INC. AND SUBSIDIARY
Condensed Consolidated Balance Sheets
(Dollars in thousands, except par value and per share amounts)

	September 30, 2018 (Unaudited)	December 31, 2017
ASSETS		
Cash and due from banks	\$ 51,980	\$ 59,255
Interest-bearing deposits at other financial institutions	229,660	266,944
Total cash and cash equivalents	281,640	326,199
Time deposits in other banks	—	600
Debt securities	222,493	223,208
Equity investments	15,101	12,226
Loans held for sale	384	1,460
Loans, net of allowance for loan loss of \$24,486 and \$24,778 at September 30, 2018 and December 31, 2017, respectively	2,438,711	2,286,766
Premises and equipment, net	52,032	53,607
Goodwill	80,950	80,950
Other intangible assets, net of accumulated amortization of \$14,678 and \$13,930 at September 30, 2018 and December 31, 2017, respectively	6,038	6,770
Bank-owned life insurance	71,070	68,010
Deferred tax asset, net	7,710	5,780
Repossessed real estate and other assets	175	705
Other assets	14,149	14,802
Total assets	<u>\$ 3,190,453</u>	<u>\$ 3,081,083</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Noninterest-bearing deposits	\$ 1,144,985	\$ 1,109,789
Interest-bearing deposits	1,545,095	1,493,183
Total deposits	2,690,080	2,602,972
Repurchase agreements	1,351	1,525
Junior subordinated debt	6,726	6,726
Other liabilities	20,445	23,646
Total liabilities	<u>2,718,602</u>	<u>2,634,869</u>
Commitments and contingencies (Note 13)		
Shareholders' equity		
Preferred stock, \$0.01 par value, 10,000,000 shares authorized, no shares issued	—	—
Common stock, \$0.01 par value; 90,000,000 shares authorized, 25,731,504 shares issued at September 30, 2018 and December 31, 2017, 24,858,632 and 24,833,232 shares outstanding at September 30, 2018 and December 31, 2017, respectively	257	257
Additional paid-in capital	344,222	343,249
Retained earnings	147,768	118,353
Treasury stock, at cost (872,872 and 898,272 shares held at September 30, 2018 and December 31, 2017, respectively)	(14,825)	(15,256)
Accumulated other comprehensive loss, net of tax of \$1,482 and \$104 at September 30, 2018 and December 31, 2017, respectively.	(5,571)	(389)
Total shareholders' equity	<u>471,851</u>	<u>446,214</u>
Total liabilities and shareholders' equity	<u>\$ 3,190,453</u>	<u>\$ 3,081,083</u>

See accompanying notes to condensed consolidated financial statements.

CBTX, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Income (Unaudited)
(Dollars in thousands, except per share amounts)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Interest income				
Interest and fees on loans	\$ 31,513	\$ 27,129	\$ 90,468	\$ 79,642
Debt securities	1,535	1,334	4,478	3,990
Federal Funds and interest-bearing deposits	1,617	1,106	3,931	2,661
Total interest income	<u>34,665</u>	<u>29,569</u>	<u>98,877</u>	<u>86,293</u>
Interest expense				
Deposits	2,961	1,964	7,035	5,659
Repurchase agreements	1	2	3	5
Federal Home Loan Bank advances	61	—	73	—
Note payable	4	269	11	784
Junior subordinated debt	112	83	314	236
Total interest expense	<u>3,139</u>	<u>2,318</u>	<u>7,436</u>	<u>6,684</u>
Net interest income	31,526	27,251	91,441	79,609
Provision (recapture) for loan losses	(1,142)	(1,654)	413	(1,388)
Net interest income after provision for loan losses	<u>32,668</u>	<u>28,905</u>	<u>91,028</u>	<u>80,997</u>
Noninterest income				
Deposit account service charges	1,597	1,395	4,572	4,412
Net gain on sale of assets	152	828	492	1,531
Card interchange fees	922	803	2,820	2,512
Earnings on bank-owned life insurance	443	459	1,359	1,120
Other	412	601	1,150	1,485
Total noninterest income	<u>3,526</u>	<u>4,086</u>	<u>10,393</u>	<u>11,060</u>
Noninterest expense				
Salaries and employee benefits	12,499	11,829	37,690	34,552
Net occupancy expense	2,428	2,221	7,126	6,805
Regulatory fees	488	458	1,546	1,689
Data processing	664	662	2,013	1,955
Printing, stationery and office	503	348	1,394	1,065
Amortization of intangibles	245	267	748	816
Professional and director fees	809	606	2,414	1,937
Correspondent bank and customer related transaction expenses	66	67	201	219
Loan processing costs	102	115	295	320
Advertising, marketing and business development	437	266	1,418	953
Repossessed real estate and other asset expense	3	340	65	543
Security and protection expense	346	331	959	1,055
Telephone and communications	342	311	1,122	972
Other expenses	1,032	1,196	3,269	3,422
Total noninterest expense	<u>19,964</u>	<u>19,017</u>	<u>60,260</u>	<u>56,303</u>
Net income before income tax expense	16,230	13,974	41,161	35,754
Income tax expense	3,207	3,927	7,984	10,140
Net income	<u>\$ 13,023</u>	<u>\$ 10,047</u>	<u>\$ 33,177</u>	<u>\$ 25,614</u>
Earnings per common share				
Basic	\$ 0.52	\$ 0.46	\$ 1.34	\$ 1.16
Diluted	\$ 0.52	\$ 0.45	\$ 1.33	\$ 1.16

See accompanying notes to condensed consolidated financial statements.

CBTX, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Comprehensive Income (Unaudited)
(Dollars in thousands)

	<u>For the Three Months Ended September 30,</u>		<u>For the Nine Months Ended September 30,</u>	
	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>
Net income	\$ 13,023	\$ 10,047	\$ 33,177	\$ 25,614
Unrealized gains (losses) on debt securities available for sale arising during the period, net	(1,957)	253	(6,583)	1,673
Reclassification adjustments for net realized gains included in net income	23	13	23	27
Change in related deferred income tax	407	(93)	1,378	(594)
Other comprehensive income (loss), net of tax	(1,527)	173	(5,182)	1,106
Total comprehensive income	\$ 11,496	\$ 10,220	\$ 27,995	\$ 26,720

See accompanying notes to condensed consolidated financial statements.

CBTX, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
For the Nine Months Ended September 30, 2018 and 2017
(Dollars in thousands, except share amounts)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock		Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount			Shares	Amount		
Balance at December 31, 2016	22,971,504	\$ 230	\$ 278,501	\$ 95,274 25,614	(909,432)	\$ (15,446)	\$ (922)	\$ 357,637 25,614
Net income	—	—	—	—	—	—	—	—
Dividends on common stock, \$0.15 per share	—	—	—	(3,309)	—	—	—	(3,309)
Stock-based compensation expense	—	—	56	—	—	—	—	56
Exercise of stock options	—	—	—	—	1,000	17	—	17
Other comprehensive income, net of tax	—	—	—	—	—	—	1,106	1,106
Balance at September 30, 2017	<u>22,971,504</u>	<u>230</u>	<u>278,557</u>	<u>117,579</u>	<u>(908,432)</u>	<u>(15,429)</u>	<u>184</u>	<u>381,121</u>
Balance at December 31, 2017	25,731,504	\$ 257	\$ 343,249	\$ 118,353 33,177	(898,272)	\$ (15,256)	\$ (389)	\$ 446,214 33,177
Net income	—	—	—	—	—	—	—	—
Dividends on common stock, \$0.15 per share	—	—	—	(3,762)	—	—	—	(3,762)
Stock-based compensation expense	—	—	1,154	—	—	—	—	1,154
Exercise of stock options	—	—	(181)	—	25,400	431	—	250
Other comprehensive loss, net of tax	—	—	—	—	—	—	(5,182)	(5,182)
Balance at September 30, 2018	<u>25,731,504</u>	<u>\$ 257</u>	<u>\$ 344,222</u>	<u>\$ 147,768</u>	<u>(872,872)</u>	<u>\$ (14,825)</u>	<u>\$ (5,571)</u>	<u>\$ 471,851</u>

See accompanying notes to condensed consolidated financial statements.

CBTX, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Cash Flows (Unaudited)
(Dollars in thousands)

	For the Nine Months Ended September	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 33,177	\$ 25,614
Adjustments to reconcile consolidated net income to net cash provided by operating activities:		
Provision (recapture) for loan losses	413	(1,388)
Depreciation	2,483	2,538
Deferred income tax provision (benefit)	(553)	535
Amortization of intangibles	748	816
Valuation adjustments on repossessed real estate and other assets	—	341
Net realized gains on debt securities	(42)	(44)
Net gains on sales of assets	(492)	(1,531)
Earnings on bank-owned life insurance	(1,359)	(1,120)
Amortization of premiums on securities	841	965
Stock-based compensation expense	1,154	56
Change in operating assets and liabilities:		
Loans held for sale	1,398	516
Other assets	641	(4,372)
Other liabilities	(3,236)	4,088
Total adjustments	1,996	1,400
Net cash provided by operating activities	35,173	27,014
Cash flows from investing activities:		
Purchases of debt securities	(336,204)	(267,970)
Proceeds from sales, calls and maturities of debt securities	312,840	240,802
Principal repayments of debt securities	16,720	15,208
Net contributions to equity investments	(2,875)	(28)
Net decrease in time deposits in other banks	600	—
Net increase in loans	(163,908)	(73,796)
Sales of loan participations	40,871	30,826
Purchases of loan participations	(31,453)	(4,091)
Proceeds from sales of U.S. Small Business Administration loans	1,972	2,173
Purchases of bank-owned life insurance	(1,700)	(15,000)
Proceeds from sales of repossessed real estate and other assets	856	1,910
Purchases of premises and equipment	(909)	(699)
Proceeds from sales of premises and equipment	—	2,977
Net cash used in investing activities	(163,190)	(67,688)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	35,196	26,330
Net increase (decrease) in interest-bearing deposits	51,912	(12,463)
Net decrease in securities sold under agreements to repurchase	(174)	(104)
Proceeds from exercise of stock options	250	17
Repayments of note payable	—	(3,322)
Dividends paid on common stock	(3,726)	(3,309)
Net cash provided by financing activities	83,458	7,149
Net decrease in cash, cash equivalents and restricted cash	(44,559)	(33,525)
Cash, cash equivalents and restricted cash, beginning	326,199	382,103
Cash, cash equivalents and restricted cash, ending	\$ 281,640	\$ 348,578

See accompanying notes to condensed consolidated financial statements.

CBTX, INC. AND SUBSIDIARY
Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1: BASIS OF PRESENTATION, NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES

Nature of Operations

CBTX, Inc., or the Company, was formed on January 26, 2007, and through its subsidiary, CommunityBank of Texas, N.A., or the Bank, operates 33 locations in the Houston and Beaumont/East Texas market areas. The Company's primary sources of revenue are from investing funds received from depositors and from providing loan and other financial services to its customers. The Bank operates under a national charter and therefore is subject to regulation by the Office of the Comptroller of the Currency, or OCC and the Federal Deposit Insurance Corporation, or FDIC. The Company is subject to regulation by the Federal Reserve Board.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and the Bank, a wholly owned subsidiary of the Company. All material intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States, or U.S. GAAP, but do not include all the information and footnotes required for complete consolidated financial statements. In management's opinion, these interim unaudited condensed consolidated financial statements include all adjustments of a normal recurring nature necessary for a fair statement of the Company's consolidated financial position at September 30, 2018 and December 31, 2017, consolidated results of operations for the three and nine months ended September 30, 2018 and 2017, consolidated shareholders' equity for the nine months ended September 30, 2018 and 2017 and consolidated cash flows for the nine months ended September 30, 2018 and 2017.

Accounting measurements at interim dates inherently involve greater reliance on estimates than at year end and the results for the interim periods shown in this report are not necessarily indicative of results to be expected for the full year due in part to global economic and financial market conditions, interest rates, access to sources of liquidity, market competition and interruptions of business processes. These interim unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 31, 2017 included within our Annual Report on Form 10-K.

Accounting Standards Recently Adopted

Accounting Standards Update, or ASU, 2014-09, *Revenue from Contracts with Customers (Topic 606)*: ASU 2014-09 requires entities to recognize revenue in a way that depicts the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The Company adopted ASU 2014-09 effective January 1, 2018 with no significant impact to the Company's consolidated financial statements as the Company's revenue is primarily comprised of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of ASU 2014-09 and noninterest income. The Company's revenue recognition for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposits accounts, did not materially change from previous practice.

ASU, 2016-01, *Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. The amendments in this update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured

at amortized cost on the balance sheet, (iv) clarifies that entities use the exit price notion when measuring the fair value of loans for disclosure purposes and not use a practicability exception, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale investments. ASU 2018-03, *Technical Corrections and Improvements to Financial Instruments—Overall (Subtopic 825-10)* clarifies certain aspects of ASU 2016-01. The Company implemented ASU 2016-01 and ASU 2018-03 effective January 1, 2018 with no significant impact to the Company's consolidated financial statements. See Note 12 – Fair Value Disclosures.

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 provides guidance related to certain cash flow issues in order to reduce the current and potential future diversity in practice. The Company implemented ASU 2016-15 effective January 1, 2018. The Company has elected to use the nature of distribution approach to determine whether income received from equity investments is operating or investing on the cash flow statement. Based on the nature of previous income streams from our equity investments, we expect these amounts will continue to be reported in cash provided by operating activities on the cash flow statement and the other items in ASU 2016-15 will be considered if such items arise.

ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*. ASU 2016-16 provides guidance stating that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The Company implemented ASU 2016-16 effective January 1, 2018. As we have not historically transferred assets between entities, we expect no material impact on the consolidated financial statements and will follow this guidance for any future intra-entity transfers of assets other than inventory.

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*. ASU 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The Company implemented ASU 2016-18 effective January 1, 2018. The Company considers its Federal Bank reserves and collateral for its interest rate swaps to be restricted and these amounts were already included in cash and equivalents in the consolidated financial statements.

ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*. ASU 2017-01 clarifies the definition and provides a more robust framework to use in determining when a set of assets and activities constitutes a business. ASU 2017-01 is intended to provide guidance when evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The Company implemented ASU 2017-01 effective January 1, 2018 and will follow this guidance for any future acquisitions or dispositions.

ASU 2017-09, *Compensation—Stock Compensation (Topic 718)*: ASU 2017-09 provides guidance about which changes in terms or conditions of a share-based award require application of modification accounting. The Company implemented ASU 2017-09 effective January 1, 2018 and will follow this guidance for any future modifications of share-based awards.

Accounting Standards Not Yet Adopted

ASU 2016-02, *Leases (Topic 842)*: ASU 2016-02 will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2018-10, *Codification Improvements to Topic 842, Leases* was issued in July 2018 to clarify narrow aspects of ASU 2016-02. In addition, ASU 2018-11, *Leases (Topic 842)* was also issued in July 2018 and allows application of ASU 2016-02 at the date of the adoption date and recognize a cumulative-effect adjustment to retained earnings. Prior to the issuance of ASU 2018-11, transition to the new lease accounting under ASU 2016-02 required using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. ASU 2016-02 will be effective for the Company on January 1, 2019. The Company will use the modified retrospective approach and intends to elect the available practical expedients on adoption.

This standard is anticipated to have a material impact on the Company's consolidated balance sheets, but is not expected to have a material impact on the Company's consolidated income statements. The Company is nearing completion of the assessment of the impacts of the standard and currently expects that the most significant impact will be an increase in assets due to the addition of right-of-use assets for assets underlying its operating leases and an increase in liabilities reflecting its liability to make the lease payments under these operating leases.

ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 will be effective on January 1, 2020. The Company is currently evaluating the potential impact of ASU 2016-13 on the consolidated financial statements.

ASU 2017-04, *Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. ASU 2017-04 eliminates Step 2 from the goodwill impairment test. In addition, the amendment eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. For public companies, ASU 2017-04 is effective for fiscal years beginning after December 15, 2019, with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is currently evaluating the potential impact of this pronouncement.

Revenue Recognition

The Company records revenue from contracts with customers in accordance with ASC 606, as applicable. A majority of the Company's revenue-generating transactions are not subject to ASC 606, such as interest and fees on loans, income from debt securities, income from federal funds and interest-bearing deposits. Our revenue-generating activities that are within the scope of ASC 606, are included in our condensed consolidated income statements in noninterest income. See table below. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed and charged either on a periodic basis or based on activity.

(Dollars in thousands)	Nine Months Ended September 30,	
	2018	2017
Deposit account service charges	\$ 4,572	\$ 4,412
Net gain on sale of assets	492	1,531
Card interchange fees	2,820	2,512

Deposit account service charges— this is comprised of fees from our customers for deposit related services, such as monthly account maintenance and activity or transaction-based fees. Revenue is recognized when our performance obligation is completed which is generally monthly for account maintenance services or when a transaction is completed. Payment for such performance obligations are generally received at the time the performance obligation is satisfied.

Net gain on sale of assets— this is comprised of gains on sales of fixed assets, gains on sales of loans and gains on sales of other real estate owned, or OREO. Gains on sales of loans are excluded from ASC 606. The performance obligation in the sale of OREO or fixed assets is delivery of control over the property to the buyer. The Company does not typically provide financing and the transaction price is identified in the purchase and sale agreement. If the Company provides financing, the Company must determine a transaction price depending on if the sales contract is at market terms and taking into account the credit risk inherent in the sale agreement.

Card interchange fees— this is comprised of fees generated from debit card transactions. Revenue is recognized when our performance obligation is completed generally when a transaction is completed. Payment for such performance obligations are generally received at the time the performance obligation is satisfied.

Cash Flow Reporting

Cash, cash equivalents and restricted cash include cash, interest-bearing and noninterest-bearing transaction accounts with other banks and federal funds sold. The Bank is required to maintain regulatory reserves with the Federal Reserve Bank and the reserve requirements for the Bank were \$20.0 million and \$15.8 million at September 30, 2018 and December 31, 2017, respectively. Additionally, as of September 30, 2018 and December 31, 2017, the Company had \$1.6 million in cash collateral used in our interest rate swap transactions.

Supplemental disclosures of cash flow information are as follows for the periods indicated below:

<u>(Dollars in thousands)</u>	<u>Nine Months Ended</u>	
	<u>September 30,</u>	
	<u>2018</u>	<u>2017</u>
Supplemental disclosures of cash flow information:		
Cash paid for taxes	\$ 7,827	\$ 9,515
Cash paid for interest on deposits and repurchase agreements	6,943	5,718
Cash paid for interest on notes payable	—	780
Cash paid for interest on junior subordinated debt	300	230
Supplemental disclosures of non-cash flow information:		
Dividends accrued for restricted stock	44	—
Repossessed real estate and other assets	312	583

NOTE 2: DEBT SECURITIES

The amortized cost and fair values of investments in debt securities as of the dates shown below were as follows:

<u>(Dollars in thousands)</u>	<u>Amortized</u>	<u>Gross</u>	<u>Gross</u>	<u>Fair Value</u>
	<u>Cost</u>	<u>Unrealized</u>	<u>Unrealized</u>	
		<u>Gains</u>	<u>Losses</u>	
September 30, 2018				
Debt securities available for sale:				
State and municipal securities	\$ 56,155	\$ 119	\$ (1,150)	\$ 55,124
U.S. agency securities:				
Debt securities	17,315	—	(628)	16,687
Collateralized mortgage obligations	66,737	8	(2,206)	64,539
Mortgage-backed securities	88,185	95	(3,239)	85,041
Other securities	1,123	—	(52)	1,071
Total	\$ 229,515	\$ 222	\$ (7,275)	\$ 222,462
Debt securities held to maturity:				
Mortgage-backed securities	\$ 31	\$ 2	\$ —	\$ 33
December 31, 2017				
Debt securities available for sale:				
State and municipal securities	\$ 60,861	\$ 1,173	\$ (118)	\$ 61,916
U.S. agency securities:				
Debt securities	17,315	—	(370)	16,945
Collateralized mortgage obligations	61,878	50	(675)	61,253
Mortgage-backed securities	82,510	330	(866)	81,974
Other securities	1,104	—	(17)	1,087
Total	\$ 223,668	\$ 1,553	\$ (2,046)	\$ 223,175
Debt securities held to maturity:				
Mortgage-backed securities	\$ 33	\$ 2	\$ —	\$ 35

The amortized cost and estimated fair value of debt securities, by contractual maturity, as of the dates shown below are as follows:

(Dollars in thousands)	Debt Securities Available for Sale		Debt Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
September 30, 2018				
Amounts maturing in:				
1 year or less	\$ 3,232	\$ 3,186	\$ —	\$ —
1 year through 5 years	22,692	22,081	—	—
5 years through 10 years	8,266	8,285	—	—
After 10 years	195,325	188,910	31	33
	<u>\$ 229,515</u>	<u>\$ 222,462</u>	<u>\$ 31</u>	<u>\$ 33</u>
December 31, 2017				
Amounts maturing in:				
1 year or less	\$ 6,203	\$ 6,194	\$ —	\$ —
1 year through 5 years	26,811	26,635	—	—
5 years through 10 years	9,215	9,348	—	—
After 10 years	181,439	180,998	33	35
	<u>\$ 223,668</u>	<u>\$ 223,175</u>	<u>\$ 33</u>	<u>\$ 35</u>

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Securities with a carrying amount of \$6.6 million and \$6.1 million were sold in the nine months ended September 30, 2018 and 2017, respectively. At September 30, 2018 and December 31, 2017, debt securities with a carrying amount of approximately \$43.5 million and \$58.7 million, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

The Company held 74 debt securities at September 30, 2018 and 52 debt securities at December 31, 2017, that were in a gross unrealized loss position for 12 months or more as illustrated in the table below. The unrealized losses are attributable primarily to changes in market interest rates relative to those available when the debt securities were acquired. The fair value of these debt securities is expected to recover as the debt securities reach their maturity or re-pricing date, or if changes in market rates for such investments decline. Management does not believe that any of the debt securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2018 and December 31, 2017, management believes the unrealized losses detailed in the table below are temporary and no impairment loss has been recorded in the Company's condensed consolidated statements of income for the nine months ended September 30, 2018 and 2017.

Debt securities with unrealized losses as of the dates shown below, aggregated by category and the length of time were as follows:

(Dollars in thousands)	Less Than Twelve Months		Twelve Months or More	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
September 30, 2018				
Debt securities available for sale:				
State and municipal securities	\$ 33,882	\$ (745)	\$ 6,498	\$ (405)
U.S. agency securities:				
Debt securities	—	—	16,687	(628)
Collateralized mortgage obligations	41,123	(1,219)	20,718	(987)
Mortgage-backed securities	39,505	(994)	39,222	(2,245)
Other securities	—	—	1,071	(52)
	<u>\$ 114,510</u>	<u>\$ (2,958)</u>	<u>\$ 84,196</u>	<u>\$ (4,317)</u>
December 31, 2017				
Debt securities available for sale:				
State and municipal securities	\$ 2,494	\$ (3)	\$ 6,516	\$ (115)
U.S. agency securities:				
Debt securities	4,464	(55)	12,481	(315)
Collateralized mortgage obligations	44,116	(380)	9,938	(295)
Mortgage-backed securities	22,079	(123)	32,538	(743)
Other securities	—	—	1,087	(17)
	<u>\$ 73,153</u>	<u>\$ (561)</u>	<u>\$ 62,560</u>	<u>\$ (1,485)</u>

NOTE 3: LOANS

Loans by loan class as of the dates shown below were as follows:

(Dollars in thousands)	September 30, 2018		December 31, 2017	
Commercial and industrial	\$ 569,334	23.1 %	\$ 559,363	24.1 %
Real estate:				
Commercial real estate	776,439	31.4 %	738,293	31.9 %
Construction and development	487,289	19.7 %	449,211	19.4 %
1-4 family residential	288,737	11.7 %	258,584	11.2 %
Multi-family residential	236,907	9.6 %	220,305	9.5 %
Consumer	39,807	1.6 %	40,433	1.7 %
Agriculture	11,609	0.5 %	11,256	0.5 %
Other	59,484	2.4 %	40,344	1.7 %
Total gross loans	2,469,606	100.0 %	2,317,789	100.0 %
Less deferred loan fees and unearned discounts	(6,025)		(4,785)	
Less allowance for loan loss	(24,486)		(24,778)	
Less loans held for sale	(384)		(1,460)	
Loans, net	<u>\$ 2,438,711</u>		<u>\$ 2,286,766</u>	

Accrued interest receivable for loans is \$7.4 million and \$6.1 million at September 30, 2018 and December 31, 2017, respectively and is included in other assets in the condensed consolidated balance sheets.

Loan Participations Purchased and Sold

From time to time, the Company will acquire and dispose of interests in loans under participation agreements with other financial institutions. Loan participations purchased and sold during the nine months ending September 30, 2018 and 2017, by loan class, were as follows:

<u>(Dollars in thousands)</u>	<u>Participations Purchased During the Period</u>	<u>Participations Sold During the Period</u>
September 30, 2018		
Commercial and industrial	\$ 7,000	\$ —
Commercial real estate	24,453	35,000
Construction and development	—	5,871
	<u>\$ 31,453</u>	<u>\$ 40,871</u>
September 30, 2017		
Commercial and industrial	\$ —	\$ 12,317
Commercial real estate	—	16,016
Construction and development	4,091	2,493
	<u>\$ 4,091</u>	<u>\$ 30,826</u>

Loans Guaranteed by the Small Business Administration

The Company participates in the Small Business Administration, or SBA, loan program. When advantageous, the Company will sell the guaranteed portions of these loans with servicing retained. SBA loans that were sold with servicing retained during the nine months ended September 30, 2018 and 2017 totaled \$2.0 million and \$2.2 million, respectively.

NOTE 4: LOAN PERFORMANCE

Nonaccrual loans, segmented by loan class, as of the dates shown below were as follows:

<u>(Dollars in thousands)</u>	<u>September 30, 2018</u>	<u>December 31, 2017</u>
Commercial and industrial	\$ 2,161	\$ 3,280
Real estate:		
Commercial real estate	2,751	3,216
Construction and development	13	252
1-4 family residential	677	898
Consumer	—	—
Total	<u>\$ 5,602</u>	<u>\$ 7,646</u>

Interest income that would have been earned under the original terms of the nonaccrual loans was \$220,000 and \$314,000 for the nine months ended September 30, 2018 and 2017, respectively.

The following is an aging analysis of the Company's past due loans, segregated by loan class, as of the dates shown below:

(Dollars in thousands)	30 to 59 days past due	60 to 89 days past due	90 days or greater past due	Total past due	Total current loans	Total loans	90 days past due and still accruing
September 30, 2018							
Commercial and industrial	\$ 351	\$ 22	\$ 1,263	\$ 1,636	\$ 567,698	\$ 569,334	\$ —
Real estate:							
Commercial real estate	523	154	1,866	2,543	773,896	776,439	—
Construction and development	87	13	—	100	487,189	487,289	—
1-4 family residential	98	114	35	247	288,490	288,737	—
Multi-family residential	—	—	—	—	236,907	236,907	—
Consumer	13	—	—	13	39,794	39,807	—
Agriculture	25	—	—	25	11,584	11,609	—
Other	—	—	—	—	59,484	59,484	—
Total loans	\$ 1,097	\$ 303	\$ 3,164	\$ 4,564	\$ 2,465,042	\$ 2,469,606	\$ —
December 31, 2017							
Commercial and industrial	\$ 943	\$ 1,071	\$ 2,535	\$ 4,549	\$ 554,814	\$ 559,363	\$ —
Real estate:							
Commercial real estate	337	841	1,866	3,044	735,249	738,293	—
Construction and development	400	—	—	400	448,811	449,211	—
1-4 family residential	807	—	143	950	257,634	258,584	—
Multi-family residential	—	—	—	—	220,305	220,305	—
Consumer	3	25	—	28	40,405	40,433	—
Agriculture	—	—	—	—	11,256	11,256	—
Other	—	—	—	—	40,344	40,344	—
Total loans	\$ 2,490	\$ 1,937	\$ 4,544	\$ 8,971	\$ 2,308,818	\$ 2,317,789	\$ —

Loans, segregated by loan class, which were restructured due to the borrower's financial difficulties during the nine months ended September 30, 2018 and 2017, which remain outstanding at the end of those periods were as follows:

(Dollars in thousands)	Number of Loans	Pre-modification Outstanding Recorded Investment	Post-modification recorded investment			
			Restructured Payments	Extended Maturity	Extended Maturity and Restructured Payments	Extended Maturity, Restructured Payments and Adjusted Interest Rate
September 30, 2018						
Commercial and industrial	4	\$ 967	\$ 921	\$ —	\$ 46	\$ —
Commercial real estate	4	2,184	2,184	—	—	—
Total	8	\$ 3,151	\$ 3,105	\$ —	\$ 46	\$ —
September 30, 2017						
Commercial and industrial	5	\$ 3,028	\$ 2,019	\$ —	\$ 1,009	\$ —
Commercial real estate	5	1,303	422	718	163	—
Total	10	\$ 4,331	\$ 2,441	\$ 718	\$ 1,172	\$ —

Typical modifications primarily relate to extending the amortization periods of the loans, converting the loans to interest only, or adjusting payment amounts for principal and interest. A significant portion of the loans modified as troubled debt restructurings by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring and as a result, the modifications did not impact the Company's determination of the allowance for loan losses.

The recorded investment in troubled debt restructurings was \$16.2 million and \$18.2 million as of September 30, 2018 and December 31, 2017, respectively. As of September 30, 2018 and December 31, 2017, \$4.7 million and \$4.8

million of restructured loans were nonaccrual loans and \$11.5 million and \$13.4 million of restructured loans were accruing interest as of those periods. At September 30, 2018, the Company has an outstanding commitment to potentially fund \$103,000 on a line of credit restructured prior to 2018. At December 31, 2017, the Company had no commitments to loan additional funds to borrowers with loans that were restructured.

There were no loans modified as a troubled debt restructured loan within the previous 12 months and for which there was a payment default. For purposes of this disclosure, a default is a loan modified as a troubled debt restructuring where the borrower is 90 days past due or results in the foreclosure and repossession of the applicable collateral.

NOTE 5: ALLOWANCE FOR LOAN LOSSES

For purposes of determining the allowance for loan losses, the Company considers the loans in its portfolio by segment, class and risk grade. Management uses judgment to determine the estimation method that fits the credit risk characteristics of each portfolio segment or class. To facilitate the assessment of risk, management reviews reports related to loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming and potential problem loans. The Company utilizes an independent third-party loan review service to review the credit risk assigned to loans on a periodic basis and the results are presented to management for review.

Activity in the allowance for loan losses segregated by loan class for the nine months ended September 30, 2018 and 2017 and the year ended December 31, 2017 was as follows:

(Dollars in thousands)	Commercial and industrial	Real Estate				Consumer	Agriculture	Other	Total
		Commercial real estate	Construction and development	1-4 family residential	Multi- family residential				
September 30, 2018									
Beginning balance	\$ 7,257	\$ 10,375	\$ 3,482	\$ 1,326	\$ 1,419	\$ 566	\$ 68	\$ 285	\$ 24,778
Provision (recapture) for loan loss	2,218	(3,467)	124	1,126	211	(173)	3	371	413
Charge-offs	(1,136)	(9)	—	(3)	—	(1)	—	(3)	(1,152)
Recoveries	424	14	—	5	—	2	—	2	447
Net (charge-offs) recoveries	(712)	5	—	2	—	1	—	(1)	(705)
Ending balance	\$ 8,763	\$ 6,913	\$ 3,606	\$ 2,454	\$ 1,630	\$ 394	\$ 71	\$ 655	\$ 24,486
Period-end amount allocated to:									
Specific reserve	\$ 542	\$ 1	\$ —	\$ 115	\$ —	\$ —	\$ —	\$ 127	\$ 785
General reserve	8,221	6,912	3,606	2,339	1,630	394	71	528	23,701
Total	\$ 8,763	\$ 6,913	\$ 3,606	\$ 2,454	\$ 1,630	\$ 394	\$ 71	\$ 655	\$ 24,486

(Dollars in thousands)	Commercial and industrial	Real Estate				Consumer	Agriculture	Other	Total
		Commercial real estate	Construction and development	1-4 family residential	Multi- family residential				
December 31, 2017									
Beginning balance	\$ 6,409	\$ 10,770	\$ 4,598	\$ 1,286	\$ 916	\$ 353	\$ 79	\$ 595	\$ 25,006
Provision (recapture) for loan loss	642	(284)	(1,116)	35	503	263	(63)	(318)	(338)
Charge-offs	(904)	(120)	—	(8)	—	(93)	—	—	(1,125)
Recoveries	1,110	9	—	13	—	43	52	8	1,235
Net (charge-offs) recoveries	206	(111)	—	5	—	(50)	52	8	110
Ending balance	\$ 7,257	\$ 10,375	\$ 3,482	\$ 1,326	\$ 1,419	\$ 566	\$ 68	\$ 285	\$ 24,778
Period-end amount allocated to:									
Specific reserve	\$ 852	\$ 64	\$ —	\$ 119	\$ —	\$ —	\$ —	\$ —	\$ 1,035
General reserve	6,405	10,311	3,482	1,207	1,419	566	68	285	23,743
Total	\$ 7,257	\$ 10,375	\$ 3,482	\$ 1,326	\$ 1,419	\$ 566	\$ 68	\$ 285	\$ 24,778

(Dollars in thousands)	Commercial and industrial	Real Estate					Consumer	Agriculture	Other	Total
		Commercial real estate	Construction and development	1-4 family residential	Multi-family residential					
September 30, 2017										
Beginning balance	\$ 6,409	\$ 10,770	\$ 4,598	\$ 1,286	\$ 916	\$ 353	\$ 79	\$ 595	\$ 25,006	
Provision (recapture) for loan loss	631	(1,137)	(1,234)	(16)	444	332	(27)	(381)	(1,388)	
Charge-offs	(791)	—	—	—	—	(83)	—	—	(874)	
Recoveries	945	7	—	12	—	24	17	8	1,013	
Net (charge-offs) recoveries	154	7	—	12	—	(59)	17	8	139	
Ending balance	\$ 7,194	\$ 9,640	\$ 3,364	\$ 1,282	\$ 1,360	\$ 626	\$ 69	\$ 222	\$ 23,757	
Period-end amount allocated to:										
Specific reserve	\$ 424	\$ —	\$ —	\$ 132	\$ —	\$ —	\$ —	\$ —	\$ 556	
General reserve	6,770	9,640	3,364	1,150	1,360	626	69	222	23,201	
Total	\$ 7,194	\$ 9,640	\$ 3,364	\$ 1,282	\$ 1,360	\$ 626	\$ 69	\$ 222	\$ 23,757	

Allocation of a portion of the allowance to one category of loans in the tables above does not preclude its availability to absorb losses in other categories. In addition to the amounts indicated in the tables above, the Company has an accumulated reserve for loan losses on unfunded commitments of \$378,000 and \$378,000 recorded in other liabilities as of September 30, 2018 and December 31, 2017, respectively.

Risk Grading

As part of the on-going monitoring of the credit quality of the Company's loan portfolio and methodology for calculating the allowance for loan losses, management assigns and tracks loan grades to be used as credit quality indicators. The following is a general description of the loan grades the Company used as of September 30, 2018 and December 31, 2017:

Pass—Credits in this category are considered “*pass*” which indicates prudent underwriting and a normal amount of risk. The range of risk within these credits can vary from little to no risk with cash securing a credit, to a level of risk that requires a strong secondary source of repayment on the debt. Pass credits with a higher level of risk may be to borrowers that are higher leveraged, less well capitalized or in an industry or economic area that is known to carry a higher level of risk, volatility, or susceptibility to weaknesses in the economy. This higher risk grade may be assigned due to out of date credit information, as well as collateral information which may need to be updated for current market value in order to allow a credit quality analysis of the credit.

Special Mention—Credits in this category contain more than the normal amount of risk and are referred to as “*special mention*” in accordance with regulatory guidelines. These credits possess clearly identifiable temporary weaknesses or trends that, if not corrected or revised, may result in a condition that exposes the Company to higher level of risk of loss.

Substandard—Credits in this category are “*substandard*” in accordance with regulatory guidelines and of unsatisfactory credit quality with well-defined weaknesses or weaknesses that jeopardize the liquidation of the debt. Credits in this category are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. These credits are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Often, the assets in this category will have a valuation allowance representative of management's estimated loss that is probable to be incurred. Substandard loans may also be placed on nonaccrual status as deemed appropriate by management. Loans substandard and on nonaccrual status are considered impaired and are evaluated for impairment.

Doubtful—Credits in this category are considered “*doubtful*” in accordance with regulatory guidelines, are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Generally, these credits will have a valuation allowance based upon management's best estimate of the losses probable to occur in the liquidation of the debt.

Loss—Credits in this category are considered “*loss*” in accordance with regulatory guidelines and are considered uncollectible and of such little value as to question their continued existence as assets on the Company's financial statements. Such credits are to be charged off or charged down when payment is acknowledged to be uncertain or when

the timing or value of payments cannot be determined. This category does not intend to imply that the debt or some portion of it will never be paid, nor does it in any way imply that the debt will be forgiven.

The Company had no loans graded Loss or Doubtful at September 30, 2018 and December 31, 2017.

Loans by risk grades and loan class as of the dates shown below were as follows:

(Dollars in thousands)	Pass	Special Mention	Substandard	Total Loans
September 30, 2018				
Commercial and industrial	\$ 553,492	5,041	10,801	\$ 569,334
Real estate:				
Commercial real estate	766,348	2,719	7,372	776,439
Construction and development	483,067	4,204	18	487,289
1-4 family residential	281,094	2,186	5,457	288,737
Multi-family residential	229,698	7,209	—	236,907
Consumer	39,539	246	22	39,807
Agriculture	11,580	—	29	11,609
Other	51,074	—	8,410	59,484
Total loans	\$ 2,415,892	\$ 21,605	\$ 32,109	\$ 2,469,606

(Dollars in thousands)	Pass	Special Mention	Substandard	Total Loans
December 31, 2017				
Commercial and industrial	\$ 535,589	\$ 8,403	\$ 15,371	\$ 559,363
Real estate:				
Commercial real estate	722,503	2,951	12,839	738,293
Construction and development	448,124	565	522	449,211
1-4 family residential	252,317	—	6,267	258,584
Multi-family residential	212,899	7,406	—	220,305
Consumer	40,144	246	43	40,433
Agriculture	11,223	—	33	11,256
Other	33,109	—	7,235	40,344
Total loans	\$ 2,255,908	\$ 19,571	\$ 42,310	\$ 2,317,789

Loan Impairment Assessment

The Company's recorded investment in impaired loans, as of the dates shown below by loan class and disaggregated based on the Company's impairment methodology was as follows:

(Dollars in thousands)	Unpaid contractual principal balance	Recorded investment with no allowance	Recorded investment with allowance	Total recorded investment	Related allowance	Average recorded investment year-to-date
September 30, 2018						
Commercial and industrial	\$ 5,508	\$ 4,327	\$ 542	\$ 4,869	\$ 542	\$ 6,266
Real estate:						
Commercial real estate	6,316	5,501	604	6,105	1	6,610
Construction and development	13	13	—	13	—	182
1-4 family residential	4,558	2,607	1,837	4,444	115	4,650
Consumer	—	—	—	—	—	9
Other	8,332	—	8,332	8,332	127	8,101
Total loans	\$ 24,727	\$ 12,448	\$ 11,315	\$ 23,763	\$ 785	\$ 25,818

(Dollars in thousands)	Unpaid contractual principal balance	Recorded investment with no allowance	Recorded investment with allowance	Total recorded investment	Related allowance	Average recorded investment year-to-date
December 31, 2017						
Commercial and industrial	\$ 11,921	\$ 6,100	\$ 1,192	\$ 7,292	\$ 852	\$ 12,090
Real estate:						
Commercial real estate	9,646	8,625	667	9,292	64	9,438
Construction and development	296	252	—	252	—	323
1-4 family residential	5,003	3,050	1,874	4,924	119	3,369
Multi-family residential	—	—	—	—	—	2
Consumer	—	—	—	—	—	21
Agriculture	—	—	—	—	—	1
Other	7,152	7,152	—	7,152	—	7,616
Total loans	\$ 34,018	\$ 25,179	\$ 3,733	\$ 28,912	\$ 1,035	\$ 32,860

(Dollars in thousands)	Unpaid contractual principal balance	Recorded investment with no allowance	Recorded investment with allowance	Total recorded investment	Related allowance	Average recorded investment year-to-date
September 30, 2017						
Commercial and industrial	\$ 15,963	\$ 10,673	\$ 1,109	\$ 11,782	\$ 424	\$ 13,626
Real estate:						
Commercial real estate	11,575	11,350	—	11,350	—	9,313
Construction and development	305	265	—	265	—	364
1-4 family residential	5,000	3,036	1,887	4,923	132	2,536
Multi-family residential	8	1	—	1	—	4
Consumer	—	—	—	—	—	37
Agriculture	—	—	—	—	—	35
Other	5,176	5,176	—	5,176	—	7,439
Total loans	\$ 38,027	\$ 30,501	\$ 2,996	\$ 33,497	\$ 556	\$ 33,354

Interest income earned on impaired loans was \$808,000 and \$946,000 for the nine months ended September 30, 2018 and 2017, respectively.

The Company's recorded investment in loans as of the dates shown below related to the balance in the allowance for loan losses based on the Company's impairment methodology was as follows:

(Dollars in thousands)	September 30, 2018			December 31, 2017		
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Loans	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Loans
Commercial and industrial	\$ 4,869	\$ 564,465	\$ 569,334	\$ 7,292	\$ 552,071	\$ 559,363
Real estate:						
Commercial real estate	6,105	770,334	776,439	9,292	729,001	738,293
Construction and development	13	487,276	487,289	252	448,959	449,211
1-4 family residential	4,444	284,293	288,737	4,924	253,660	258,584
Multi-family residential	—	236,907	236,907	—	220,305	220,305
Consumer	—	39,807	39,807	—	40,433	40,433
Agriculture	—	11,609	11,609	—	11,256	11,256
Other	8,332	51,152	59,484	7,152	33,192	40,344
Total	\$ 23,763	\$ 2,445,843	\$ 2,469,606	\$ 28,912	\$ 2,288,877	\$ 2,317,789

An impairment analysis is performed for all loans graded substandard and placed on nonaccrual status. If management determines a loan is impaired, the loan is written down to its estimated realizable value through a charge to the allowance for loan losses. At September 30, 2018 and December 31, 2017, the allowance allocated to specific reserves for loans individually evaluated for impairment was \$785,000 and \$1.0 million, respectively.

NOTE 6: PREMISES AND EQUIPMENT

Premises and equipment are summarized as follows as of the dates shown below:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Land	\$ 13,466	\$ 13,466
Buildings and leasehold improvements	52,216	51,664
Furniture and equipment	15,237	14,887
Vehicles	202	202
	81,121	80,219
Less accumulated depreciation and amortization	(29,089)	(26,612)
Premises and equipment, net	<u>\$ 52,032</u>	<u>\$ 53,607</u>

Depreciation expense was \$2.5 million and \$2.5 million for the nine months ended September 30, 2018 and 2017, respectively, which is included in net occupancy expense on the Company's condensed consolidated statements of income. Net gains and losses on dispositions of premises and equipment of \$742,000 for the nine months ended September 30, 2017, were recognized and are included in net gain on sale of assets in the condensed consolidated statements of income. There were no dispositions of premises and equipment in the nine months ended September 30, 2018.

NOTE 7: GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is not amortized and there have been no changes in goodwill during the nine months ended September 30, 2018 or the year ended December 31, 2017. The Company's other intangibles are being amortized over their estimated useful lives of seven to 20 years. Based on the results of the Company's assessment, management does not believe any impairment of goodwill or other intangible assets existed at September 30, 2018 or December 31, 2017.

Other intangibles, net of accumulated amortization, were as follows as of the dates shown below:

(Dollars in thousands)	Weighted Amortization Period	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
September 30, 2018				
Other intangible assets, net				
Core deposits	5.4 years	\$ 13,750	\$ (12,442)	\$ 1,308
Customer relationships	10.3 years	6,629	(2,099)	4,530
Servicing assets	15.7 years	337	(137)	200
Total other intangible assets, net		<u>\$ 20,716</u>	<u>\$ (14,678)</u>	<u>\$ 6,038</u>
December 31, 2017				
Other intangible assets, net				
Core deposits	6.2 years	\$ 13,750	\$ (12,051)	\$ 1,699
Customer relationships	11.0 years	6,629	(1,767)	4,862
Servicing assets	17.3 years	321	(112)	209
Total other intangible assets, net		<u>\$ 20,700</u>	<u>\$ (13,930)</u>	<u>\$ 6,770</u>

Servicing Assets

Changes in the related servicing assets as of the dates indicated below were as follows:

(Dollars in thousands)	Nine Months Ended September 30,	
	2018	2017
Balance at beginning of year	\$ 209	\$ 186
Increase from loan sales	38	58
Decrease from serviced loans paid off or foreclosed	(22)	—
Amortization	(25)	(26)
Balance at end of period	<u>\$ 200</u>	<u>\$ 218</u>

NOTE 8: DEPOSITS

Deposits as of the dates shown below were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Interest-bearing demand accounts	\$ 367,120	\$ 363,015
Money market accounts	722,382	702,299
Saving accounts	94,344	95,842
Certificates and other time deposits, \$100,000 or greater	182,552	172,469
Certificates and other time deposits, less than \$100,000	178,697	159,558
Total interest-bearing deposits	1,545,095	1,493,183
Noninterest-bearing deposits	1,144,985	1,109,789
Total deposits	<u>\$ 2,690,080</u>	<u>\$ 2,602,972</u>

At September 30, 2018 and December 31, 2017, the Company had \$46.4 million and \$45.3 million in deposits from public entities and brokered deposits of \$109.8 million and \$88.3 million, respectively. The Company had no major concentrations of deposits at September 30, 2018 or December 31, 2017 from any single or related groups of depositors.

NOTE 9: NOTES PAYABLE AND LINES OF CREDIT***Note Payable***

In conjunction with an acquisition, the Company entered into a loan agreement on February 1, 2015 for \$31.0 million. On November 13, 2017, the Company paid the then remaining outstanding balance in full.

Frost Line of Credit

On December 13, 2017, the Company entered into a loan agreement, or the Loan Agreement, with Frost Bank, which provides for a \$30.0 million revolving line of credit, or Line of Credit. The Company can make draws on the Line of Credit for a period of 12 months beginning on the date of the Loan Agreement, after which the Company will not be permitted to make further draws and the outstanding balance will amortize over a period of 60 months. Interest accrues on outstanding borrowings at a rate equal to the maximum "Latest" U.S. prime rate of interest per annum and payable quarterly in the first 12 months and thereafter quarterly principal and interest payments are required over a term of 60 months. The entire outstanding balance and unpaid interest is payable in full on December 13, 2023.

The Company may prepay the principal amount of any loan under the Loan Agreement without premium or penalty. The obligations of the Company under the Loan Agreement are secured by a valid and perfected first priority lien on all of the issued and outstanding shares of capital stock of the Bank.

Covenants made under the Loan Agreement include, among other things, the Company maintaining tangible net worth of not less than \$240 million, the Company maintaining a free cash flow coverage ratio of not less than 1.25 to 1.00, the Bank's Texas Ratio (as defined under the Loan Agreement) not to exceed 15%, the Bank's Total Capital Ratio (as defined under the Loan Agreement) of not less than 12% and restrictions on the ability of the Company and its subsidiaries to incur certain additional debt. The Company was in compliance with these covenants at September 30, 2018.

As of September 30, 2018, there were no outstanding borrowings on this line and the Company did not draw on this line during the period from December 13, 2017, when the Company entered the agreement, to September 30, 2018.

Additional Lines of Credit

The Federal Home Loan Bank System, or FHLB, allows us to borrow on a blanket floating lien status collateralized by certain loans. As of September 30, 2018 and December 31, 2017, total borrowing capacity of \$893.3 million and \$793.3 million, respectively, was available under this arrangement. During the second and third quarter

of 2018, we borrowed under this agreement on a short-term basis and as of September 30, 2018 and December 31, 2017, there were no outstanding FHLB advances.

As of September 30, 2018 and December 31, 2017, we maintained four federal funds lines of credit with commercial banks that provide for the availability to borrow up to an aggregate of \$75.0 million, in federal funds. There were no funds under these lines of credit outstanding as of September 30, 2018 or December 31, 2017.

NOTE 10: JUNIOR SUBORDINATED DEBT

Crosby Statutory Trust I

Prior to being acquired in 2008 by the Company, Crosby Bancshares, Inc. received proceeds of junior subordinated debt held by a trust that is funded by common securities purchased by Crosby Bancshares, Inc. and trust preferred securities in the amount of \$5.0 million that are held by other investors. Funds raised by the trust totaling \$5.2 million were loaned to Crosby Bancshares, Inc. in the form of junior subordinated debt. This debt was assumed by the Company at the date of acquisition. This debt is generally subordinated to other debt and deposits reflected on the consolidated balance sheets. The subordinated debt securities have a due date of December 15, 2035 and interest is payable quarterly.

The interest rate of the debt is equal to the London Interbank Offered Rate of U.S. Dollar deposits in Europe, or LIBOR, plus 1.44%, reset quarterly, which was 3.77% at September 30, 2018 and 3.03% at December 31, 2017. The Company has the right to redeem these debt securities in whole, or from time to time in part, provided that all accrued and unpaid interest has been paid.

County Bancshares Trust I

Prior to being acquired in 2007 by the Company, County Bancshares, Inc. received proceeds of junior subordinated debt held by a trust that is funded by common securities, all of which were purchased by County Bancshares, Inc. and trust preferred securities in the amount of \$5.5 million that are held by other investors. Funds raised by the trust totaling \$5.7 million were loaned to County Bancshares, Inc. in the form of junior subordinated debt. This debt was transferred to the Company at the date of acquisition. In 2015, the Company purchased approximately \$4.1 million of the outstanding preferred securities, reducing the outstanding preferred securities to \$1.6 million. This debt is generally subordinated to other debt and deposits reflected on the consolidated balance sheets presented. The subordinated debt securities have a due date of April 7, 2035 and interest is payable quarterly.

The interest rate of the debt is equal to LIBOR, plus 2% and is reset quarterly. The rate of interest was 4.34% at September 30, 2018 and 3.36% at December 31, 2017. The Company has the right to redeem these debt securities in whole or from time to time in part, provided that all accrued and unpaid interest has been paid.

NOTE 11: RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Company, through the Bank, has and expects to continue to conduct routine banking business with related parties, including its executive officers and directors. Related parties also include stockholders, and their affiliates in which they directly or indirectly have 5% or more beneficial ownership in the Company.

Loans—In the opinion of management, loans to related parties were on substantially the same terms, including interest rates and collateral, as those prevailing at the time of comparable transactions with other persons and did not involve more than a normal risk of collectability or present any other unfavorable features to the Company. The Company had approximately \$200.5 million and \$205.8 million in loans to related parties at September 30, 2018 and December 31, 2017, respectively. As of September 30, 2018 and December 31, 2017, there were no loans made to related parties deemed nonaccrual, past due, restructured or classified as potential problem loans.

Unfunded Commitments—At September 30, 2018 and December 31, 2017, the Company had approximately \$75.0 million and \$69.7 million in unfunded loan commitments to related parties, respectively.

Deposits—The Company held related party deposits of approximately \$236.2 million and \$224.4 million at September 30, 2018 and December 31, 2017, respectively.

Advertising—The Company incurred advertising expenses of approximately \$0 and \$71,000 for the nine months ended September 30, 2018 and 2017, respectively, to a vendor that is solely owned by a director of the Company.

NOTE 12: FAIR VALUE DISCLOSURES

The Company uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction occurring in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability.

In estimating fair value, we use valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Such valuation techniques are consistently applied.

Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Valuation inputs are categorized in a three-level hierarchy, from highest to lowest level of observable inputs. The highest level of inputs are prices in active markets for identical assets or liabilities and the lowest level of inputs are unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs—Inputs are based upon unadjusted quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs—Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means. Level 2 investments consist primarily of obligations of U.S. government sponsored enterprises and agencies, obligations of state and municipal subdivisions, corporate bonds and mortgage-backed securities.

Level 3 Inputs—Significant unobservable inputs that reflect an entity's own assumptions that market participants would use in pricing the assets or liabilities.

During the nine months ending September 30, 2018 and the year ended December 31, 2017, there were no transfers of assets or liabilities within the levels of the fair value hierarchy.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use observable market-based parameters as inputs. Valuation adjustments may be made to ensure that assets and liabilities are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time.

The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to

determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Financial Instruments Recorded at Fair Value

Assets and liabilities measured at fair value on a recurring basis include the following:

Debt Securities Available for Sale: Debt securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For those debt securities classified as Level 2, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayments speeds, credit information and the bond's terms and conditions, among other things. The other securities in the table below are mutual funds and the fair value is determined by using unadjusted quoted market prices which are considered Level 1 inputs.

Interest Rate Swaps with Customers: For interest rate swaps with customers classified as Level 2, the Company obtains fair value measurements from an independent pricing service which uses the income approach. The income approach calls for the utilization of valuation techniques to convert future cash flows as due to be exchanged per the terms of the financial instrument, into a single present value amount. Measurement is based on the value indicated by the market expectations about those future amounts as of the measurement date. The proprietary curves of the independent pricing service utilize pricing models derived from industry standard analytic tools, considering both Level 1 and Level 2 inputs.

Interest Rate Swaps with Financial Institutions: For interest rate swaps with financial institutions classified as Level 2, the Company obtains fair value measurements from an independent pricing service which uses the income approach. The income approach calls for the utilization of valuation techniques to convert future cash flows as due to be exchanged per the terms of the financial instrument, into a single present value amount. Measurement is based on the value indicated by the market expectations about those future amounts as of the measurement date. The proprietary curves of the independent pricing service utilize pricing models derived from industry standard analytic tools, taking into account both Level 1 and Level 2 inputs.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis as of the dates shown below, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value.

(Dollars in thousands)	September 30, 2018	December 31, 2017
	Fair Value	Fair Value
Financial assets:		
Level 1 inputs:		
Debt securities available for sale		
Other securities	\$ 1,071	\$ 1,087
Level 2 inputs:		
Debt securities available for sale		
State and municipal securities	55,124	61,916
U.S. Agency Securities:		
Debt securities	16,687	16,945
Collateralized mortgage obligations	64,539	61,253
Mortgage-backed securities	85,041	81,974
Interest rate swaps with customers	7	340
Interest rate swaps with financial institutions	1,708	426
Total financial assets	\$ 224,177	\$ 223,941
Financial liabilities:		
Level 2 inputs:		
Interest rate swaps with customers	\$ 1,708	\$ 426
Interest rate swaps with financial institutions	7	340
Total financial liabilities	\$ 1,715	\$ 766

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis as they are subject to fair value adjustments in certain circumstances, such as evidence of impairment. Financial assets measured at fair value on a non-recurring basis during the reported periods include certain impaired loans reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Repossessed real estate and other assets as well as collateral values are estimated using Level 2 inputs based on observable market data, typically in the case of real estate collateral, or Level 3 inputs based on customized discounting criteria, typically in the case of non-real estate collateral such as inventory, accounts receivable, equipment or other business assets.

Certain assets measured at fair value on a non-recurring basis as of the dates shown below were as follows:

<u>(Dollars in thousands)</u>	<u>September 30, 2018</u> <u>Level 3</u> <u>Inputs</u>	<u>December 31, 2017</u> <u>Level 3</u> <u>Inputs</u>
Impaired loans:		
Commercial and industrial	\$ —	\$ 340
Commercial real estate	603	603
1-4 family residential	1,722	1,755
Other	8,205	—
Total impaired loans	\$ 10,530	\$ 2,698

Non-Financial Assets and Non-Financial Liabilities

The Company does not have any non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. Non-financial assets measured at fair value on a non-recurring basis during the reported periods include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in other non-interest expense. The fair value of a foreclosed asset is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. During the nine months ended September 30, 2018 and during 2017, we used Level 2 inputs for our fair value measurements for foreclosed assets.

Foreclosed assets that were remeasured subsequent to initial recognition and reported at fair value as of the dates shown below were as follows:

<u>(Dollars in thousands)</u>	<u>September 30,</u> <u>2018</u>	<u>December 31,</u> <u>2017</u>
Foreclosed assets remeasured at initial recognition:		
Carrying value of foreclosed assets prior to measurement	\$ 175	\$ 881
Charge-offs recognized in the allowance for loan losses	—	—
Fair value	<u>\$ 175</u>	<u>\$ 881</u>
Foreclosed assets remeasured subsequent to initial recognition:		
Carrying value of foreclosed assets prior to measurement	\$ —	\$ 227
Write-downs included in other noninterest expense	—	(51)
Fair value	<u>\$ —</u>	<u>\$ 176</u>

Fair Value Disclosure for all Financial Instruments

The Company is required to disclose the fair value of all financial instruments, including those financial assets and financial liabilities not recorded at fair value in its consolidated balance sheets, for which it is practicable to estimate fair value. The table below summarizes the fair market values and carrying amount of all financial instruments of the Company as of the dates shown below.

(Dollars in thousands)	September 30, 2018		December 31, 2017	
	Fair Value	Carrying Amount	Fair Value	Carrying Amount
Financial assets:				
Level 1 inputs:				
Cash and due from banks	\$ 51,980	\$ 51,980	\$ 59,255	\$ 59,255
Interest bearing deposits in banks	229,660	229,660	266,944	266,944
Debt securities available for sale	1,071	1,071	1,087	1,087
Level 2 inputs:				
Time deposits in other banks	—	—	600	600
Debt securities available for sale	221,391	221,391	222,088	222,088
Debt securities held to maturity	33	31	35	33
Bank-owned life insurance	71,070	71,070	68,010	68,010
Servicing asset	200	200	209	209
Accrued interest receivable	8,419	8,419	7,429	7,429
Interest rate swaps with customers	7	7	340	340
Interest rate swaps with financial institutions	1,708	1,708	426	426
Level 3 inputs:				
Equity investments	15,101	15,101	12,226	12,226
Loans, including held for sale, net	2,443,014	2,439,095	2,299,742	2,288,226
Total financial assets	\$ 3,043,654	\$ 3,039,733	\$ 2,938,391	\$ 2,926,873
Financial liabilities:				
Level 1 inputs:				
Noninterest-bearing deposits	\$ 1,144,985	\$ 1,144,985	\$ 1,109,789	\$ 1,109,789
Level 2 inputs:				
Interest-bearing deposits	1,474,684	1,545,095	1,437,013	1,493,183
Repurchase agreements	1,351	1,351	1,525	1,525
Federal Home Loan Bank advances	—	—	—	—
Junior subordinated debt	6,726	6,726	6,726	6,726
Accrued interest payable	555	555	374	374
Interest rate swaps with customers	1,708	1,708	426	426
Interest rate swaps with financial institutions	7	7	340	340
Total financial liabilities	\$ 2,630,016	\$ 2,700,427	\$ 2,556,193	\$ 2,612,363

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The fair value of loans is determined using a discounted cash flow analyses and includes such factors as credit and prepayment risk and economic forecasts for interest rates in accordance with ASU 2016-01.

Equity Investments— The Company has unconsolidated investments that are considered equity securities meaning they represent ownership interests (such as common or preferred stock). Our equity investments do not have readily determinable fair values and are shown in the table below for the dates indicated.

(Dollars in thousands)	September 30, 2018	December 31, 2017
Federal Reserve stock	\$ 9,271	\$ 9,271
Federal Home Loan Bank stock	3,294	1,189
The Independent Bankers Financial Corporation stock	141	141
Community Reinvestment Act investments	2,395	1,625
Total	\$ 15,101	\$ 12,226

Banks that are members of the FHLB, are required to maintain a stock investment in the FHLB calculated as a percentage of aggregate outstanding mortgages, outstanding FHLB advances and other financial instruments. Banks that are members of the Federal Reserve System are required to annually subscribe to Federal Reserve Bank stock in specific ratios to the Bank's equity. Although FHLB and Federal Reserve Bank Stock are considered equity securities, they do not have readily determinable fair values because ownership is restricted and they lack a market. These investments can be sold back only at their par value of \$100 per share and can only be sold to the Federal Home Loan Banks or Federal Reserve Banks or to another member institution. In addition, the equity ownership rights are more limited than would be the case for a public company, because of the oversight role exercised by regulators in the process of budgeting and approving dividends. As a result, these investments are carried at cost and evaluated for impairment.

The Company also holds an investment in the stock of The Independent Bankers Financial Corporation, or TIB. This investment has limited marketability. As a result, these investments are carried at cost and evaluated for impairment.

The Company has investments in two private investment funds and a limited partnership. These investments are qualified Community Reinvestment Act, or CRA, investments under the Small Business Investment Company program of the SBA. There are limited to no observable price changes in orderly transactions for identical investments or similar investments from the same issuers that are actively traded and as a result, these investments are stated at cost.

Our equity investments are evaluated for impairment based on an assessment of qualitative indicators. Impairment indicators to be considered include, but are not limited to (i) a significant deterioration in the earnings, performance, credit rating, asset quality or business prospects of the investee, (ii) a significant adverse change in the regulatory, economic or technological environment of the investee, (iii) a significant adverse change in the general market conditions of either the geographical area or the industry in which the investee operates, (iv) a bona fide offer to purchase, an offer by the investee to sell, or completed auction process for the same or similar investment for an amount less than the carrying amount of that investment. There were no such qualitative indicators as of September 30, 2018.

NOTE 13 COMMITMENTS AND CONTINGENCIES AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

Unfunded Loan Commitments

The Company is party to various financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit for loans in process, commercial lines of credit, overdraft protection lines, and standby letters of credit at both fixed and variable rates of interest. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of those instruments reflect the extent of the involvement the Company has in particular classes of financial instruments. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Company uses the same credit policies in making these commitments and conditional obligations as it does for on-balance-sheet instruments. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if considered necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer.

Commitments to extend credit and standby letters of credit as of the dates shown below were as follows:

<u>(Dollars in thousands)</u>	<u>September 30, 2018</u>	<u>December 31, 2017</u>
Commitments to extend credit, variable	\$ 737,355	\$ 626,441
Commitments to extend credit, fixed	93,007	61,608
	<u>\$ 830,362</u>	<u>\$ 688,049</u>
 Standby letters of credit	 <u>\$ 26,485</u>	 <u>\$ 28,977</u>

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being fully drawn upon, the total commitment amounts disclosed above do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to our customers.

Derivative Financial Instruments

The Company has outstanding interest rate swap contracts in which the Bank entered into an interest rate swap with a customer and entered into an offsetting interest rate swap with another financial institution at the same time. These interest rate swap contracts are not designated as hedging instruments for mitigating interest rate risk of the Bank. The objective of the transactions is to allow the Bank's customers to effectively convert a variable rate loan to a fixed rate.

In connection with each swap transaction, the Bank agrees to pay interest to the customer on a notional amount at a variable interest rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, the Bank agrees to pay a third-party financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. Because the Bank acts as an intermediary for its customer, changes in the fair value of the underlying derivative contracts are designed to offset each other and would not significantly impact the Company's operating results except in certain situations where there is a significant deterioration in the customer's credit worthiness or that of the counterparties. At September 30, 2018 and December 31, 2017, no such deterioration was determined by management.

At September 30, 2018 and December 31, 2017, the Company had 12 and 14 interest rate swap agreements outstanding with borrowers and financial institutions, respectively. These derivative instruments are not designated as accounting hedges and changes in the net fair value are recognized in noninterest income or expense. Fair value amounts are included in other assets and other liabilities. Derivative instruments outstanding as of as of the dates listed shown were as follows:

<u>(Dollars in thousands)</u>	<u>Classification</u>	<u>Notional Amounts</u>	<u>Fair Value</u>	<u>Fixed Rate</u>	<u>Floating Rate</u>	<u>Weighted Average Maturity</u>
September 30, 2018						
Interest rate swaps with customers	Other Assets	\$ 3,296	\$ 7	5.89% - 7.25%	LIBOR 1M + 3.00% - 3.20%	2.96 years
Interest rate swaps with financial institution	Other Assets	35,556	1,708	4.00% - 5.65%	LIBOR 1M + 2.50% - 3.25%	7.89 years
Interest rate swaps with customers	Other Liabilities	35,556	(1,708)	4.00% - 5.65%	LIBOR 1M + 2.50% - 3.25%	7.89 years
Interest rate swaps with financial institution	Other Liabilities	3,296	(7)	5.89% - 7.25%	LIBOR 1M + 3.00% - 3.20%	2.96 years
Total derivatives not designated as hedging instruments		<u>\$ 77,704</u>	<u>\$ —</u>			

<u>(Dollars in thousands)</u>	<u>Classification</u>	<u>Notional Amounts</u>	<u>Fair Value</u>	<u>Fixed Rate</u>	<u>Floating Rate</u>	<u>Weighted Average Maturity</u>
December 31, 2017						
Interest rate swaps with customers	Other Assets	\$ 25,882	\$ 340	4.75% - 7.25%	LIBOR 1M + 2.50% - 3.20%	7.83 years
Interest rate swaps with financial institution	Other Assets	16,579	426	4.00% - 5.15%	LIBOR 1M + 2.50% - 3.25%	8.12 years
Interest rate swaps with customers	Other Liabilities	16,579	(426)	4.00% - 5.15%	LIBOR 1M + 2.50% - 3.25%	8.12 years
Interest rate swaps with financial institution	Other Liabilities	25,882	(340)	4.75% - 7.25%	LIBOR 1M + 2.50% - 3.20%	7.83 years
Total derivatives not designated as hedging instruments		<u>\$ 84,922</u>	<u>\$ —</u>			

Repurchase Agreements

At September 30, 2018 and December 31, 2017, the Company had outstanding funds amounting to \$1.4 million and \$1.5 million respectively, received from the sale of securities that were sold under agreements to repurchase. Securities subject to the transfer of ownership under the repurchase agreements are included in pledged securities, and the carrying value of these securities is disclosed in Note 2. The Company transacts these repurchase agreements with its customers and pays interest rates on these funds according to the terms of each repurchase agreement.

Contingent Liabilities

The Company is committed to contribute capital into two private investment funds and a limited partnership under the Small Business Investment Company program of the SBA. At September 30, 2018 and December 31, 2017, the Company had \$3.0 million and \$3.8 million, respectively, in outstanding unfunded commitments to these funds which are subject to call. Cumulative capital contributions to these funds of \$2.4 million and \$1.6 million are included in other investments in the Company's condensed consolidated balance sheets at September 30, 2018 and December 31, 2017, respectively.

The Company is subject to claims and lawsuits which arise primarily in the ordinary course of business. Based on information presently available and advice received from legal counsel representing the Company, it is the opinion of management that the disposition or ultimate determination of such claims and lawsuits will not have a material adverse effect on the financial position or results of operations of the Company.

Lease Commitments

The Company leases several of its banking facilities under operating leases. Total rent expense for operating leases of premises and equipment was approximately \$1.4 million and \$1.4 million for the nine months ended September 30, 2018 and 2017, respectively, and is reflected in net occupancy expense on the condensed consolidated statements of income.

NOTE 14: EMPLOYEE BENEFIT PLANS AND DEFERRED COMPENSATION ARRANGEMENTS

Employee Benefit Plans

The Company maintains a 401(k) employee benefit plan in which substantially all employees that complete three months of service may participate. The Company, at its discretion, may match a portion of each employee's contribution. The Company, also at its discretion, may make additional contributions during the Plan year. For the nine months ended September 30, 2018 and 2017, the Company contributed \$1.4 million and \$1.3 million to the plan, respectively.

Executive Deferred Compensation Arrangements

The Company established an executive incentive compensation arrangement with several officers of the Bank, in which these officers are eligible for performance based incentive bonus compensation. As part of this compensation arrangement, the Company will contribute one-fourth of the incentive bonus amount into a deferred compensation account. The deferred amounts accrue a market rate of interest and are payable to the employees upon separation from the Bank provided the Plan's vesting arrangements have been met. At September 30, 2018 and December 31, 2017, the amount payable, including interest, for this deferred plan was approximately \$2.5 million and \$2.4 million respectively, and is included in other liabilities in the condensed consolidated balance sheets.

Salary Continuation Agreements

The Company entered into a salary continuation arrangement in 2008 with the Company's then President and CEO that calls for payments of \$100,000 per year for a period of 10 years commencing at age 65. Payments under the plan began during 2014. The Company's liability was approximately \$441,000 and \$503,000 at September 30, 2018 and December 31, 2017, respectively, determined using discounted cash flows and is included in other liabilities in the condensed consolidated balance sheets.

In October 2017, the Company entered into a salary continuation arrangement with the Company's President and CEO that calls for payments of \$200,000 per year payable for a period of 10 years commencing at age 70. Payments under the plan will begin in 2024. The Company's liability was approximately \$195,000 and \$32,000 at September 30, 2018 and December 31, 2017, determined using discounted cash flows and is included in other liabilities in the condensed consolidated balance sheets.

Change of Control Agreements

In 2017, the Company entered into employment agreements with certain executive officers. These agreements provide for severance benefits if we terminate the executive without cause or the executive resigns with good reason, as defined in the agreements. In addition, upon a change of control, as that term is defined in the agreements, these employees will be entitled to an aggregate amount estimated to be \$4.1 million at September 30, 2018, in accordance with the terms of their respective agreements. No compensation has been recorded to date as a change of control condition is not deemed probable.

VB Texas, Inc. and Vista Bank Texas entered into change of control and non-competition agreements with certain employees of VB Texas, Inc., who are now employees of the Bank. The Company's initial public offering completed November 10, 2017 triggered the change of control provisions of these agreement and we paid these employees an aggregate amount of \$2.5 million during the nine months ended September 30, 2018.

NOTE 15: STOCK-BASED COMPENSATION

The Company acquired a stock option plan which originated under VB Texas, Inc. as a part of a merger of the two companies. The options granted to employees must be exercised within 10 years from the date of grant and vesting schedules are determined on an individual basis. At the merger date, all outstanding options became fully vested and were converted to options of the Company's common stock at an exchange ratio equal to the acquisition exchange rate for common shares. No options were granted under this plan after October 24, 2016.

The Company also acquired a stock option plan that originated in May 2011 under VB Texas, Inc., or the 2011 Plan. At the merger date, all outstanding options became fully vested and were converted to options of the Company's common stock at an exchange ratio equal to the acquisition exchange rate for common shares. The 2011 Plan was terminated on August 7, 2017 and as of that date, there were no options outstanding under this plan.

In May 2014, the Company adopted the 2014 Stock Option Plan, or the 2014 Plan. The 2014 Plan was approved by the Company's shareholders and limits the number of shares that may be optioned to 1,127,200. The 2014 Plan provides that no options may be granted after May 20, 2024. Options granted under the 2014 Plan expire 10 years from the date of grant and become exercisable in installments over a period of one to five years, beginning on the first anniversary of the date of grant. At September 30, 2018, 959,200 options were available for future grant under the 2014 Plan.

On September 13, 2017, the Company's shareholders approved the Company's 2017 Omnibus Incentive Plan, or the 2017 Plan. The 2017 Plan authorizes the Company to grant options and restricted stock awards as well as various other types of stock-based and other awards that are not stock-based to eligible employees, consultants and non-employee directors up to an aggregate of 600,000 shares of common stock. At September 30, 2018, 368,920 share-based awards were available for future grant under the 2017 Plan.

Stock option activity for the periods shown below was as follows:

	For the Nine Months Ended September 30,			
	2018		2017	
(Dollars in thousands, except per share data)	Number of Shares Underlying Options	Weighted Average Exercise Price	Number of Shares Underlying Options	Weighted Average Exercise Price
Outstanding at beginning of period	260,322	\$ 16.00	248,314	\$ 12.80
Granted	—	\$ —	80,000	\$ 21.00
Forfeited	—	\$ —	(12,160)	\$ 11.24
Exercised	(25,400)	\$ 9.85	(1,000)	\$ 16.80
Outstanding at end of period	234,922	\$ 16.67	315,154	\$ 14.93

Cash received due to exercise of stock options during the nine months ended September 30, 2018 and 2017 was \$250,000 and \$17,000, respectively.

The following tables summarize our stock options as of the dates shown below.

Stock Options	September 30, 2018		
	Exercisable	Unvested	Outstanding
Number of shares underlying options	134,723	100,199	234,922
Weighted-average exercise price per share	\$ 14.54	\$ 19.53	\$ 16.67
Aggregate intrinsic value (in thousands)	\$ 2,829	\$ 1,605	\$ 4,433
Weighted-average contractual term (years)	5.5	8.0	6.6

Restricted stock activity for the periods shown below was as follows:

	For the Nine Months Ended September 30,			
	2018		2017	
(Dollars in thousands, except per share data)	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of period	212,580	\$ 26.71	—	\$ —
Granted	18,500	\$ 29.71	—	\$ —
Forfeited	—	\$ —	—	\$ —
Vested	—	\$ —	—	\$ —
Outstanding at end of period	231,080	\$ 26.95	—	\$ —

Restricted stock grants will vest over the service period in equal increments over a period of two to five years, beginning on the first anniversary of the date of grant. The market value of the Company's common stock at the date of grant is used as the estimate of fair value of restricted stock. The shares of the restricted stock are fully issued at the time of the grant and the grantee becomes the record owner of the restricted stock and has voting, dividend and other shareholder rights. The shares of restricted stock are non-transferable and subject to forfeiture until the restricted stock vests and any dividends with respect to the restricted stock are subject to the same restrictions, including the risk of forfeiture. At September 30, 2018, \$44,000 was accrued for dividends payable to restricted stock holders. These dividends will be paid upon vesting of the restricted stock.

The following tables summarizes our restricted stock awards as of the date shown below.

Restricted stock	September 30, 2018		
	Exercisable	Unvested	Outstanding
Number of shares underlying restricted stock	—	231,080	231,080
Weighted-average grant date fair value per share	\$ —	\$ 26.95	\$ 26.95
Aggregate intrinsic value (in thousands)	\$ —	\$ 8,213	\$ 8,213
Weighted-average contractual term (years)	—	3.9	3.9

Stock-based compensation expense is recognized in the condensed consolidated statements of income based on their fair values on the date of the grant. For the nine months ended September 30, 2018 and 2017, stock compensation expense was \$1.2 million and \$56,000, respectively. As of September 30, 2018, there was approximately \$5.4 million of total unrecognized compensation expense related to the stock-based compensation arrangements, which is expected to be recognized in the Company's consolidated statements of income over a weighted-average period of 3.8 years.

NOTE 16: REGULATORY MATTERS

Regulatory Capital

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Company and Bank's Common Equity Tier 1 capital includes common stock and related capital surplus, net of treasury stock, and retained earnings. In connection with the adoption of the Basel III Capital Rules, the Company and Bank elected to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. Common Equity Tier 1 for both the Company and Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities, and subject to transition provisions.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Company and Bank. The capital conservation buffer is designed to absorb losses during periods of economic stress and, as detailed above, effectively increases the minimum required risk-weighted capital ratios. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer and, if applicable, the countercyclical capital buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of the dates shown below for the Company and Bank.

(Dollars in thousands)	Actual		Minimum Capital Required for Capital Adequacy Purposes		Minimum Capital Required Basel III Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2018								
Common Equity Tier I to Risk-Weighted Assets:								
Consolidated	\$ 391,556	14.3%	\$ 123,271	4.5%	\$ 191,755	7.0%	N/A	N/A
Bank Only	\$ 350,337	12.8%	\$ 123,259	4.5%	\$ 182,549	7.0%	\$ 178,040	6.5%
Tier I Capital to Risk-Weighted Assets:								
Consolidated	\$ 397,956	14.5%	\$ 164,361	6.0%	\$ 232,845	8.5%	N/A	N/A
Bank Only	\$ 350,337	12.8%	\$ 164,345	6.0%	\$ 232,822	8.5%	\$ 219,126	8.0%
Total Capital to Risk-Weighted Assets:								
Consolidated	\$ 422,820	15.4%	\$ 219,148	8.0%	\$ 287,632	10.5%	N/A	N/A
Bank Only	\$ 375,202	13.7%	\$ 219,216	8.0%	\$ 287,604	10.5%	\$ 273,908	10.0%
Tier 1 Leverage Capital to Average Assets:								
Consolidated	\$ 397,956	12.8%	\$ 123,987	4.0%	\$ 123,987	4.0%	N/A	N/A
Bank Only	\$ 350,336	11.3%	\$ 123,987	4.0%	\$ 123,987	4.0%	\$ 154,983	5.0%
December 31, 2017								
Common Equity Tier I to Risk-Weighted Assets:								
Consolidated	\$ 361,322	14.2%	\$ 114,628	4.5%	\$ 178,310	7.0%	N/A	N/A
Bank Only	\$ 322,414	12.7%	\$ 114,252	4.5%	\$ 178,150	7.0%	\$ 165,425	6.5%
Tier I Capital to Risk-Weighted Assets:								
Consolidated	\$ 367,722	14.4%	\$ 152,837	6.0%	\$ 216,519	8.5%	N/A	N/A
Bank Only	\$ 322,414	12.7%	\$ 152,700	6.0%	\$ 216,325	8.5%	\$ 203,600	8.0%
Total Capital to Risk-Weighted Assets:								
Consolidated	\$ 392,878	15.4%	\$ 203,782	8.0%	\$ 267,464	10.5%	N/A	N/A
Bank Only	\$ 347,569	13.7%	\$ 203,600	8.0%	\$ 267,726	10.5%	\$ 254,501	10.0%
Tier 1 Leverage Capital to Average Assets:								
Consolidated	\$ 367,722	12.3%	\$ 119,769	4.0%	\$ 119,769	4.0%	N/A	N/A
Bank Only	\$ 322,414	10.8%	\$ 119,403	4.0%	\$ 119,403	4.0%	\$ 149,253	5.0%

As of September 30, 2018 and December 31, 2017, the Company and its bank subsidiary, CommunityBank of Texas, National Association, were “well capitalized” based on the ratios presented above.

The Company and Bank are subject to the regulatory capital requirements administered by the Federal Reserve Board and, for the Bank, the OCC. Regulatory authorities can initiate certain mandatory actions if the Company or the Bank fail to meet the minimum capital requirements, which could have a direct material effect on our financial statements. Management believes, as of September 30, 2018 and December 31, 2017, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

Dividend Restrictions

In the ordinary course of business, the Company may be dependent upon dividends from the Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends

declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years.

NOTE 17: INCOME TAXES

The provision for income tax expense and effective tax rates for the periods shown below were as follows:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Provision for income tax expense	\$ 3,207	\$ 3,927	\$ 7,984	\$ 10,140
Effective tax rate	19.8 %	28.1 %	19.4 %	28.4 %

The Tax Cuts and Jobs Act of 2017 was enacted December 22, 2017 and lowered the corporate federal income tax rate in the U.S. from 35% to 21%. The differences between the federal statutory rate and the effective tax rates presented in the table above were primarily attributable to permanent differences primarily related to tax exempt interest and bank-owned life insurance.

NOTE 18: EARNINGS PER SHARE

Basic earnings per common share is computed as net income available to common shareholders divided by the weighted-average number of common shares outstanding during the period.

Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock using the treasury stock method.

The following table illustrates the computation of basic and diluted earnings per share for the dates shown below.

(Dollars in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income for common shareholders	\$ 13,023	\$ 10,047	\$ 33,177	\$ 25,614
Weighted-average shares (thousands)				
Basic weighted-average shares outstanding	24,859	22,063	24,850	22,062
Dilutive effect of outstanding stock options and unvested restricted stock awards	201	75	157	82
Diluted weighted-average shares outstanding	25,060	22,138	25,007	22,144
Earnings per share:				
Basic	\$ 0.52	\$ 0.46	\$ 1.34	\$ 1.16
Diluted	\$ 0.52	\$ 0.45	\$ 1.33	\$ 1.16

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and the accompanying notes included in Item I of Part I of this Quarterly Report on Form 10-Q, as well as our consolidated financial statements and the accompanying notes for the year ended December 31, 2017, included in our Annual Report on Form 10-K. In this Quarterly Report on Form 10-Q, unless otherwise indicated or the context otherwise requires, all references to “we,” “our,” “us,” “ourselves,” and “the Company” refer to CBTX, Inc., a Texas corporation, and its consolidated subsidiaries. All references in this Quarterly Report on Form 10-Q to “CommunityBank of Texas” or “the Bank” refer to CommunityBank of Texas, National Association, our wholly-owned bank subsidiary.

Cautionary Note Regarding Forward-looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements. These forward-looking statements reflect our current views with respect to, among other things, future events and our financial performance. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “continue,” “will,” “anticipate,” “seek,” “estimate,” “intend,” “plan,” “projection,” “would” and “outlook,” or the negative version of those words or other comparable words or phrases of a future or forward-looking nature. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about our industry, management’s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, we caution you that any such forward-looking statements are not guarantees of future performance and are subject to risks, assumptions and uncertainties that are difficult to predict. Although we believe that the expectations reflected in these forward-looking statements are reasonable as of the date made, actual results may prove to be materially different from the results expressed or implied by the forward-looking statements.

There are or will be important factors that could cause our actual results to differ materially from those indicated in these forward-looking statements, including, but not limited to, the risks described in Part I — Item 1A. — Risk Factors in our Annual Report on Form 10-K and the following:

- natural disasters and adverse weather, acts of terrorism, an outbreak of hostilities or other international or domestic calamities, and other matters beyond our control;
- the geographic concentration of our markets in Beaumont and Houston, Texas;
- our ability to prudently manage our growth and execute our strategy;
- risks associated with our acquisition and *de novo* branching strategy;
- changes in management personnel;
- the amount of nonperforming and classified assets that we hold;
- time and effort necessary to resolve nonperforming assets;
- deterioration of our asset quality;
- interest rate risk associated with our business;
- business and economic conditions generally and in the financial services industry, nationally and within our primary markets;
- volatility and direction of oil prices and the strength of the energy industry, generally and within Texas;
- the composition of our loan portfolio, including the identity of our borrowers and the concentration of loans in specialized industries;
- changes in the value of collateral securing our loans;
- our ability to maintain important deposit customer relationships and our reputation;
- our ability to maintain effective internal control over financial reporting;

- operational risks associated with our business;
- increased competition in the financial services industry, particularly from regional and national institutions;
- volatility and direction of market interest rates;
- liquidity risks associated with our business;
- systems failures or interruptions involving our information technology and telecommunications systems or third-party servicers;
- interruptions or breaches in the Company's information system security;
- the failure of certain third-party vendors to perform;
- environmental liability associated with our lending activities;
- the institution and outcome of litigation and other legal proceedings against us or to which we may become subject;
- changes in the laws, rules, regulations, interpretations or policies relating to financial institution, accounting, tax, trade, monetary and fiscal matters;
- further government intervention in the U.S. financial system; and
- other factors that are discussed in the section to this Quarterly Report on Form 10-Q entitled "Risk Factors".

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this Quarterly Report on Form 10-Q. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate. Accordingly, you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made, and we do not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise. New factors emerge from time to time, and it is not possible for us to predict which will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Overview

We are a bank holding company that operates through our wholly-owned subsidiary, CommunityBank of Texas National Association, in Houston and Beaumont/East Texas market areas. As of September 30, 2018, we had consolidated total assets of \$3.2 billion, total loans of \$2.4 billion, total deposits of \$2.7 billion and total shareholders' equity of \$471.9 million.

The following discussion and analysis present our financial condition and results of operations on a consolidated basis. However, because we conduct our material business operations through CommunityBank of Texas, National Association, the discussion and analysis relate to activities primarily conducted by the Bank. As a bank holding company that operates through one segment, community banking, we generate most of our revenue from interest on loans and investments. We incur interest expense on deposits and other borrowed funds, as well as noninterest expense, such as salaries and employee benefits and occupancy expenses.

Changes in market interest rates and the interest rates we earn on interest-earning assets or pay on interest-bearing liabilities, as well as in the volume and types of interest-earning assets, interest-bearing and noninterest-bearing liabilities, are usually the largest drivers of periodic changes in net interest spread, net interest margin and net interest income. Fluctuations in market interest rates are driven by many factors, including governmental monetary policies, inflation, deflation, macroeconomic developments, changes in unemployment, the money supply, political and international conditions and conditions in domestic and foreign financial markets. Periodic changes in the volume and types of loans in our loan portfolio are affected by, among other factors, economic and competitive conditions in Texas, as well as developments affecting the real estate, technology, financial services, insurance, transportation, manufacturing and energy sectors within our target markets and throughout the state of Texas.

Results of Operations

Net income for the nine months ended September 30, 2018 was \$33.2 million compared to \$25.6 million for nine months ended September 30, 2017, an increase of \$7.6 million, or 29.5%. This increase is primarily due to a \$11.8 million increase in net interest income and a \$2.2 million decrease in income taxes offset by a \$1.8 million increase in provision (recapture) for loan losses and a \$4.0 million increase in noninterest expense. Net income for the three months ended September 30, 2018 was \$13.0 million compared to \$10.0 million for three months ended September 30, 2017, an increase of \$3.0 million, or 29.6%. This increase is primarily due to a \$4.3 million increase in net interest income and a \$720,000 decrease in income taxes offset by a \$512,000 increase in provision (recapture) for loan losses and a \$947,000 increase in noninterest expense. See further analysis of these fluctuations in the related discussions that follow.

(Dollars in thousands, except per share data)	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	Increase (Decrease)		2018	2017	Increase (Decrease)	
Interest income	\$ 34,665	\$ 29,569	\$ 5,096	17.2 %	\$ 98,877	\$ 86,293	\$ 12,584	14.6 %
Interest expense	3,139	2,318	821	35.4 %	7,436	6,684	752	11.3 %
Net interest income	31,526	27,251	4,275	15.7 %	91,441	79,609	11,832	14.9 %
Provision (recapture) for loan losses	(1,142)	(1,654)	512	(31.0)%	413	(1,388)	1,801	(129.8)%
Noninterest income	3,526	4,086	(560)	(13.7)%	10,393	11,060	(667)	(6.0)%
Noninterest expense	19,964	19,017	947	5.0 %	60,260	56,303	3,957	7.0 %
Income before income taxes	16,230	13,974	2,256	16.1 %	41,161	35,754	5,407	15.1 %
Income tax expense	3,207	3,927	(720)	(18.3)%	7,984	10,140	(2,156)	(21.3)%
Net income	\$ 13,023	\$ 10,047	\$ 2,976	29.6 %	\$ 33,177	\$ 25,614	\$ 7,563	29.5 %
Earnings per share - Basic	\$ 0.52	\$ 0.46	\$ 0.06		\$ 1.34	\$ 1.16	\$ 0.18	
Earnings per share - Diluted	0.52	0.45	0.07		1.33	1.16	0.17	

Net Interest Income for the Nine Months Ended September 30, 2018 Compared to the Nine Months Ended September 30, 2017.

Net interest income for the nine months ended September 30, 2018 was \$91.4 million compared to \$79.6 million for nine months ended September 30, 2017, an increase of \$11.8 million, or 14.9%. For the nine months ended September 30, 2018, net interest margin and net interest spread were 4.29% and 3.98%, respectively, compared to 3.97% and 3.72% for the nine months ended September 30, 2017. The increase in the interest margin and net interest spread is primarily attributed to the increase of average loans and increased average yields on loans and federal funds sold, partially offset by increased rates on interest-bearing deposits. Changes in rates paid on interest-bearing deposits for the nine months ended September 30, 2018 reduced the net interest margin by \$1.4 million as compared to the nine months ended September 30, 2017.

Tax equivalent net interest margin, which is defined as net interest income adjusted for tax-free income divided by average interest-earning assets, was 4.32% for the nine months ended September 30, 2018 and 4.05% for the nine months ended September 30, 2017. Tax equivalent adjustments to net interest margin are the result of increasing income from tax-free securities and loans by an amount equal to the taxes that would have been paid if the income were fully taxable based on a federal tax rate applicable to the periods indicated, thus making tax-exempt yields comparable to taxable asset yields.

The following tables present, for the periods indicated, average outstanding balances for each major category of interest-earning assets and interest-bearing liabilities, the interest income or interest expense and the average yield or rate on an annualized basis. Any nonaccrual loans have been included in the tables as loans carrying a zero yield.

(Dollars in thousands)	For the Nine Months Ended September 30,					
	2018			2017		
	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate
Assets						
Interest-earnings assets:						
Total loans ⁽¹⁾	\$ 2,366,714	\$ 90,468	5.11 %	\$ 2,190,975	\$ 79,642	4.86 %
Debt securities	227,552	4,478	2.63 %	220,396	3,990	2.42 %
Federal funds sold and other interest-earning assets	242,529	3,334	1.84 %	257,628	2,110	1.10 %
Nonmarketable equity securities	15,449	597	5.17 %	14,690	551	5.01 %
Total interest-earning assets	2,852,244	\$ 98,877	4.63 %	2,683,689	\$ 86,293	4.30 %
Allowance for loan losses	(25,318)			(25,719)		
Noninterest-earnings assets	289,391			280,139		
Total assets	\$ 3,116,317			\$ 2,938,109		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing deposits	\$ 1,499,925	\$ 7,035	0.63 %	\$ 1,497,845	\$ 5,659	0.51 %
Repurchase agreements	1,492	3	0.27 %	2,409	5	0.28 %
FHLB advances	4,487	73	2.18 %	—	—	— %
Note payable	—	11	— %	25,841	784	4.06 %
Junior subordinated debt	10,826	314	3.88 %	10,826	236	2.91 %
Total interest-bearing liabilities	1,516,730	\$ 7,436	0.66 %	1,536,921	\$ 6,684	0.58 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	1,118,408			1,012,952		
Other liabilities	21,744			18,080		
Total noninterest-bearing liabilities	1,140,152			1,031,032		
Shareholders' equity	459,435			370,156		
Total liabilities and shareholders' equity	\$ 3,116,317			\$ 2,938,109		
Net interest income		\$ 91,441			\$ 79,609	
Net interest spread ⁽²⁾			3.98 %			3.72 %
Net interest margin ⁽³⁾			4.29 %			3.97 %
Net interest margin—tax equivalent ⁽⁴⁾			4.32 %			4.05 %

(1) Includes average outstanding balances of loans held for sale of \$571,000 and \$853,000 for the nine months ended September 30, 2018 and 2017, respectively.

(2) Net interest spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.

(3) Net interest margin is equal to net interest income divided by average interest-earning assets.

(4) A tax equivalent adjustment of \$798,000 and \$1.8 million for the nine months ended September 30, 2018 and 2017, respectively, was computed using a federal income tax rate of 21% for 2018 and 35% for 2017.

The following tables present information regarding changes in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and changes attributable to changes in interest rates. For purposes of these tables, changes attributable to both rate and volume that cannot be segregated have been allocated to rate.

(Dollars in thousands)	For the Nine Months Ended		
	September 30, 2018 Compared to 2017		
	Increase (Decrease) due to		Total
Volume	Rate		
Interest-earning assets:			
Total loans	\$ 6,388	\$ 4,438	\$ 10,826
Debt securities	130	358	488
Federal funds sold and other interest-earning assets	(124)	1,348	1,224
Nonmarketable equity securities	28	18	46
Total increase in interest income	6,422	6,162	12,584
Interest-bearing liabilities:			
Interest-bearing deposits	8	1,368	1,376
Repurchase agreements	(2)	—	(2)
FHLB advances	73	—	73
Note payable	(773)	—	(773)
Junior subordinated debt	—	78	78
Total increase (decrease) in interest expense	(694)	1,446	752
Increase in net interest income	\$ 7,116	\$ 4,716	\$ 11,832

Net Interest Income for the Three Months Ended September 30, 2018 Compared to the Three Months Ended September 30, 2017.

Net interest income for the three months ended September 30, 2018 was \$31.5 million compared to \$27.3 million for three months ended September 30, 2017, an increase of \$4.3 million, or 15.7%. For three months ended September 30, 2018, net interest margin and net interest spread were 4.28% and 3.90%, respectively, compared to 3.98% and 3.73% for the three months ended September 30, 2017. The increase in the interest margin and net interest spread is primarily attributed to the increase in the average loans and increased average yields on loans and federal funds sold, partially offset by increased rates on interest-bearing deposits. Changes in rates paid on interest-bearing deposits for the three months ended September 30, 2018 reduced the net interest margin by \$960,000 as compared to the three months ended September 30, 2017.

Tax equivalent net interest margin, which is defined as net interest income adjusted for tax-free income divided by average interest-earning assets, was 4.31% for the three months ended September 30, 2018 and 4.07% for the three months ended September 30, 2017. Tax equivalent adjustments to net interest margin are the result of increasing income from tax-free securities and loans by an amount equal to the taxes that would have been paid if the income were fully taxable based on a federal tax rate applicable to the periods indicated, thus making tax-exempt yields comparable to taxable asset yields.

	For the Three Months Ended September 30,					
	2018			2017		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/Interest Paid	Average Yield/Rate	Average Outstanding Balance	Interest Earned/Interest Paid	Average Yield/Rate
Assets						
Interest-earnings assets:						
Total loans ⁽¹⁾	\$ 2,404,491	\$ 31,513	5.20 %	\$ 2,191,016	\$ 27,129	4.91 %
Securities	230,592	1,535	2.64 %	223,132	1,334	2.37 %
Federal funds sold and other interest-earning assets	272,739	1,404	2.04 %	284,334	927	1.29 %
Nonmarketable equity securities	16,799	213	5.01 %	14,695	179	4.83 %
Total interest-earning assets	2,924,621	\$ 34,665	4.70 %	2,713,177	\$ 29,569	4.32 %
Allowance for loan losses	(25,689)			(25,316)		
Noninterest-earnings assets	292,598			290,767		
Total assets	\$ 3,191,530			\$ 2,978,628		
Liabilities and Shareholders' Equity						
Interest-bearing liabilities:						
Interest-bearing deposits	\$ 1,530,077	\$ 2,961	0.77 %	\$ 1,501,732	\$ 1,964	0.52 %
Repurchase agreements	1,516	1	0.26 %	2,404	2	0.33 %
FHLB advances	11,141	61	2.17 %	—	—	— %
Note payable	—	4	— %	24,742	269	4.31 %
Junior subordinated debt	10,826	112	4.14 %	10,826	83	3.04 %
Total interest-bearing liabilities	1,553,560	\$ 3,139	0.80 %	1,539,704	\$ 2,318	0.60 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	1,145,516			1,041,731		
Other liabilities	23,600			18,844		
Total noninterest-bearing liabilities	1,169,116			1,060,575		
Shareholders' equity	468,854			378,349		
Total liabilities and shareholders' equity	\$ 3,191,530			\$ 2,978,628		
Net interest income		\$ 31,526			\$ 27,251	
Net interest rate spread ⁽²⁾			3.90 %			3.73 %
Net interest margin ⁽³⁾			4.28 %			3.98 %
Net interest margin—tax equivalent ⁽⁴⁾			4.31 %			4.07 %

(1) Includes average outstanding balances of loans held for sale of \$741,000 and \$1.1 million for the three months ended September 30, 2018 and 2017, respectively.

(2) Net interest spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.

(3) Net interest margin is equal to net interest income divided by average interest-earning assets.

(4) A tax equivalent adjustment of \$261,000 and \$1.1 million for the three months ended September 30, 2018 and 2017, respectively, was computed using a federal income tax rate of 21% for 2018 and 35% for 2017.

The following tables present information regarding changes in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and changes attributable to changes in interest rates. For purposes of these tables, changes attributable to both rate and volume that cannot be segregated have been allocated to rate.

(Dollars in thousands)	For the Three Months Ended September 30, 2018 Compared to 2017		
	Increase (Decrease) due to		
	Volume	Rate	Total
Interest-earning assets:			
Total loans	\$ 2,643	\$ 1,741	\$ 4,384
Debt securities	45	156	201
Federal funds sold and other interest-earning assets	(38)	515	477
Nonmarketable equity securities	26	8	34
Total increase in interest income	<u>2,676</u>	<u>2,420</u>	<u>5,096</u>
Interest-bearing liabilities:			
Interest-bearing deposits	37	960	997
Repurchase agreements	(1)	—	(1)
FHLB advances	61	—	61
Note payable	(265)	—	(265)
Junior subordinated debt	—	29	29
Total increase (decrease) in interest expense	<u>(168)</u>	<u>989</u>	<u>821</u>
Increase in net interest income	<u>\$ 2,844</u>	<u>\$ 1,431</u>	<u>\$ 4,275</u>

Provision for Loan Losses

The provision for loan losses is an expense we use to maintain an allowance for loan losses at a level which is deemed appropriate by management to absorb inherent losses on existing loans. For a description of the factors considered by our management in determining the allowance for loan losses see “—Financial Condition—Allowance for Loan Losses.” The provision for loan losses for the nine months ended September 30, 2018 was \$413,000, compared to a \$1.4 million recapture for the nine months ended September 30, 2017 and \$1.1 million recapture for the three months ended September 30, 2018, compared to a \$1.7 million recapture for the three months ended September 30, 2017. The recaptures during the three and nine months ended September 30, 2017, were primarily the result of pay-offs of certain classified and problem loans, which resulted in the reversal of their related allowance for loan losses. The recapture during the three months ended September 30, 2018, was driven by strong credit quality, improved national and local economic trends, continuing low nonperforming and impaired loans and minimal charge off history. See further discussion of our allowance for loan losses and the factors considered in “— Financial Condition”.

Noninterest Income

Our primary sources of recurring noninterest income are deposit account service charges, gains on the sale of assets, card interchange fees and earnings on bank-owned life insurance. Noninterest income does not include loan origination fees to the extent they exceed the direct loan origination costs, which are generally recognized over the life of the related loan as an adjustment to yield using the interest method.

For the nine months ended September 30, 2018, noninterest income totaled \$10.4 million, a decrease of \$667,000, or 6.0%, compared to \$11.1 million for the nine months ended September 30, 2017, primarily due to lower net gains on sales of assets during 2018, partially offset by increases in card interchange fees and earnings on bank-owned life insurance. Noninterest income totaled \$3.5 million for the three months ended September 30, 2018 and totaled \$4.1 million for the three months ended September 30, 2017. The decrease of \$560,000, between the quarterly period was primarily due to lower net gains on sales of assets during the 2018 quarter.

The major categories of noninterest income for the periods indicated were as follows:

(Dollars in thousands)	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	Increase (Decrease)		2018	2017	Increase (Decrease)	
Noninterest income:								
Deposit account service charges	\$ 1,597	\$ 1,395	\$ 202	14.5 %	\$ 4,572	\$ 4,412	\$ 160	3.6 %
Net gain on sale of assets	152	828	(676)	(81.6)%	492	1,531	(1,039)	(67.9)%
Card interchange fees	922	803	119	14.8 %	2,820	2,512	308	12.3 %
Earnings on bank-owned life insurance	443	459	(16)	(3.5)%	1,359	1,120	239	21.3 %
Other	412	601	(189)	(31.4)%	1,150	1,485	(335)	(22.6)%
Total noninterest income	<u>\$ 3,526</u>	<u>\$ 4,086</u>	<u>\$ (560)</u>	(13.7)%	<u>\$ 10,393</u>	<u>\$ 11,060</u>	<u>\$ (667)</u>	(6.0)%

Net Gain on Sale of Assets. Net gain on sale of assets consists of the gains associated with the sale of fixed assets, loans and OREO. Net gain on sale of assets decreased \$1.0 million, or 67.9%, for the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017 and decreased \$676,000, or 81.6%, from the three months ended September 30, 2017 to the same period in 2018, primarily due to gains on sales of two branches in the third quarter of 2017.

Earnings on bank-owned life insurance. The Company has purchased life insurance policies on certain employees, which are carried on the condensed consolidated balance sheet at their cash surrender value. Changes in the cash surrender value of the policies are recorded in noninterest income. Earnings on bank-owned life insurance increased \$239,000 during the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017.

Noninterest Expense

Generally, noninterest expense is composed of employee expenses and costs associated with operating our facilities, obtaining and retaining customer relationships and providing bank services. The largest component of noninterest expense is salaries and employee benefits. Noninterest expense also includes operational expenses, such as occupancy expenses, depreciation and amortization of our facilities and our furniture, fixtures and office equipment, professional and director fees, regulatory fees, including FDIC assessments, data processing expenses, printing and office supplies, amortization of intangibles, and advertising and marketing expenses.

For the nine months ended September 30, 2018, noninterest expense totaled \$60.3 million, an increase of \$4.0 million, or 7.0%, compared to \$56.3 million for the nine months ended September 30, 2017. For the three months ended September 30, 2018, noninterest expense totaled \$20.0 million, an increase of \$947,000, or 5.0%, compared to \$19.0 million for the three months ended September 30, 2017. The increase in noninterest expense from 2017 to 2018 is largely due to increases in salaries and employee benefits during 2018.

The major categories of noninterest expense for the periods indicated were as follows:

(Dollars in thousands)	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	Increase (Decrease)		2018	2017	Increase (Decrease)	
Noninterest expense:								
Salaries and employee benefits	\$ 12,499	\$ 11,829	\$ 670	5.7 %	\$ 37,690	\$ 34,552	\$ 3,138	9.1 %
Net occupancy expense	2,428	2,221	207	9.3 %	7,126	6,805	321	4.7 %
Regulatory fees	488	458	30	6.6 %	1,546	1,689	(143)	(8.5)%
Data processing	664	662	2	0.3 %	2,013	1,955	58	3.0 %
Printing, stationery and office	503	348	155	44.5 %	1,394	1,065	329	30.9 %
Amortization of intangibles	245	267	(22)	(8.2)%	748	816	(68)	(8.3)%
Professional and director fees	809	606	203	33.5 %	2,414	1,937	477	24.6 %
Correspondent bank and customer related expense	66	67	(1)	(1.5)%	201	219	(18)	(8.2)%
Loan processing	102	115	(13)	(11.3)%	295	320	(25)	(7.8)%
Advertising, marketing and business development	437	266	171	64.3 %	1,418	953	465	48.8 %
Repossessed real estate and other assets	3	340	(337)	(99.1)%	65	543	(478)	(88.0)%
Security and protection expense	346	331	15	4.5 %	959	1,055	(96)	(9.1)%
Telephone and communications	342	311	31	10.0 %	1,122	972	150	15.4 %
Other expense	1,032	1,196	(164)	(13.7)%	3,269	3,422	(153)	(4.5)%
	\$	\$			\$	\$		
Total noninterest expense	<u>19,964</u>	<u>19,017</u>	<u>\$ 947</u>	5.0 %	<u>60,260</u>	<u>56,303</u>	<u>\$ 3,957</u>	7.0 %

Salaries and Employee Benefits. Salaries and employee benefits are the largest component of noninterest expense and include payroll expense, the cost of incentive compensation, benefit plans, health insurance and payroll taxes. Salaries and employee benefits increased \$3.1 million, or 9.1%, during the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017 and \$670,000, or 5.7% during the three months ended September 30, 2018 compared to the three months ended September 30, 2017. These increases were primarily due to increases in salaries and incentive compensation, health insurance premiums and stock compensation expense.

Net Occupancy Expense. Net occupancy expense includes rent, lease expenses, depreciation and other related costs. Net occupancy expense increased \$321,000 during the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017 and \$207,000 during the three months ended September 30, 2018 as compared to the three months ended September 30, 2017. Although we sold two branches in the third quarter of 2017, costs for repairs and maintenance and other costs related to occupancy increased in 2018.

Professional and Director Fees. Professional and director fees, which include legal, audit, loan review and consulting fees, were \$2.4 million and \$1.9 million for the nine months ended September 30, 2018 and 2017, respectively. The increase of \$477,000 was primarily due to an increase in audit and consulting fees.

Advertising, Marketing and Business Development. Advertising, marketing and business development expenses were \$1.4 million and \$953,000 for the nine months ended September 30, 2018 and 2017, respectively. The increase was primarily due to an increase in media costs associated with the Company's branding campaign that began early in the second quarter of 2017 and continued into 2018.

Repossessed Real Estate and Other Assets. Costs related to repossessed real estate and other assets decreased \$478,000, or 88.0% during the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017 and \$337,000, or 99.1%, during the three months ended September 30, 2018 as compared to the three months ended September 30, 2017. These decreases were due to a reduction in the number of repossessed and other assets in 2018 as compared to 2017 and a resulting decrease in related costs.

Income Tax Expense

The amount of income tax expense we incur is impacted by the amounts of our pre-tax income, tax-exempt income and other nondeductible expenses. Deferred tax assets and liabilities are reflected at current income tax rates in effect for the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

For the nine months ended September 30, 2018 and 2017, our effective tax rate was 19.4% and 28.4% and for the three months ended September 30, 2018 and 2017, our effective tax rate was 19.8% and 28.1%, respectively. The Tax Cuts and Jobs Act of 2017 was effective January 1, 2018 and lowered the corporate federal income tax rate in the U.S. from 35% to 21%.

Financial Condition

Total assets were \$3.2 billion as of September 30, 2018, compared to \$3.1 billion as of December 31, 2017, an increase of \$109.4 million, or 3.5%, due primarily to an increase in loans of \$151.8 million, partially offset by a \$44.6 million decrease in cash and cash equivalents. See further analysis in the related discussions that follow.

Loan Portfolio

As of September 30, 2018, gross loans were \$2.5 billion, an increase of \$151.8 million, or 6.6%, compared to \$2.3 billion at December 31, 2017. Our loans grew from December 31, 2017 to September 30, 2018 due to organic growth, needs of existing customers and demand.

Our portfolio by loan class as of the dates indicated was as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017	Increase (Decrease)	
Commercial and industrial	\$ 569,334	\$ 559,363	\$ 9,971	1.8 %
Real estate:				
Commercial real estate	776,439	738,293	38,146	5.2 %
Construction and development	487,289	449,211	38,078	8.5 %
1-4 family residential	288,737	258,584	30,153	11.7 %
Multi-family residential	236,907	220,305	16,602	7.5 %
Consumer	39,807	40,433	(626)	(1.6)%
Agricultural	11,609	11,256	353	3.1 %
Other	59,484	40,344	19,140	47.4 %
Gross loans	2,469,606	2,317,789	151,817	6.6 %
Less deferred fees and unearned discount	6,025	4,785	1,240	
Less loans held for sale	384	1,460	(1,076)	
Total loans	<u>\$ 2,463,197</u>	<u>2,311,544</u>	<u>\$ 151,653</u>	
Loans as a percentage of deposits	91.6%	88.8%		
Loans as a percentage of total assets	77.2%	75.0%		

The contractual maturity ranges of loans in our loan portfolio and the amount of such loans with fixed and variable interest rates in each maturity range as of the dates indicated were as follows:

(Dollars in thousands)	1 Year or Less	1 Year Through 5 Years	After 5 Years	Total
September 30, 2018				
Commercial and industrial	\$ 287,695	\$ 242,713	\$ 38,926	\$ 569,334
Real estate:				
Commercial real estate	111,541	459,866	205,032	776,439
Construction and development	127,037	315,017	45,235	487,289
1-4 family residential	18,188	47,074	223,475	288,737
Multi-family residential	22,235	30,902	183,770	236,907
Consumer	25,035	14,672	100	39,807
Agricultural	10,250	1,359	—	11,609
Other	24,534	33,173	1,777	59,484
Total loans	\$ 626,515	\$ 1,144,776	\$ 698,315	\$ 2,469,606
Fixed rate loans	\$ 188,457	\$ 622,197	\$ 306,117	\$ 1,116,771
Variable rate loans	438,058	522,579	392,198	1,352,835

(Dollars in thousands)	1 Year or Less	1 Year Through 5 Years	After 5 Years	Total
December 31, 2017				
Commercial and industrial	\$ 324,434	\$ 183,915	\$ 51,014	\$ 559,363
Real estate:				
Commercial real estate	109,920	434,390	193,983	738,293
Construction and development	149,227	234,783	65,201	449,211
1-4 family residential	19,332	48,563	190,689	258,584
Multi-family residential	56,855	25,229	138,221	220,305
Consumer	25,169	14,652	612	40,433
Agricultural	9,820	1,436	—	11,256
Other	24,694	13,870	1,780	40,344
Total loans	\$ 719,451	\$ 956,838	\$ 641,500	\$ 2,317,789
Fixed rate loans	\$ 212,052	\$ 566,321	\$ 252,419	\$ 1,030,792
Variable rate loans	507,399	390,517	389,081	1,286,997

Nonperforming Assets

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status whether or not such loans are considered past due. In general, we place loans on nonaccrual status when they become 90 days past due. We also place loans on nonaccrual status if they are less than 90 days past due if the collection of principal or interest is in doubt. When interest accrual is discontinued, all unpaid accrued interest is reversed from income. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are, in management's opinion, reasonably assured.

The components of nonperforming assets as of the dates indicated were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Nonaccrual loans by category:		
Commercial and industrial	\$ 2,161	\$ 3,280
Real estate:		
Commercial real estate	2,751	3,216
Construction and development	13	252
1-4 family residential	677	898
Consumer	—	—
Total nonaccrual loans	5,602	7,646
Accruing loans 90 or more days past due	—	—
Total nonperforming loans	5,602	7,646
Foreclosed assets, including other real estate:		
Commercial real estate, construction and development, land and land development	175	298
Residential real estate	—	407
Total foreclosed assets	175	705
Total nonperforming assets	\$ 5,777	\$ 8,351
Nonperforming loans to total loans	0.23 %	0.33 %
Nonperforming assets to total assets	0.18 %	0.27 %

Potential Problem Loans

From a credit risk standpoint, we classify loans in one of five categories: pass, special mention, substandard, doubtful or loss. Within the pass category, we classify loans into one of the following three subcategories based on perceived credit risk, including repayment capacity and collateral security: high quality, good and satisfactory. The classifications of loans reflect a judgment about the risks of default and loss associated with the loan. We review the ratings of our credits on a monthly basis. Ratings are adjusted to reflect the degree of risk and loss that is believed to be inherent in each credit as of each monthly reporting period. Our methodology is structured so that specific reserve allocations are increased in accordance with deterioration in credit quality (and a corresponding increase in risk and loss) or decreased in accordance with improvement in credit quality (and a corresponding decrease in risk and loss).

Pass—Credits in this category are considered “*pass*” which indicates prudent underwriting and a normal amount of risk. The range of risk within these credits can vary from little to no risk with cash securing a credit, to a level of risk that requires a strong secondary source of repayment on the debt. Pass credits with a higher level of risk may be to borrowers that are higher leveraged, less well capitalized or in an industry or economic area that is known to carry a higher level of risk, volatility, or susceptibility to weaknesses in the economy. This higher risk grade may be assigned due to out of date credit information, as well as collateral information, which may need to be updated for current market value in order to allow a credit quality analysis of the credit.

Special Mention—Credits in this category contain more than the normal amount of risk and are referred to as “*special mention*” in accordance with regulatory guidelines. These credits possess clearly identifiable temporary weaknesses or trends that, if not corrected or revised, may result in a condition that exposes the Company to higher level of risk of loss.

Substandard—Credits in this category are “*substandard*” in accordance with regulatory guidelines and of unsatisfactory credit quality with well-defined weaknesses or weaknesses that jeopardize the liquidation of the debt. Credits in this category are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. These credits are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Often, the assets in this category will have a valuation allowance representative of management’s estimated loss that is probable to be incurred. Substandard loans may also be placed on nonaccrual status as deemed appropriate by management. Loans substandard and on nonaccrual status are considered impaired and are evaluated for impairment.

Doubtful—Credits in this category are considered “*doubtful*” in accordance with regulatory guidelines, are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Generally, these credits will have a valuation allowance based upon management’s best estimate of the losses probable to occur in the liquidation of the debt.

Loss— Credits in this category are considered “*loss*” in accordance with regulatory guidelines and are considered uncollectible and of such little value as to question their continued existence as assets on the Company’s financial statements. Such credits are to be charged off or charged down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. This category does not intend to imply that the debt or some portion of it will never be paid, nor does it in any way imply that the debt will be forgiven.

The Company had no loans graded Loss or Doubtful at September 30, 2018 and December 31, 2017.

The internal ratings of our loans as of the dates indicated were as follows:

<u>(Dollars in thousands)</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Total</u>
September 30, 2018				
Commercial and industrial	\$ 553,492	\$ 5,041	\$ 10,801	\$ 569,334
Real estate:				
Commercial real estate	766,348	2,719	7,372	776,439
Construction and development	483,067	4,204	18	487,289
1-4 family residential	281,094	2,186	5,457	288,737
Multi-family residential	229,698	7,209	—	236,907
Consumer	39,539	246	22	39,807
Agricultural	11,580	—	29	11,609
Other	51,074	—	8,410	59,484
Total	\$ 2,415,892	\$ 21,605	\$ 32,109	\$ 2,469,606

<u>(Dollars in thousands)</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Total</u>
December 31, 2017				
Commercial and industrial	\$ 535,589	\$ 8,403	\$ 15,371	\$ 559,363
Real estate:				
Commercial real estate	722,503	2,951	12,839	738,293
Construction and development	448,124	565	522	449,211
1-4 family residential	252,317	—	6,267	258,584
Multi-family residential	212,899	7,406	—	220,305
Consumer	40,144	246	43	40,433
Agricultural	11,223	—	33	11,256
Other	33,109	—	7,235	40,344
Total	\$ 2,255,908	\$ 19,571	\$ 42,310	\$ 2,317,789

Allowance for Loan Losses

We maintain an allowance for loan losses that represents management’s best estimate of the loan losses and risks inherent in our loan portfolio. The amount of the allowance for loan losses should not be interpreted as an indication that charge-offs in future periods will necessarily occur in those amounts. In determining the allowance for loan losses, we estimate losses on specific loans, or groups of loans, where the probable loss can be identified and reasonably determined. The balance of our allowance for loan losses is based on internally assigned risk classifications of loans, historical loan loss rates, changes in our loan portfolio, overall portfolio quality, industry concentrations, delinquency trends, current economic factors and the estimated impact of current economic conditions on certain historical loan loss rates. Please see “—Critical Accounting Policies—Loans and Allowance for Loan Losses.”

In reviewing our loan portfolio, we consider risk elements applicable to particular loan types or categories to assess the quality of individual loans. Some of the risk elements we consider include:

Commercial and industrial loans—the debt service coverage ratio (income from the business in excess of operating expenses compared to loan repayment requirements), the operating results of the commercial, industrial or professional enterprise, the borrower’s business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;

Commercial real estate loans and multi-family residential loans—the debt service coverage ratio, operating results of the owner in the case of owner-occupied properties, the loan-to-value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;

1-4 family residential mortgage loans— the borrower’s ability to repay the loan, including a consideration of the debt-to-income ratio and employment and income stability, the loan-to-value ratio and the age, condition and marketability of the collateral; and

Construction and development loans—the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan-to-value ratio.

As of September 30, 2018, the allowance for loan losses totaled \$24.5 million, or 0.99%, of gross loans and as of December 31, 2017, the allowance for loan losses totaled \$24.8 million, or 1.07%, of gross loans. Our allowance for loan losses as of September 30, 2018, decreased by \$292,000, or 1.2%, compared to December 31, 2017 due to the reversal of allowance for loan losses as a result of strong credit quality, improved national and local economic trends, continuing low nonperforming and impaired loans and minimal charge off history.

Activity in the allowance for loan losses as of the dates indicated was as follows:

(Dollars in thousands)	For the Nine Months Ended September 30, 2018	For the Year Ended December 31, 2017
Allowance for loan losses at beginning of period	\$ 24,778	\$ 25,006
Provision (recapture) for loan losses	413	(338)
Charge-offs:		
Commercial and industrial	1,136	904
Real estate:		
Commercial real estate	9	120
1-4 family residential	3	8
Consumer	1	93
Other	3	—
Total charge-offs	<u>1,152</u>	<u>1,125</u>
Recoveries:		
Commercial and industrial	424	1,110
Real estate:		
Commercial real estate	14	9
1-4 family residential	5	13
Consumer	2	43
Agricultural	—	52
Other	2	8
Total recoveries	<u>447</u>	<u>1,235</u>
Net (charge-offs) recoveries	<u>(705)</u>	<u>110</u>
Allowance for loan losses at end of period	<u>\$ 24,486</u>	<u>\$ 24,778</u>
Allowance for loan losses to end of period loans	0.99 %	1.07 %
Net charge-offs to average loans ⁽¹⁾	0.04 %	— %

(1) The ratio calculations for the nine months ended September 30, 2018 were annualized.

The allowance for loan losses by loan category as of the periods indicated was as follows:

(Dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	Percent	Amount	Percent
Commercial and industrial	\$ 8,763	35.8 %	\$ 7,257	29.3 %
Real estate:				
Commercial real estate	6,913	28.2 %	10,375	41.9 %
Construction and development	3,606	14.7 %	3,482	14.0 %
1-4 family residential	2,454	10.0 %	1,326	5.4 %
Multi-family residential	1,630	6.7 %	1,419	5.7 %
Consumer	394	1.6 %	566	2.3 %
Agricultural	71	0.3 %	68	0.3 %
Other	655	2.7 %	285	1.1 %
Total allowance for loan losses	<u>\$ 24,486</u>	<u>100.0 %</u>	<u>\$ 24,778</u>	<u>100.0 %</u>

Securities

We use our securities portfolio to provide a source of liquidity, provide an appropriate return on funds invested, manage interest rate risk, meet collateral requirements and meet regulatory capital requirements. As of September 30, 2018, the carrying amount of our securities totaled \$222.5 million compared to \$223.2 million as of December 31, 2017, a decrease of \$715,000, or 0.3%. The decrease was the result of maturities, sales, calls and paydowns outpacing purchases. The fair value of our security portfolio also decreased due to changing market interest rates. Securities represented 7.0% and 7.2% of total assets as of September 30, 2018 and December 31, 2017, respectively. Amortized cost and estimated fair value of our investments in debt securities as of the dates shown was as follows.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<i>September 30, 2018</i>				
Debt securities available for sale:				
State and municipal securities	\$ 56,155	\$ 119	\$ (1,150)	\$ 55,124
U.S. agency securities:				
Debt securities	17,315	—	(628)	16,687
Collateralized mortgage obligations	66,737	8	(2,206)	64,539
Mortgage-backed securities	88,185	95	(3,239)	85,041
Other securities	1,123	—	(52)	1,071
Total available for sale securities	<u>\$ 229,515</u>	<u>\$ 222</u>	<u>\$ (7,275)</u>	<u>\$ 222,462</u>
Debt securities held to maturity:				
Mortgage-backed securities	<u>\$ 31</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 33</u>

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<i>December 31, 2017</i>				
Debt securities available for sale:				
State and municipal securities	\$ 60,861	\$ 1,173	\$ (118)	\$ 61,916
U.S. agency securities:				
Debt securities	17,315	—	(370)	16,945
Collateralized mortgage obligations	61,878	50	(675)	61,253
Mortgage-backed securities	82,510	330	(866)	81,974
Other securities	1,104	—	(17)	1,087
Total available for sale securities	<u>\$ 223,668</u>	<u>\$ 1,553</u>	<u>\$ (2,046)</u>	<u>\$ 223,175</u>
Debt securities held to maturity:				
Mortgage-backed securities	<u>\$ 33</u>	<u>\$ 2</u>	<u>\$ —</u>	<u>\$ 35</u>

Our mortgage-backed securities at September 30, 2018 and December 31, 2017, were agency securities. We do not hold any Fannie Mae or Freddie Mac preferred stock, corporate equity, collateralized debt obligations, collateralized loan obligations, structured investment vehicles, private label collateralized mortgage obligations, subprime, Alt-A or second lien elements in our portfolio.

Amortized cost of held to maturity securities and the fair value of available for sale securities, maturities and approximated weighted-average yield based on estimated annual income divided by the average amortized cost of our debt securities portfolio as of the dates indicated was as follows:

(Dollars in thousands)	1 Year or Less		After 1 Year to 5 years		After 5 Years to 10 Years		After 10 Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Total	Yield
September 30, 2018										
State and municipal securities	\$ 2,040	2.3 %	\$ 4,534	2.6 %	\$ 4,322	2.6 %	\$ 44,228	2.9 %	\$ 55,124	2.8 %
U.S. agency securities:										
Debt securities	—	— %	16,687	1.7 %	—	— %	—	— %	16,687	1.7 %
Collateralized mortgage obligations	—	— %	—	— %	—	— %	64,539	2.8 %	64,539	2.8 %
Mortgage-backed securities	75	3.1 %	860	2.9 %	3,963	3.6 %	80,174	2.6 %	85,072	2.7 %
Other securities	1,071	2.2 %	—	— %	—	— %	—	— %	1,071	2.2 %
Total debt securities	\$ 3,186	2.3 %	\$ 22,081	1.9 %	\$ 8,285	3.1 %	\$ 188,941	2.8 %	\$ 222,493	2.7 %

(Dollars in thousands)	1 Year or Less		After 1 Year to 5 years		After 5 Years to 10 Years		After 10 Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Total	Yield
December 31, 2017										
State and municipal securities	\$ 5,107	2.1 %	\$ 9,999	2.5 %	\$ 2,265	2.4 %	\$ 44,545	2.9 %	\$ 61,916	2.7 %
U.S. agency securities:										
Debt securities	—	— %	15,005	1.7 %	1,940	1.9 %	—	— %	16,945	1.7 %
Collateralized mortgage obligations	—	— %	—	— %	—	— %	61,253	2.5 %	61,253	2.5 %
Mortgage-backed securities	—	— %	1,631	2.8 %	5,143	3.6 %	75,233	2.5 %	82,007	2.5 %
Other securities	1,087	2.1 %	—	— %	—	— %	—	— %	1,087	2.1 %
Total debt securities	\$ 6,194	2.1 %	\$ 26,635	2.0 %	\$ 9,348	2.9 %	\$ 181,031	2.6 %	\$ 223,208	2.5 %

The contractual maturity of a collateralized mortgage obligation or mortgage-backed security is the date at which the last underlying mortgage matures and is not a reliable indicator of their expected life because borrowers have the right to prepay their obligations at any time. The weighted-average life of our securities portfolio was 5.8 years with an estimated modified duration of 5.0 years as of September 30, 2018. As of September 30, 2018, we did not own securities of any one issuer, other than the U.S. government and its agencies, for which aggregate adjusted cost exceeded 10.0% of the consolidated shareholders' equity.

Deposits

We offer a variety of deposit products, which have a wide range of interest rates and terms, including demand, savings, money market and time accounts. We rely primarily on competitive pricing policies, convenient locations, electronic delivery channels and personalized service to attract and retain these deposits. Total deposits as of September 30, 2018, were \$2.7 billion, an increase of \$87.1 million, or 3.3%, compared to \$2.6 billion as of December 31, 2017. Noninterest-bearing deposits as of September 30, 2018, were \$1.1 billion, an increase of \$35.2 million, or 3.2%, compared to \$1.1 billion as of December 31, 2017. Total interest-bearing account balances as of September 30, 2018, were \$1.5 billion, an increase of \$51.9 million, or 3.5%, from \$1.5 billion as of December 31, 2017. The changes in deposits from December 31, 2017 to September 30, 2018 are due to normal fluctuations in customer activities.

(Dollars in thousands)	September 30, 2018		December 31, 2017	
	Amount	Percent	Amount	Percent
Interest-bearing demand accounts	\$ 367,120	13.6 %	\$ 363,015	14.0 %
Money market accounts	722,382	26.9 %	702,299	27.0 %
Saving accounts	94,344	3.5 %	95,842	3.7 %
Certificates and other time deposits, \$100,000 or greater	182,552	6.8 %	172,469	6.6 %
Certificates and other time deposits, less than \$100,000	178,697	6.6 %	159,558	6.1 %
Total interest-bearing deposits	1,545,095	57.4 %	1,493,183	57.4 %
Noninterest-bearing deposits	1,144,985	42.6 %	1,109,789	42.6 %
Total deposits	\$ 2,690,080	100.0 %	\$ 2,602,972	100.0 %

Certificates of deposit by time remaining until maturity as of the dates indicated were as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Three months or less	\$ 60,899	\$ 63,482
Over three months through six months	63,611	57,471
Over six months through 12 months	116,811	84,476
Over 12 months through three years	103,477	102,864
Over three years	16,451	23,734
Total	\$ 361,249	\$ 332,027

Average balances and average rates paid on deposits for the periods indicated are shown in the table below. Average rates paid for the nine months ended September 30, 2018 were computed on an annualized basis.

(Dollars in thousands)	For the Nine Months Ended September 30, 2018		For the Year Ended December 31, 2017	
	Average Balance	Average Rate	Average Balance	Average Rate
Interest-bearing demand accounts	\$ 359,416	0.23 %	\$ 349,672	0.22 %
Savings accounts	95,313	0.06 %	88,883	0.06 %
Money market accounts	702,044	0.76 %	721,327	0.58 %
Certificates and other time deposits, \$100,000 or greater	168,489	0.66 %	175,793	0.54 %
Certificates and other time deposits, less than \$100,000	174,663	1.19 %	167,675	1.01 %
Total interest-bearing deposits	1,499,925	0.63 %	1,503,350	0.51 %
Noninterest-bearing deposits	1,118,408	—	1,031,707	—
Total deposits	\$ 2,618,333	0.36 %	\$ 2,535,057	0.30 %

The ratio of average noninterest-bearing deposits to average total deposits was 42.7% for the nine months ended September 30, 2018 and 40.7% for the year ended December 31, 2017.

Borrowings

Frost Line of Credit. On December 13, 2017, the Company entered into a loan agreement, or the Loan Agreement, with Frost Bank, which provides for a \$30.0 million revolving line of credit, or Line of Credit. The Company can make draws on the Line of Credit for a period of 12 months beginning on the date of the Loan Agreement, after which the Company will not be permitted to make further draws and the outstanding balance will amortize over a period of 60 months. Interest accrues on outstanding borrowings at a rate equal to the maximum “Latest” U.S. prime rate of interest per annum and payable quarterly in the first 12 months and thereafter quarterly principal and interest payments are required over a term of 60 months. The entire outstanding balance and unpaid interest is payable in full on December 13, 2023.

The Company may prepay the principal amount of any loan under the Loan Agreement without premium or penalty. The obligations of the Company under the Loan Agreement are secured by a valid and perfected first priority lien on all of the issued and outstanding shares of capital stock of the Bank.

As of September 30, 2018, there were no outstanding borrowings on this line and the Company did not draw on this line during the period from December 13, 2017, when the Company entered the agreement, to September 30, 2018.

Junior Subordinated Debt. In connection with the acquisition of Crosby Bancshares, Inc. during 2008, we assumed \$5.2 million in junior subordinated debentures underlying common securities and trust preferred securities. The subordinated debt securities have a due date of December 15, 2035 and interest is payable quarterly. The interest rate of the debt is equal to the LIBOR, plus 1.44%, reset quarterly, which was 3.77% at September 30, 2018 and 3.03% at December 31, 2017. The Company has the right to redeem these debt securities in whole, or from time to time in part, provided that all accrued and unpaid interest has been paid.

In connection with the acquisition of County Bancshares, Inc. during 2007, we assumed \$5.7 million in junior subordinated debt underlying common securities and trust preferred securities. In 2015, we purchased approximately \$4.1 million of the outstanding preferred securities, reducing the outstanding preferred securities to \$1.6 million. The subordinated debt securities have a due date of April 7, 2035 and interest is payable quarterly. The interest rate of the debt is equal to LIBOR, plus 2% and is reset quarterly. The rate of interest was 4.34% at September 30, 2018 and 3.36% at December 31, 2017. The Company has the right to redeem these debt securities in whole or from time to time in part, provided that all accrued and unpaid interest has been paid.

Liquidity and Capital Resources

Liquidity

Liquidity involves our ability to raise funds to support asset growth and acquisitions or reduce assets to meet deposit withdrawals and other payment obligations, to maintain reserve requirements and otherwise to operate on an ongoing basis and manage unexpected events.

For the nine months ended September 30, 2018 and the year ended December 31, 2017, liquidity needs were primarily met by core deposits, security and loan maturities and amortizing security and loan portfolios. Although access to advances from the FHLB are available as discussed above, we do not generally rely on this external funding source.

The FHLB allows us to borrow on a blanket floating lien status collateralized by certain loans. As of September 30, 2018 and December 31, 2017, total borrowing capacity of \$893.3 million and \$793.3 million, respectively, was available under this arrangement. As of September 30, 2018 and December 31, 2017, there were no outstanding FHLB advances.

As of September 30, 2018 and December 31, 2017, we maintained four federal funds lines of credit with commercial banks that provide for the availability to borrow up to an aggregate of \$75.0 million, in federal funds. There were no funds under these lines of credit outstanding as of September 30, 2018 and December 31, 2017.

The composition of our funding sources and uses as a percentage of average total assets for the periods indicated was as follows:

	For the Nine Months Ended September 30, 2018	For the Year Ended December 31, 2017
Sources of funds:		
Deposits:		
Interest-bearing	48.1 %	50.5 %
Noninterest-bearing	35.9 %	34.7 %
Repurchase agreements	0.1 %	0.1 %
FHLB advances	0.1 %	— %
Note payable	— %	0.7 %
Junior subordinated debt	0.4 %	0.4 %
Other liabilities	0.7 %	0.7 %
Shareholders' equity	14.7 %	12.9 %
Total sources	<u>100.0 %</u>	<u>100.0 %</u>
Uses of funds:		
Loans	76.0 %	74.2 %
Debt securities	7.3 %	7.4 %
Federal funds sold and other interest-earning assets	7.8 %	9.2 %
Nonmarketable equity securities	0.5 %	0.5 %
Other noninterest-earning assets	8.4 %	8.7 %
Total uses	<u>100.0 %</u>	<u>100.0 %</u>
Average loans to average deposits	90.4 %	87.0 %

Our primary source of funds is deposits and our primary use of funds is loans. We do not expect a change in the primary source or use of our funds in the foreseeable future.

As of September 30, 2018, we had \$830.4 million in outstanding commitments to extend credit and \$26.5 million in commitments associated with outstanding standby and commercial letters of credit, compared to \$688.0 million in outstanding commitments to extend credit and \$29.0 million in commitments associated with outstanding standby and commercial letters of credit as of December 31, 2017. Since commitments associated with letters of credit and commitments to extend credit may expire unused, the total outstanding may not necessarily reflect the actual future cash funding requirements.

As of September 30, 2018, we had no exposure to future cash requirements associated with known uncertainties or capital expenditure of a material nature.

As of September 30, 2018, we had cash and cash equivalents of \$281.6 million, compared to \$326.2 million as of December 31, 2017, a decrease of \$44.6 million. The decrease was primarily due to an increase in gross loans of \$151.8 million, which outpaced the \$87.1 million increase in deposits and net income of \$33.2 million. See the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2018 for additional analysis.

Capital Resources

Total shareholders' equity increased to \$471.9 million as of September 30, 2018, compared to \$446.2 million as of December 31, 2017, an increase of \$25.6 million, or 5.7%, after giving effect to \$3.8 million in dividends to common shareholders declared during the nine months ended September 30, 2018.

Capital management consists of providing equity and other instruments that qualify as regulatory capital to support current and future operations. Banking regulators view capital levels as important indicators of an institution's financial soundness. As a general matter, FDIC insured depository institutions and their holding companies are required to maintain minimum capital relative to the amount and types of assets they hold. We are subject to regulatory capital requirements at the bank holding company and bank levels.

At September 30, 2018 and December 31, 2017, the Company and the Bank were in compliance with all applicable regulatory capital requirements, and the Bank was classified as "well capitalized" for purposes of the FDIC's

prompt corrective action regulations. The OCC or the FDIC may require the Bank to maintain capital ratios above the required minimums and the Federal Reserve may require the Company to maintain capital ratios above the required minimums.

As we deploy our capital and continue to grow our operations, our regulatory capital levels may decrease depending on our level of earnings. However, we expect to monitor and control our growth to remain in compliance with all regulatory capital standards applicable to us.

The following table presents the regulatory capital ratios for our Company and the Bank as of the dates indicated.

(Dollars in thousands)	Actual		Minimum Capital Required for Capital Adequacy Purposes		Minimum Capital Required Basel III Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2018								
Common Equity Tier I to Risk-Weighted Assets:								
Consolidated	\$ 391,556	14.3%	\$ 123,271	4.5%	\$ 191,755	7.0%	N/A	N/A
Bank Only	\$ 350,337	12.8%	\$ 123,259	4.5%	\$ 182,549	7.0%	\$ 178,040	6.5%
Tier I Capital to Risk-Weighted Assets:								
Consolidated	\$ 397,956	14.5%	\$ 164,361	6.0%	\$ 232,845	8.5%	N/A	N/A
Bank Only	\$ 350,337	12.8%	\$ 164,345	6.0%	\$ 232,822	8.5%	\$ 219,126	8.0%
Total Capital to Risk-Weighted Assets:								
Consolidated	\$ 422,820	15.4%	\$ 219,148	8.0%	\$ 287,632	10.5%	N/A	N/A
Bank Only	\$ 375,202	13.7%	\$ 219,216	8.0%	\$ 287,604	10.5%	\$ 273,908	10.0%
Tier 1 Leverage Capital to Average Assets:								
Consolidated	\$ 397,956	12.8%	\$ 123,987	4.0%	\$ 123,987	4.0%	N/A	N/A
Bank Only	\$ 350,336	11.3%	\$ 123,987	4.0%	\$ 123,987	4.0%	\$ 154,983	5.0%
December 31, 2017								
Common Equity Tier I to Risk-Weighted Assets:								
Consolidated	\$ 361,322	14.2%	\$ 114,628	4.5%	\$ 178,310	7.0%	N/A	N/A
Bank Only	\$ 322,414	12.7%	\$ 114,252	4.5%	\$ 178,150	7.0%	\$ 165,425	6.5%
Tier I Capital to Risk-Weighted Assets:								
Consolidated	\$ 367,722	14.4%	\$ 152,837	6.0%	\$ 216,519	8.5%	N/A	N/A
Bank Only	\$ 322,414	12.7%	\$ 152,700	6.0%	\$ 216,325	8.5%	\$ 203,600	8.0%
Total Capital to Risk-Weighted Assets:								
Consolidated	\$ 392,878	15.4%	\$ 203,782	8.0%	\$ 267,464	10.5%	N/A	N/A
Bank Only	\$ 347,569	13.7%	\$ 203,600	8.0%	\$ 267,726	10.5%	\$ 254,501	10.0%
Tier 1 Leverage Capital to Average Assets:								
Consolidated	\$ 367,722	12.3%	\$ 119,769	4.0%	\$ 119,769	4.0%	N/A	N/A
Bank Only	\$ 322,414	10.8%	\$ 119,403	4.0%	\$ 119,403	4.0%	\$ 149,253	5.0%

(1) The Federal Reserve may require the Company to maintain capital ratios above the required minimums.

(2) The OCC or the FDIC may require the Bank to maintain capital ratios above the required minimums.

Contractual Obligations

In the normal course of operations, the Company enters into certain contractual obligations, such as obligations for operating leases, certificates of deposits and borrowings. Future cash payments associated with our contractual obligations, as of the dates indicated were as follows:

(Dollars in thousands)	1 year or less	More than 1 year but less than 3 years	3 years or more but less than 5 years	5 years or more	Total
September 30, 2018					
Non-cancelable future operating leases	\$ 2,058	\$ 4,268	\$ 4,491	\$ 10,602	\$ 21,419
Certificates of deposit	241,321	103,477	16,451	—	361,249
Junior subordinated debt	—	—	—	6,726	6,726
Total	<u>\$ 243,379</u>	<u>\$ 107,745</u>	<u>\$ 20,942</u>	<u>\$ 17,328</u>	<u>\$ 389,394</u>
December 31, 2017					
Non-cancelable future operating leases	\$ 1,573	\$ 2,803	\$ 2,975	\$ 10,833	\$ 18,184
Certificates of deposit	205,429	102,864	23,734	—	332,027
Junior subordinated debt	—	—	—	6,726	6,726
Total	<u>\$ 207,002</u>	<u>\$ 105,667</u>	<u>\$ 26,709</u>	<u>\$ 17,559</u>	<u>\$ 356,937</u>

Off-Balance Sheet Items

In the normal course of business, we enter into various transactions, which, in accordance with GAAP, are not included in our consolidated balance sheets. We enter into these transactions to meet the financing needs of our customers. These transactions include commitments to extend credit and standby and commercial letters of credit, which involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amounts recognized in our consolidated balance sheets.

Our commitments associated with outstanding standby and commercial letters of credit and commitments to extend credit expiring by period as of the date indicated are summarized below.

(Dollars in thousands)	1 year or less	More than 1 year but less than 3 years	3 years or more but less than 5 years	5 years or more	Total
September 30, 2018					
Standby and commercial letters of credit	\$ 24,583	\$ 1,902	\$ —	\$ —	\$ 26,485
Commitments to extend credit	507,415	249,235	33,187	40,524	830,361
Total	<u>\$ 531,998</u>	<u>\$ 251,137</u>	<u>\$ 33,187</u>	<u>\$ 40,524</u>	<u>\$ 856,846</u>
December 31, 2017					
Standby and commercial letters of credit	\$ 27,996	\$ 981	\$ —	\$ —	\$ 28,977
Commitments to extend credit	386,505	257,223	25,546	18,775	688,049
Total	<u>\$ 414,501</u>	<u>\$ 258,204</u>	<u>\$ 25,546</u>	<u>\$ 18,775</u>	<u>\$ 717,026</u>

Standby and commercial letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party. In the event of nonperformance by the customer, we have rights to the underlying collateral, which can include commercial real estate, physical plant and property, inventory, receivables, cash and/or marketable securities. Our credit risk associated with issuing letters of credit is essentially the same as the risk involved in extending loan facilities to our customers.

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Interest Rate Sensitivity and Market Risk

As a financial institution, our primary component of market risk is interest rate volatility. Our asset, liability and funds management policy provides management with the guidelines for effective funds management and we have established a measurement system for monitoring our net interest rate sensitivity position. We have historically managed our sensitivity position within our established guidelines.

Fluctuations in interest rates will ultimately impact both the level of income and expense recorded on most of our assets and liabilities and the market value of all interest-earning assets and interest-bearing liabilities, other than those which have a short-term to maturity. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a decrease in current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income.

We manage our exposure to interest rates by structuring our balance sheet in the ordinary course of business. We do not enter into instruments such as leveraged derivatives, financial options, financial future contracts or forward delivery contracts to reduce interest rate risk. Based upon the nature of our operations, we are not subject to foreign exchange or commodity price risk. We do not own any trading assets.

Our exposure to interest rate risk is managed by the Funds Management Committee of the Bank, in accordance with policies approved by the Bank's Board of Directors. The committee formulates strategies based on appropriate levels of interest rate risk. In determining the appropriate level of interest rate risk, the committee considers the impact on earnings and capital of the current outlook on interest rates, potential changes in interest rates, regional economies, liquidity, business strategies and other factors. The committee meets regularly to review, among other things, the sensitivity of assets and liabilities to interest rate changes, the book and market values of assets and liabilities, unrealized gains and losses, purchase and sale activities, commitments to originate loans and the maturities of investments and borrowings. Additionally, the committee reviews liquidity, cash flow flexibility, maturities of deposits and consumer and commercial deposit activity. Management employs methodologies to manage interest rate risk, which include an analysis of relationships between interest-earning assets and interest-bearing liabilities and an interest rate shock simulation model.

We use interest rate risk simulation models and shock analyses to test the interest rate sensitivity of net interest income and fair value of equity and the impact of changes in interest rates on other financial metrics. Contractual maturities and re-pricing opportunities of loans are incorporated in the model, as are prepayment assumptions, maturity data and call options within the investment portfolio. Average life of non-maturity deposit accounts are based on standard regulatory decay assumptions and are incorporated into the model. The assumptions used are inherently uncertain and the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model's simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

On a quarterly basis, we run two simulation models including a static balance sheet and dynamic growth balance sheet. These models test the impact on net interest income and fair value of equity from changes in market interest rates under various scenarios. Under the static and dynamic growth models, rates are shocked instantaneously and ramped rate changes over a 12-month horizon based upon parallel and non-parallel yield curve shifts. Parallel shock scenarios assume instantaneous parallel movements in the yield curve compared to a flat yield curve scenario. Non-parallel simulation involves analysis of interest income and expense under various changes in the shape of the yield curve. Our internal policy regarding internal rate risk simulations currently specifies that for instantaneous parallel shifts of the yield curve, estimated net income at risk for the subsequent one-year period should not decline by more than 10% for a 100 basis-point shift, 20% for a 200-basis point shift and 30% for a 300-basis point shift.

Simulated change in net interest income and fair value of equity over a 12-month horizon as of the dates indicated below were as follows:

Change in Interest Rates (Basis Points)	September 30, 2018		December 31, 2017	
	Percent Change in Net Interest Interest	Percent Change in Fair Value of Equity	Percent Change in Net Interest Interest	Percent Change in Fair Value of Equity
+ 300	16.4 %	(5.6)%	19.6 %	3.9 %
+ 200	11.4 %	(1.9)%	13.5 %	5.5 %
+ 100	6.0 %	(0.3)%	6.9 %	6.4 %
Base	— %	— %	— %	— %
-100	(6.1)%	(6.8)%	(7.2)%	(10.3)%

The results are primarily due to behavior of demand, money market and savings deposits during such rate fluctuations. We have found that, historically, interest rates on these deposits change more slowly than changes in the discount and federal funds rates. This assumption is incorporated into the simulation model and is generally not fully reflected in a gap analysis. The assumptions incorporated into the model are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model's simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various strategies.

Impact of Inflation

Our condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q have been prepared in accordance with GAAP. GAAP requires the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative value of money over time due to inflation or recession.

Unlike many industrial companies, substantially all of our assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Interest rates may not necessarily move in the same direction or in the same magnitude as the prices of goods and services. However, other operating expenses do reflect general levels of inflation.

Non-GAAP Financial Measures

Our accounting and reporting policies conform to GAAP and the prevailing practices in the banking industry. However, we also evaluate our performance based on certain additional non-GAAP financial measures. We classify a financial measure as being a non-GAAP financial measure if that financial measure excludes or includes amounts, or is subject to adjustments that have the effect of excluding or including amounts, that are not included or excluded in the most directly comparable measure calculated and presented in accordance with GAAP as in effect from time to time in the U.S. in our statements of income, balance sheets or statements of cash flows. Non-GAAP financial measures do not include operating and other statistical measures or ratios or statistical measures calculated using exclusively financial measures calculated in accordance with GAAP. Non-GAAP financial measures should not be considered in isolation or as a substitute for the most directly comparable or other financial measures calculated in accordance with GAAP. Moreover, the way we calculate the non-GAAP financial measures may differ from that of other companies reporting measures with similar names.

We calculate tangible equity as total shareholders' equity, less goodwill and other intangible assets, net of accumulated amortization and tangible book value per share as tangible equity divided by shares of common stock outstanding at the end of the relevant period. The most directly comparable GAAP financial measure for tangible book value per share is book value per share. We calculate tangible assets as total assets less goodwill and other intangible assets, net of accumulated amortization. The most directly comparable GAAP financial measure for tangible equity to tangible assets is total shareholders' equity to total assets. We believe that tangible book value per share and tangible equity to tangible assets are measures that are important to many investors in the marketplace who are interested in book value per share and total shareholders' equity to total assets, exclusive of change in intangible assets.

(Dollars in thousands, except per share data)	September 30, 2018	December 31, 2017
Tangible Equity		
Total shareholders' equity	\$ 471,851	\$ 446,214
Adjustments:		
Goodwill	80,950	80,950
Other intangibles	6,038	6,770
Tangible equity	<u>\$ 384,863</u>	<u>\$ 358,494</u>
Tangible Assets		
Total assets	\$ 3,190,453	\$ 3,081,083
Adjustments:		
Goodwill	80,950	80,950
Other intangibles	6,038	6,770
Tangible assets	<u>\$ 3,103,465</u>	<u>\$ 2,993,363</u>
Common shares outstanding ⁽¹⁾⁽²⁾	24,859	24,833
Book value per share	\$ 19.0	\$ 18.0
Tangible book value per share	\$ 15.5	\$ 14.4
Total shareholders' equity to total assets	14.8 %	14.5 %
Tangible equity to tangible assets	12.4 %	12.0 %

(1) Excludes the dilutive effect, if any, of 234,922 and 260,322 shares of common stock issuable upon exercise of outstanding stock options as of September 30, 2018 and December 31, 2017, respectively.

(2) Excludes the dilutive effect, if any, of 231,080 and 212,580 shares of restricted stock issuable upon vesting as of September 30, 2018 and December 31, 2017, respectively.

Critical Accounting Policies

Our accounting policies are described in Note 1 to our consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2017. We believe that of our accounting policies, the following may involve a higher degree of judgment and complexity:

Securities

Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value. Unrealized gains and losses are excluded from earnings and reported, net of tax, as a separate component of shareholders' equity until realized. Securities within the available for sale portfolio may be used as part of our asset/liability strategy and may be sold in response to changes in interest rate risk, prepayment risk or other similar economic factors. Securities held to maturity are carried at cost, adjusted for the amortization of premiums and the accretion of discounts.

Interest earned on these assets is included in interest income. Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates debt securities for other-than-temporary impairment, or OTTI, on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment

is split into two components as follows: (i) OTTI related to credit loss, which must be recognized in the income statement, and (ii) OTTI related to other factors, which is recognized in other comprehensive income, net of applicable taxes. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the security.

Loans Held for Investment

Loans held for investment are those that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs, and an allowance for loan losses. Loans are typically secured by specific items of collateral including business assets, consumer assets and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Interest income is accrued on the unpaid principal balance. Loan origination fees and certain direct origination costs are deferred and recognized as adjustments to interest income using a level yield methodology without anticipating payoffs.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable and reasonably estimable credit losses inherent in the loan portfolio. In determining the allowance, the Company estimates losses on individual impaired loans, or groups of loans which are not impaired, where the probable loss can be identified and reasonably estimated. On a quarterly basis, the Company assesses the risk inherent in the Company's loan portfolio based on qualitative and quantitative trends in the portfolio, including the internal risk classification of loans, historical loss rates, changes in the nature and volume of the loan portfolio, industry or borrower concentrations, delinquency trends, detailed reviews of significant loans with identified weaknesses and the impacts of local, regional and national economic factors on the quality of the loan portfolio. Based on this analysis, the Company records a provision for loan losses to maintain the allowance at appropriate levels.

Determining the amount of the allowance is considered a critical accounting estimate, as it requires significant judgment and the use of subjective measurements, including management's assessment of overall portfolio quality. The Company maintains the allowance at an amount the Company believes is sufficient to provide for estimated losses inherent in the Company's loan portfolio at each balance sheet date, and fluctuations in the provision for loan losses may result from management's assessment of the adequacy of the allowance. Changes in these estimates and assumptions are possible and may have a material impact on the Company's allowance, and therefore the Company's financial position, liquidity or results of operations.

Transfers of Financial Assets

Management accounts for the transfers of financial assets as sales when control over the assets has been surrendered. Control is surrendered when the assets have been isolated, a transferee obtains the right to pledge or exchange the transferred assets and there is no agreement to repurchase the assets before their maturity. The Company's loan participations sold subject to this guidance which met the conditions to be treated as a sale were recorded as such. Any securities sold under agreements to repurchase that did not meet the criteria are included in securities available for sale and repurchase agreements in the consolidated balance sheets.

Goodwill and Other Intangibles

The excess purchase price over the fair value of net assets from acquisitions, or goodwill, is evaluated for impairment at least annually and on an interim basis if an event or circumstance indicates that it is likely an impairment has occurred. The Company first assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, the Company determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing a two-step impairment test is unnecessary. If the Company concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. The fair value of net assets is estimated based on an analysis of the Company's market value.

Determining the fair value of goodwill is considered a critical accounting estimate because the allocation of the fair value of goodwill to assets and liabilities requires significant management judgment and the use of subjective measurements. Variability in the market and changes in assumptions or subjective measurements used to allocate fair value are reasonably possible and may have a material impact on the Company's financial position, liquidity or results of operations.

The Company's other intangible assets include core deposits, loan servicing assets and customer relationship intangibles, which can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. Other intangible assets are tested for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Emerging Growth Company

The Jump Start Our Business Start-ups, or JOBS Act permits an "emerging growth company" to take advantage of an extended transition period to comply with new or revised accounting standards applicable to public companies. However, we have decided not to take advantage of this provision and we will comply with new or revised accounting standards to the same extent that compliance is required for non-emerging growth companies. Our decision to opt out of the extended transition period under the JOBS Act is irrevocable.

Recently Issued Accounting Pronouncements

See "Note 1 – Basis of Presentation, Nature of Operations and Summary of Significant Accounting and Reporting Policies" to the condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company manages market risk, which, as a financial institution is primarily interest rate volatility, through the Asset-Liability Committee of the Bank, in accordance with policies approved by its board of directors. The Company uses an interest rate risk simulation model and shock analysis to test the interest rate sensitivity of net interest income and fair value of equity, and the impact of changes in interest rates on other financial metrics. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Interest Rate Sensitivity and Market Risk" herein for a discussion of how we manage market risk.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures — As of the end of the period covered by this Report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management was required to apply judgment in evaluating its controls and procedures. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act) were effective as of the end of the period covered by this Report.

Changes in internal control over financial reporting — There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently subject to any material legal proceedings. We are from time to time subject to claims and litigation arising in the ordinary course of business. These claims and litigation may include, among other things,

allegations of violation of banking and other applicable regulations, competition law, labor laws and consumer protection laws, as well as claims or litigation relating to intellectual property, securities, breach of contract and tort. We intend to defend ourselves vigorously against any pending or future claims and litigation.

At this time, in the opinion of management, the likelihood is remote that the impact of such proceedings, either individually or in the aggregate, would have a material adverse effect on our consolidated results of operations, financial condition or cash flows. However, one or more unfavorable outcomes in any claim or litigation against us could have a material adverse effect for the period in which they are resolved. In addition, regardless of their merits or their ultimate outcomes, such matters are costly, divert management's attention and may materially and adversely affect our reputation, even if resolved in our favor.

Item 1A. Risk Factors

There have been no material changes in the risk factors as disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

None.

Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
3.1	First Amended and Restated Certificate of Formation of CBTX, Inc. (incorporated by reference to Exhibit 3.1 to the Company's Form S-1 filed with the Commission on October 13, 2017)
3.2	Second Amended and Restated Bylaws of CBTX, Inc. (incorporated by reference to Exhibit 3.2 to the Company's Form S-1 filed with the Commission on October 13, 2017)
4.1	Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company's Form S-1 filed with the Commission on October 13, 2017)
31.1*	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101*	The following materials from CBTX's Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Condensed Consolidated Statements of Comprehensive Income (Loss), (iv) Condensed Consolidated Statements of Changes in Shareholders' Equity, (v) Condensed Consolidated Statements of Cash Flows, and (vi) Notes to Condensed Consolidated Financial Statements.

* Filed with this Quarterly Report on Form 10-Q

** Furnished with this Quarterly Report on Form 10-Q

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CBTX, INC.
(Registrant)

Date: October 31, 2018

/s/ Robert R. Franklin, Jr.
Robert R. Franklin, Jr.
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

Date: October 31, 2018

/s/ Robert T. Pigott, Jr.
Chief Financial Officer
(Principal Financial and Accounting Officer)

CERTIFICATION

I, Robert R. Franklin, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of CBTX, Inc. for the quarter ended September 30, 2018;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2018

/s/ Robert R. Franklin, Jr.

Robert R. Franklin, Jr.

Chairman, President and Chief Executive Officer

CERTIFICATION

I, Robert T. Pigott, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of CBTX, Inc. for the quarter ended September 30, 2018;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2018

/s/ Robert T. Pigott, Jr.
Robert T. Pigott, Jr.
Chief Financial Officer

CERTIFICATION

In connection with the Quarterly Report on Form 10-Q of CBTX, Inc. (the "Company") for the quarter ended September 30, 2018 (the "Report"), as filed with the Securities and Exchange Commission on the date hereof, I, Robert R. Franklin, Jr., Chairman, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert R. Franklin, Jr.

Robert R. Franklin, Jr.
Chairman, President and Chief Executive Officer
Date: October 31, 2018

CERTIFICATION

In connection with the Quarterly Report on Form 10-Q of CBTX, Inc. (the "Company") for the quarter ended September 30, 2018 (the "Report"), as filed with the Securities and Exchange Commission on the date hereof, I, Robert T. Pigott, Jr., Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert T. Pigott, Jr.
Robert T. Pigott, Jr.
Chief Financial Officer
Date: October 31, 2018
